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Article

## Fiscal Rules and Federal Capacity in American Fiscal History: Lessons for Europe?

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### Abstract

Recent comparative fiscal federalism work has noted how the US displays a mix of substantial federal capacity and no federal fiscal rules for sub-federal units as opposed to the EU's mix of regulation and lack of capacity. The difference is explained by the lack of federal capacity in the EU case, which presumably creates a need for regulation. However, these studies are cross-sectional. This carries the obvious drawback of abstracting the actual political and historical processes that have given rise to the respective mixes of regulation and capacity in the two polities. In this article, I trace the historical process by which the specific mix of no rules and capacity became entrenched in the US in the second half of the 20th century and ask whether that political-economic history has any lessons for the EU today.

### Keywords

comparative federalism; fiscal capacity; fiscal federalism; fiscal rules; political development

### Issue

This article is part of the issue “Comparative Fiscal Federalism and the Post-Covid EU: Between Debt Rules and Borrowing Power” edited by Sergio Fabbrini (LUISS University), Tiziano Zgaga (University of Konstanz), and Tomasz P. Woźniakowski (University of Wrocław/ LUISS University).

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### 1. Introduction

Since the outbreak of the eurozone crisis in 2010, comparative federalism scholarship seeking to draw lessons for the EU from the history of fiscal institutions in federal unions has flourished (Bordo et al., 2011; Frieden, 2016; Henning & Kessler, 2012; Kirkegaard & Posen, 2018; Sargent, 2012; Woźniakowski, 2022). Comparisons to the US have had pride of place in this literature. The focus on “lessons” betrays a key fact about this literature, namely that much of it has come at the request of European policymakers grappling with how to develop a more stable set of monetary and fiscal institutions in the EU. One key observation, whose potential implications for the EU have been insufficiently discussed (Georgiou, 2023), is that the US and the EU feature diametrically opposed mixes of federal fiscal rules for the constituent units of the union and federal fiscal capacity (Cottarelli & Guerguil, 2015; Hallerberg, 2014). While the EU has a mix of intrusive (at least on paper) fiscal rules for member states (the Stability and Growth Pact) and almost

non-existent central fiscal capacity, the US has the exact opposite: no federal rules whatsoever on state fiscal behaviour along a large federal budget. This “fiscal policy mix” is one of the key themes of this special issue, as laid out in the introduction (Woźniakowski et al., 2023).

The literature tends to explain the difference by the lack of federal capacity in the EU case, which presumably creates a need for regulation. It should be noted that this was not the explanation put forward by most economists in the 1990s when the Stability and Growth Pact was negotiated. The dominant rationales for the EU rules were the fear of fiscal dominance and the attempt to prevent negative spillovers from member-state fiscal policies. It is only since the eurozone crisis forced onto the policy agenda the issue of a federal EU fiscal capacity that the above explanation has become prominent.

There are two problems with the way the literature arrives at this explanation, however. First, many other federal unions with federal fiscal capacity do have at least some rules constraining sub-federal fiscal behaviour. The relationship between no regulation and

capacity is not a necessary one but a historical and political construction. Second, the comparative studies that note the distinct mixes of regulation and capacity are cross-sectional. They compare the US fiscal system of the early 21st century with the EU's system of public finance. Yet, what has driven most of the comparative federalism literature is the quest for insights into how the EU can *develop* into a more stable monetary and fiscal arrangement. Policymakers are interested in processes of political development leading to stable institutions and the lessons such historical experiences may carry for the policy challenge they need to address today. Static cross-sectional studies are not particularly helpful in that respect because they abstract the actual political and historical processes that shaped the institutional equilibria they describe and compare. In other words, the comparison of the fiscal policy mix in the EU and the US may tell us where the EU should aim to go, but it does not tell us much about how it might get there.

The methodological implication here is that drawing policy lessons for the EU from the US fiscal system requires first and foremost examining how the system was created, not how it functions today. Instead of comparing the US to the EU, one needs to compare American political development to European integration. This article thus offers a historical analysis of the emergence of the US system and then asks whether that history has any lessons for the EU today.

To do this, however, it is necessary to offer a more precise description of the contemporary American fiscal system. As the guest editors observe in the introduction to this thematic issue (Woźniakowski et al., 2023), the distinction between regulation and capacity needs to be refined by differentiating between autonomous and dependent modes of fiscal instruments and between the revenue and spending side of the budget. I would add the balance sheet dimension too—As I will show, the way fiscal liabilities are structured across levels of government is of crucial importance. Indeed, when referring to a “fiscal capacity,” the underlying reality is multifaceted: Such a capacity revolves around a precise mix of fiscal powers at the constitutional level, revenue streams (including borrowing proceeds) and spending commitments at the level of flows and assets and liabilities at the level of stocks. The comparative fiscal federalism literature tends to focus on the size of budgets and thus on just the level of centralised spending; however, that is inadequate to accurately capture the reality and dynamics of fiscal systems, especially in systems of multi-level government.

Section 2 thus offers a succinct description of the American fiscal system. Crucially, the absence of regulation acquires its full meaning when one observes that it is synonymous with a system of market discipline for municipal debt and a substantial degree of vertical fiscal imbalance. In the US, “municipal” debt refers to the debt of any government other than the federal government. State, city, county, and special jurisdiction (school districts for example) governments are included. The US

is thus a rather rare example of a federal union in which “hard budget constraints” constrain sub-federal government fiscal policy.

The historical circumstances in which market discipline was established form the first of the two historical episodes that have shaped the structure of the contemporary American fiscal system. The second is the rise of federal fiscal capacity starting in the 1930s. These are the subject of Section 3. Section 4 looks at the lessons the American experience has for the EU.

A crucial dimension of the historical process that has given shape to the contemporary American fiscal system is the sequencing of these two developments. Another is the historical timing of each episode in relation to the broader processes of the development of government intervention in the modern economy (e.g., North, 1985; Walker & Vatter, 1997) and the rise and growing concentration of bondholder power (Roos, 2019). I suggest that because the EU differs from the US on these two crucial historical dimensions, the path to, and substantive outcome of, a “capacity without regulation” institutional equilibrium in the EU will differ substantially from the US experience.

## 2. The Substance of the American System

The US federal government has no power to directly constrain or steer the conduct of fiscal policy by other levels of government, whether the states or local governments. The states are fiscally sovereign (Rodden, 2012), largely because the 11th Amendment essentially renders them immune from prosecution for defaulting on their obligations (Orth, 1987). However, scholars who study the political economy of fiscal federalism consider the US as a (successful) example of a federal union with “hard budget constraints” on sub-federal governments (Inman, 2003; Rodden, 2012; Rodden et al., 2003; Wibbels, 2003). They identify the established reputation of the federal government of refusing to bail out sub-federal governments that get into fiscal trouble as the source of a system of market discipline that efficiently constrains fiscal behaviour by state and local governments. Rodden (2006, Chapter 4) has shown that credit rating agencies and investors price the default risk of US states as opposed to that of German Länder for example, where the market perception is that the federal government ultimately backstops the Länder. In support of this assessment, scholars cite the rarity of state and local government defaults since the late 19th century (Inman, 2003; Rodden, 2012) as well as the fact that, during the Great Recession, the budget shortfalls in the states were only correlated with the depth of the local recession, suggesting that the institutional framework is not the source of poor fiscal performance (Inman, 2010).

A second, and related, feature of the system is that the states invariably (with the sole exception of Vermont) have a set of more or less stringent rules governing their fiscal behaviour (for the most widely cited state-by-state

stringency evaluation of the rules, see ACIR, 1987). The rules that have received the most attention in the literature are the various balanced budget rules (for a succinct summary of the history of the introduction of the various types of rules, see Rodriguez-Tejedo & Wallis, 2012). The key point in relation to the theme of this article is that these rules have been adopted entirely independently by the states and in response to demand by their own citizenry—in no way do they represent external political constraints. By contrast, in the EU, only Germany had independently adopted national fiscal rules before the Maastricht Treaty was ratified in 1992 and its convergence criteria (the precursor to the Stability and Growth Pact) were introduced by the same token (IMF, 2022). The states adopted rules for the first time after the 1840s defaults, i.e., once the system of market discipline was established. As a result, whether they have an independent impact on fiscal performance or not (a point of dispute in the relevant literature) is less significant than the fact that they are themselves a consequence of the primary feature of the system which is market discipline.

One result of the balanced budget rules is that the states do not have the means to conduct countercyclical deficit-financed stabilisation policy in times of recession. Krugman (2008) famously railed against the “Fifty Herbert Hoovers” during the Great Recession. Such stabilisation is entirely the responsibility of the federal government.

Consequently, the structure of public debt in the US is heavily skewed towards the federal government. In yearend 2022, outstanding federal government debt stood at around 120% of GDP, as opposed to about 14% for municipal debt (Federal Reserve Bank of St. Louis, n.d.). But whereas the federal government debt has a single issuer, municipal debt has around 93,000 potential issuers (that is approximately the number of state and local governments in the 2017 US Census of Governments). As a result, the holders of municipal debt are predominantly retail investors (households and non-profit organisations held 40.4% of that debt in 2022; Municipal Securities Rulemaking Board, 2022, p. 4) as opposed to the federal debt that is held by institutional investors. As Rodden (2012, p. 136) has observed, this means that municipal debt involves no “too-big-to-fail” problem and any cross-state spillovers resulting from potential defaults are limited. Consequently, the political power of the bondholders over the federal government is quite limited, as opposed to state governments where retail investors enjoy concentrated influence as voters (state debt tends to be held by residents).

Of course, a key feature of the system is the substantial fiscal capacity of the federal government. The federal budget hovered between 20% and 25% of GDP in the decade preceding the 2020 crisis and soared to 30% in 2020–2021. During that time, the combined budget of states and local governments hovered between 13% and 15% of GDP, excluding the federal help received

through grants-in-aid. Indeed, what is much less well known outside the US is that the federal budget funds to a large extent a series of transfers (grants-in-aid) to state and local governments, the bulk of which comes in the shape of matching grants. In 2019, the total amounted to about 750 billion US dollars (3.5% of US GDP), accounting for about a third of total state spending. About 85% of these grants-in-aid are for welfare programs as these are for the most part administered by the states (CRS, 2019). In the public finance jargon, this large-scale transfer of revenue from the federal to sub-federal governments is called “vertical fiscal imbalance.” In times of systemic stress like the Great Recession or 2020–2021, Congress channels federal reflationary spending through increased grants-in-aid (Inman, 2010; Rodden, 2012, pp. 134–135). In 2021, these amounted to 1.245 trillion US dollars and 5.6% of GDP (OMB, 2023, p. 205). This is both the result of the procyclical fiscal retrenchment generated by the states’ fiscal rules and of the structure of intergovernmental relations in the US. Because most welfare programs are administered by the states and because the easiest way of reflating the economy is to boost spending on these programs, Congress is forced to act through the states when it wants to pursue a fiscal stimulus. This differs from a bailout because Congress adopts measures applying to all the states instead of targeting transfers to those in fiscal dire straits or assuming their liabilities. However, the increased grants-in-aid do reduce default risks and fiscal pressures on the states. Grants-in-aid thus accounted for 23.9% of state and local spending in 2015, 27% in 2020, and fully 38.5% in 2021 (OMB, 2023, p. 206).

In summary, the two dimensions of the American fiscal system each encompass a more complex reality. “No regulation” refers to a system of market discipline for a small portion of the overall system, whose share of total public borrowing is much smaller than its share of total spending and whose liabilities are held by diffuse and powerless bondholders. “Capacity” refers to a large federal budget tasked with providing macroeconomic stabilisation and welfare spending for the system as a whole, but which largely relies on and funds the states through intergovernmental transfers. Put differently, the system is not structured around two entirely separate spheres of government and fiscal policy, as the American constitutional doctrine of dual sovereignty might imply and as the shorthand of “no regulation and capacity” suggests. That is true of the liabilities of each sphere, but not of revenue, spending, or the distribution of fiscal policy functions.

### 3. The Historical Emergence of the American System

Two crucial historical episodes have given rise to the present American fiscal system. The first was the wave of state defaults in 1841–1843 (English, 1996; Grinath et al., 1997; Rodden, 2006, Chapter 3; Wibbels, 2003). The failure of the federal government to provide a bailout

established the system of market discipline that still prevails today. The second was the emergence of what economic historian John J. Wallis has called the “third system of government finance” (Wallis, 2000) during the New Deal in the 1930s (Wallis, 1984). Its rise has driven the growth of grants-in-aid funding and the federal budget and led to the centralisation of the system.

In 1841–1843, eight states and one territory defaulted on debts accumulated during the two previous decades for infrastructural investment and the chartering of state banks. A legislative effort to provide a federal bailout was led in Congress by representatives of these states. The Johnson Plan essentially proposed a repeat of the Hamiltonian assumption of state debts in 1790 (Edling, 2007; McCraw, 2012, Chapters 8–9). The federal government would provide bailouts to all the states, not just those in distress. This was designed to win over representatives from the fiscally sound states. The proposal failed—it never actually reached the floor for a vote and neither of the two national parties (Whigs and Democrats) endorsed it.

I see three distinct explanations for this in the literature: the Congressional balance of virtuous versus profligate state coalitions, the power(lessness) of bondholders, and the nature of the federal bargain and the associated fiscal policy functions of the overall system.

Wibbels (2003) argues that the bailout proposal failed because the profligate states were in a minority in Congress (eight out of 26, 16 out of 42 senators, and 60 out of 242 representatives). This variable on its own, however, fails to explain the 1790 Hamiltonian assumption. Hamilton did not have a majority in Congress for his debt assumption plan before the famous bargain with James Madison in which he agreed to support the transfer of the federal capital from New York to the banks of the Potomac in exchange for Madison procuring congressional votes for the plan. Two other variables complete the picture and, crucially, provide a link to the New Deal episode.

First, bondholders were rather powerless, for two reasons. First, these were retail investors, not concentrated institutional investors in “too-big-to-fail” institutions. Second, in the majority, they were out-of-state and even extra-US, mostly British, residents. Indeed, the politics of the defaults pitted state citizens as taxpayers against foreigners as bondholders. In his book on the political economy of sovereign debt, Roos (2019) argues that throughout the 20th century debt restructurings and defaults have become ever rarer due to the growing concentration and centralisation of creditors. Bondholders have gone from a multitude of retail investors to a handful of too-big-to-fail international financial institutions, which explains the rise of bondholder power and the decline of losses inflicted on them. This framework neatly explains the failure of British bondholders of US state debts in the 1840s to get their government to exert serious diplomatic pressure on their behalf (Rodden, 2006, p. 60), as well as their failure to

sway the defaulting states to repay by withholding credit for all states and the federal government (English, 1996).

A second reason for this failure provides the link with the third explanation. In his various writings, Edling (2007, 2014) has shown that what he calls the “first American fiscal regime” was essentially driven by the need to provide the federal government with the fiscal means to provide for the common defence. States and local governments were responsible for any infrastructural investment that did take place (Wallis, 2000) during this period. Cross-state spillovers were limited and fiscal policy did not perform any of the modern public finance functions that it would come to perform in the 20th century (Musgrave, 1939)—certainly not macroeconomic stabilisation and income redistribution (the two functions most closely related to the Keynesian revolution in fiscal policy). The Constitution even forbade the federal government from redistributing wealth and income across the union (through the constitutional requirement of apportioning geographically direct taxes). Even whether the federal bargain could be said to include the power for the federal government to raise direct taxes is debatable. Congress only levied an income tax for the first time during the Civil War in 1861, and the Supreme Court struck down the next attempt in the Wilson–Gorman Tariff Act of 1894 in its famous *Pollock v. Farmers’ Loan & Trust Company* ruling the following year. It would take the 16th Amendment in 1913 to clarify that the federal government could freely exercise its taxation powers.

This distribution of fiscal responsibilities corresponds to what scholars of American federalism call the “dual federalism” of the first 140 or so years in American history (Walker, 1999, Chapter 3). Unlike the Hamiltonian assumption, the states’ fiscal troubles in the 1840s were unrelated to the common defence. They derived from the attempt to raise the productive potential of local economies, which under the prevailing understanding of the nature of the constitutional bargain was considered a matter for the “sovereign” states, not the federal government. This understanding was grounded in the material reality of the American economy being a collection of locally organised economies rather than an integrated unit. Infrastructural investment thus generated little spillovers. It was therefore particularly hard for proponents of assumption to convincingly argue that the federal government was, politically if not legally, liable for state debts. And because the states were not dependent on borrowed funds for anything other than capital expenditures, they could overcome the obstacle of temporarily being deprived of funding by foreign creditors.

The second historical episode is the rise of the third system of government finance during the 1930s. That episode involved three distinct but related developments: a steep rise in the fiscal size of government, a centralisation of fiscal activity in the federal government, and the rise of “intergovernmental relations” and grants-in-aid. Total government spending approximately

doubled from slightly below 10% in 1929 to slightly below 20% in the second half of the 1930s, and after the Second World War, the steady upward trend continued. But whereas in 1929 the federal government accounted for about a third of total spending, by the middle of the 1930s its share overtook that of state and local governments. In the post-war period, that share fluctuated around two-thirds (U.S. Bureau of Economic Analysis, n.d.). However, at the same time as the growing fiscal weight of the federal government, grants-in-aid became a permanent feature of the system, and have trended upwards ever since. Scholars of American federalism see these grants-in-aid as the hallmark of the new era of “cooperative federalism” (Walker, 1999, Chapters 4–6) introduced by the New Deal.

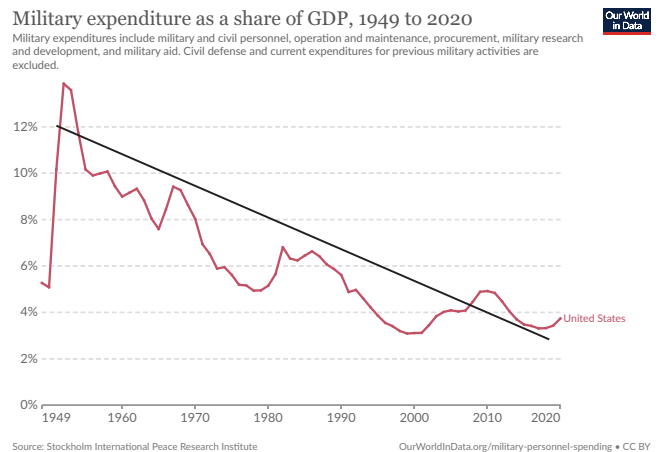
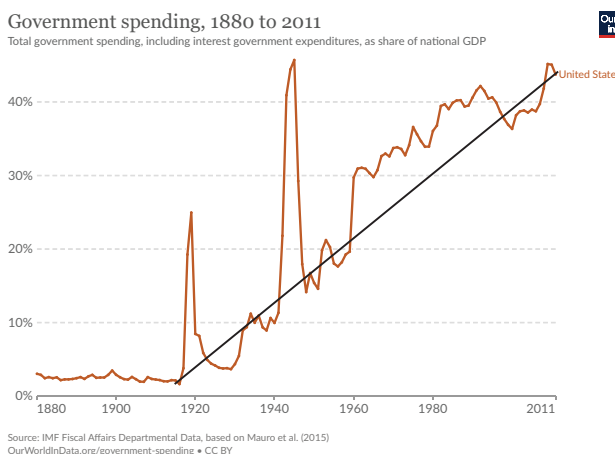
The growth in the overall size of government is easily explained by the rise of the modern welfare state and Keynesian macroeconomic management in the US—the “fiscal revolution in America” (Stein, 1969). Modern public finance policy functions came into their own. In Musgrave’s classic typology, these functions are macroeconomic stabilisation, capital allocation, and income redistribution. Admittedly, capital allocation has a longer history than the other two, in particular through public spending for infrastructural investment, which modern territorial states performed very early on and much before the steep rise in the fiscal size of government that occurred in the 20th century. With the advent of the modern public economy, however, that function was also stepped up, largely due to the vast expansion in education and health outlays.

A key characteristic of modern public finance, and one which marks a sharp break in the fiscal history of advanced capitalist countries including the US, is that the growth in the fiscal size of government it entails is driven by civilian, not military, spending. Piketty (2022, p. 126) has recently referred to this as the “fiscal state’s second leap forward.” It is worth dwelling on this in relation to American fiscal history and in particular to the advent and maturation of the “third system of govern-

ment finance” (Wallis, 2000) from the 1930s onwards because, in this case, this development coincides with the rise of the American imperial and national security state. The US emerged as the global hegemon from the Second World War and the National Security Act of 1947 created the apparatus of the contemporary American national security state. This might lead one to think that both the growth in the overall size of government and the fiscal centralisation that came with it were due to the crucial role played by the federal government in projecting American military power abroad. If such were the case, the fiscal transformation of the 1930s and 1940s would stand in continuity with the central role the federal government has always played in providing for the common defence of the union, which drove American political development and fiscal history in the first century of the American Republic as forcefully argued by Edling (2007, 2014). That is not the case, however. Figure 1 clarifies this very neatly. The trends in total government and military spending as a share of GDP have moved in opposite directions from the end of the Second World War onwards. If military spending had been the driver of fiscal development in the post-1930s era, then at least since the late 1940s the fiscal size of government in the US should have declined in line with the decline in the relative size of military spending.

Given that the rise in total government spending was not driven by the growth in the fiscal function that was already the prerogative of the federal government, two key questions arise. Why did fiscal activity and modern public finance policy functions become concentrated at the federal level of government? And why did the growth in the fiscal size of government and fiscal centralisation occur nearly simultaneously?

The obvious functionalist argument in this connection is that, in the 20th century, the US became a mature modern economy integrated at a national scale, in which cross-state spillovers became a major feature as did the need to pursue macroeconomic stabilisation. Indeed, this is the core of Beer’s (1973) classic account



**Figure 1.** Trends in total government and military spending as a share of GDP, in the US. Source: Ortiz-Ospina and Roser (2016) and Herre et al. (2013).

of the “modernisation of American federalism” and the rise of federal power. That both of these challenges (managing spillovers and stabilising the macroeconomy) are best pursued by the federal level of government is the core prescription of the theory of fiscal federalism (Oates, 1972).

The functionalist argument, however, does not explain the politics surrounding the fiscal transformation of the American government. In fact, the progressive impulse to institute welfare state policies (including income taxes, social insurance schemes, and increased public spending on health and education) originated in the states at the turn of the 20th century (Robertson, 2017, Chapter 6). Until 1932, the growth of state and local fiscal activity far outpaced that of federal activity (Robertson, 2017, p. 123). But for two distinct reasons, the modern public economy did not flourish there.

First, as one of the key texts of the American Political Development school argues, the states were administratively very weak (Skowronek, 1982). They were organisations dominated by their respective legislatures (giving party machines extensive political influence) and judiciaries—a “state of courts and parties” as Skowronek (1982) summed it up. In the fiscal realm, their weakness, coupled with the balanced budget rules that many states had already adopted, meant that when the Great Depression hit, most of them were unable to maintain revenue levels (Robertson, 2017, pp. 143–144). This meant that there was no institutional inertia favouring the states over the federal government when functional pressures in favour of expanded administrative capacity and fiscal activity started arising. The institutional obstacles on the way to federal empowerment were weak.

There was a second positive political reason for carrying out the fiscal revolution directly at the federal level. States in the more industrialised North-East and the Mid-West did initiate progressive reforms. But very quickly, the limits of state-by-state reform made themselves felt, as interstate competition limited the extent to which such reforms could be implemented (Robertson, 2017, Chapter 6). The first reaction to this obstacle was the movement for uniform state legislation (Graebner, 1977). But just as, say, direct tax harmonisation in the EU has been impossible to achieve under conditions of unanimity, so did uniform state legislation prove a failure. As Robertson (2017, p. 133) explains: “Very few uniform laws, even for commercial transactions, were ever adopted by all the states. It was federal spending power that provided an alternative way to motivate states across the nation to take action.” Indeed, grants-in-aid, in the form of matching grants, first arose during the first three decades of the 20th century as a way of overcoming the obstacle of interstate competition. They were the carrot by which the federal government wished to get the states to adopt its policies—but they mostly provided funds for infrastructural investment and manpower policies. The novelty of the New Deal was to

generalise and hugely expand this model (Wallis, 1984), extend it to social insurance and, after 1937, task it with stabilisation functions:

The growth of national grants-in-aid during the New Deal [w]as “astounding.” Federal grant spending exploded from \$250 million in 1932 to \$2.9 billion in 1934. Grants constituted thirty percent of all federal spending in 1935. Federal grants amounted to \$4 billion in 1940, sixteen times higher than spending in 1932. (Robertson, 2017, p. 149)

The spike in federal fiscal activity was probably greater than it would otherwise have been for a third reason related to constitutional politics. The 10th Amendment and the doctrine of enumerated powers place limits on federal regulatory powers. The Supreme Court relied on these to invalidate several federal laws regulating economic activity in the early decades of the 20th century and then struck down the flagship legislation of the early New Deal, the National Industrial Recovery Act, in 1935. Implementing federal policy thus came to depend even more on using the fiscal carrot to prod the states in the desired direction because the regulatory stick was constitutionally unavailable.

Finally, the grants-in-aid solution involved a crucial political advantage that explains its success. In the New Deal party system, the pivotal role was held by the Southern Democrats (Katznelson et al., 1993). The representatives of the segregated South opposed any notion of New Deal liberalism transforming their local labour markets structured around white supremacy and low-wage black labour. They opposed liberal labour legislation and would only accept federal welfare spending if the states maintained the power to administer the programs. Roosevelt for example insisted that the draft Social Security Act should rely on the states “as much as possible”:

New Deal policy designers favored substantial state authority over welfare programs...because [it] was politically expedient. State control could allow conservative Southern Democrats to support such a bill, because it would allow Southern states to maintain white supremacy in their region. (Robertson, 2017, p. 153)

#### 4. Lessons for the European Union Today?

The historical timing of the two episodes is crucial in explaining the overall shape of the system. The occurrence of the 1840s fiscal crisis at a time when the modern public economy was not yet in place was key to its outcome. It made it much easier for the federal government to refuse to step in because its fiscal role was limited to military affairs, because the consequences of allowing the troubled states to default were limited and because concentrated bondholder power did not yet exist.

In response, the states adopted rules constraining their fiscal behaviour. This, in turn, contributed to their being unable to become the conduits of the fiscal revolution in the 20th century once the modern public economy came into its own. This, together with interstate competition, cleared the way for the federal government. But the constitutional structure inherited from the time of “dual federalism,” and the fact that Southern segregationists exploited that structure to preserve the institutions of the local labour market, shaped the fiscal revolution into the peculiar structure of “cooperative federalism” that relies on a substantial volume of intergovernmental transfers while allowing the states to administer the welfare programs they receive the grants for.

Are there any lessons for the EU from this history? The US experience displays a fundamental difference from the EU’s: historical timing. The attempt to fashion an EU fiscal system since Maastricht comes long after modern public finance policy functions became entrenched in the fiscal systems of the member states themselves and at a time of highly concentrated bondholder power. In the US, the two historical episodes described in the previous section took place either before or simultaneously with the rise of the modern public economy and bondholder power. This has important consequences.

Compare, first, the 1840s fiscal crisis in the US with the eurozone crisis of 2010–2012. As I have argued elsewhere (Georgiou, 2022a), the eurozone crisis was at its core a conflict pitting institutional investors against the German government and its Northern allies over whether a system of market discipline would be institutionalised for the governance of the sovereign debt market in the EU. The German government had insisted on the no-bailout clause in the Maastricht Treaty. It waived the no-bailout commitment aside in Spring 2010, out of a fear that a disorderly Greek default would amount to another “Lehman” moment. But very quickly, it came back to the negotiating table with the proposal of inserting orderly restructuring procedures in member state bonds, which was agreed upon in October–November 2010. The bondholders pushed back, went on a credit strike and forced the Berlin government to backtrack and tacitly agree to the backstopping of member state bonds by the European Central Bank from 2012 onwards. Not only is market discipline dead as an organising principle, but the backstopping of sovereign bonds by the European Central Bank has become increasingly open-ended and unconditional, exceptionally so since 2020 and in particular since the introduction of the Transmission Protection Instrument.

In other words, all of the ingredients that forced the most fiscally powerful EU member states to discard market discipline were absent in the 1840s US: concentrated bondholder power, spillovers, and government dependence on a steady flow of bond finance for the funding of fundamental policy functions. This was despite the fact that the EU’s decision-making system afforded

those member states the final say over bailouts due to the unanimity requirement that governs such decisions in the European Council—just as the system of congressional representation did in the 1840s and which Wibbels (2003) picked up as the explanation for the defaults.

There is one other reason for the failure of Germany and its allies to impose a system of market discipline for public debt in the EU, which provides the link to the comparison of the transformation of the American fiscal system from the 1930s onwards with the EU’s attempt since 2010 to create a federal fiscal capacity. Contrary to what obtains in the US since the 1930s, the vast majority of public debt in the EU is the liability of member states, not the federal centre. This may now slowly and gradually change, but throughout the 2010s allowing a member state to default would have signalled that a huge proportion of what were hitherto the key safe assets of the system were no longer risk-free. This would have profoundly destabilising financial and macroeconomic effects—Safe assets are, as per the International Monetary Fund (2012, pp. 81–122) itself, the “financial system’s cornerstone” and advanced capitalist states’ public debt is the safe asset par excellence. In other words, the extreme decentralisation of fiscal liabilities in the EU makes the introduction of hard-budget constraints in the shape of market discipline illusory—quite unlike the situation in the US.

The current distribution of fiscal liabilities in the EU points to a key contrast between its experience since 2010 and the transformation of the American fiscal system in the 1930s. In the US, the constituent states of the union were administratively and fiscally weak and were already part of an integrated single market in which interstate competition placed limits on what they could do fiscally. Their weakness cleared the way for the federal government. As put by Young (2018, p. 176):

Movements towards centralization in America occurred at roughly the same time as (and partly as a result of) pressures to expand the role of government generally...the arcs of centralization and of the growth of government largely coincided. In Europe, the movement towards unification began well after much of the expansion of government generally had already taken place.

Consequently:

Institutional inertia thus plays a profoundly different role in Europe and the United States. Efforts to decentralize American government...confront an entrenched federal regulatory and welfare bureaucracy....In Europe, by contrast, the entrenched bureaucracies exist at the member state level.

The entrenched bureaucracies are not the only obstacle deriving from the historical timing of the “movement towards centralisation” in relation to the “fiscal state’s second leap forward” in the EU. Another is the



difficulty in terms of financial and market dynamics of transitioning from the extreme decentralisation of fiscal liabilities to a more centralised structure akin to that of the American system. One crucial difficulty is what happens to member state public debt during the transition period—the period during which the EU steps up its emission of bonds before it has reached a plateau in terms of the stock of outstanding bonds at levels that would ensure an adequate supply of supranational safe assets for investors to hold. Clearly, during this period market discipline cannot be applied to member state bond markets. Member state treasuries are thus under little pressure to relinquish their hold on public bond issuance since they enjoy the benefits of the European Central Bank’s backstopping of their bonds. Second, the transition raises issues of market liquidity for investors. As I was told in an interview and subsequent email exchange by Alessandro Tentori (chief investment officer for Southern Europe for Axa-Investment Managers), investors want to see the EU move closer to the American structure of public debt with a European equivalent of the US Treasury bond market. However, they are weary of “another EU-backed bond which might compete for liquidity with issuers such as France and Germany” and instead favour “a broader euro-version” (A. Tentori, personal communication, April 12, 2023). That “broader euro-version” has echoes of the “eurobonds” that Germany and its allies rejected in 2010–2015 (Matthijs & McNamara, 2015), namely the introduction of joint and several liability for member state debt. The political difficulty of joint and several liability is precisely that it pools liability for “legacy” debt, namely bonds issued independently by member states prior to the establishment of institutions governing the system of joint and several liability. Indeed, fiscal centralisation in the US is not based on joint and several liability: Each level of government is liable for its own emissions.

It thus appears quite unlikely that the EU will be able to quickly, if ever, transfer a substantial amount of fiscal activity to the federal level—such as to replicate the structure of the distribution of fiscal liabilities that obtains in the US, and which allows market discipline to operate on municipal debt. In fact, the strength and established fiscal size and policy functions of the member states suggest that a viable future for an EU fiscal capacity could be an extreme version of the US grants-in-aid system: The bulk of borrowing could be carried out at the federal level while the bulk of spending would remain at the member state level. However weak they may have been, the US states were still sufficiently strong to force the federal government to opt for “cooperative federalism” instead of outright federal responsibility. EU member states are even stronger than US states were in the 1930s but would still benefit from a federal fiscal capacity.

Next Generation EU (NGEU) is indeed a first step in that direction. The EU only spends an infinitesimal fraction of the proceeds raised through borrowing backed by the EU budget. The rest is channelled to the mem-

ber states in a system of grants-in-aid and “intergovernmental relations” that strongly resembles the American case. The loans component of NGEU still places ultimate liability for paying back investors in EU debt with the Commission. If a member state defaults, the Commission will be left to pick up the tab. The EU member states are less dependent overall on these transfers than the American states are on federal transfers, but the American federal government directly spends a much greater proportion of its revenues than the Commission does. NGEU has raised the question of whether it is the precursor to a permanent fiscal capacity. Its advantages are very clear: It provides safe assets that investors crave, has macroeconomically and macrofinancially stabilising effects, and is politically very popular in a majority of member states. It is also worth remembering that the politician who first dubbed NGEU “Europe’s Hamiltonian moment” is currently the German chancellor (Georgiou, 2022b), i.e., the leader of the key member state whose reluctance on the matter had until 2020 postponed the introduction of such a fiscal capacity. If NGEU is successfully implemented, it will provide both additional momentum in favour of a permanent EU fiscal capacity and a blueprint for such a capacity that would rely on grants-in-aid much more heavily than the US federal budget has ever done.

The prospect of a permanent European version of the grants-in-aid system also suggests that the EU could finally solve the enforcement problem that it faces with the European Semester—or indeed issues of the rule of law. Despite the fact that the EU is not constrained by any equivalent of the American “anti-commandeering” constitutional doctrine (Young, 2018, p. 163), its capacity to actually enforce its economic policy recommendations (including the excessive deficit rules) and even rule of law treaty obligations and Court of Justice of the EU rulings is admittedly negligible. In the US, by contrast, where the notion that the federal government can constrain the policy choices of the states is unthinkable, the federal government has succeeded in exercising substantial influence thanks to the fiscal carrot of grants-in-aid, by designing those grants as matching grants. Indeed, the lure of NGEU funds has led the Hungarian government to backtrack on its ongoing rule of law disputes with the European Parliament and Commission. Similarly, the new, far-right, Meloni government in Italy has also been surprisingly compliant and has shunned any confrontations with the Commission on its economic policy commitments since entering office in 2022 (“Italy’s Meloni needs the cash,” 2023).

The prospect of an EU version of the grants-in-aid system raises another crucial issue, however, namely that of the power to raise revenue autonomously. The US could only carry out the fiscal transformation of the 1930s because the federal government enjoyed an unrestrained power to tax following the adoption of the 16th Amendment in 1913. It could therefore embark upon large-scale borrowing on the basis that the full

productive potential of its vast economy was available to it for raising revenue. That is a constitutional amendment the EU will have to adopt too if it is to permanently scale up its own fiscal activity. As argued by García Antón (2023) elsewhere in this issue, this would imply revising Article 311 TFEU governing the revenue side of the EU budget to subject it to the ordinary legislative procedure while also developing a new normative justification for EU taxes as policy tools invested with democratic and redistributive functions. As Woźniakowski et al. (2023) point out, such a process of “fiscalisation” would introduce an unmistakable political dimension to Europe’s economic and monetary union. That would potentially have similar profoundly transformational consequences as the introduction of the third American fiscal regime.

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### Conflict of Interests

The author declares no conflict of interests.

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