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Beware Of Greeks Seeking Gifts

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In the early days of the American republic there was a tremendous debate among the founding fathers about federalism. Alexander Hamilton, the first secretary of the Treasury, and Thomas Jefferson, the secretary of State, were at odds over the question of the power of the central government and its fiscal responsibilities. Hamilton favored strong federal and fiscal policies, Jefferson did not. Hamilton won the day.

Fiscal federalism not only gives the federal government the power to tax, but also allows a central government to allocate shares of its revenues to lower levels of government. Federal governments can use this power to achieve certain goals and enforce standards among their constituent states. The ability to make unconditional transfers to lower levels of government enables the federal government to offset shocks to specific regions. The ability to make conditional transfers allows the federal government to influence the fiscal behavior of lower levels of government.

Over the decades there have been many battles about the rights of states and the ability of the federal government to interfere with local prerogatives, but Hamilton understood that the strong federal structure provides a framework within which these issues can be resolved. What does this have to do with Greece? It points out one of the basic flaws in the European experiment that is the eurozone: There is no strong federal structure that can come to the aid of individual members of the currency union. Indeed the rules of the union specifically forbid bailing out any member states.

Many observers recognized this design flaw when the eurozone was created, and reinforced the idea when weaker economies like Greece were allowed to enter. The initial premise was that fiscal standards for membership, combined with the benefits of staying in the eurozone, would create the discipline necessary to restrain fiscal intemperance. Dream on!

It was clear to anyone willing to look that the standards for membership were being fudged for Greece and others. But the benefits of joining were viewed as significant. Member countries have (generally) reduced their borrowing costs by eliminating currency risk. If investors see membership as reversible, that could change quickly. There was always the hope that the monetary discipline of the common euro currency would induce fiscal discipline as well. That was wishful thinking, given the undisciplined history of weaker members of the union.

There is also a case to be made (as Vincenzo Quadrini and I have shown theoretically) that the optimal position is to be a country that trades extensively with a currency union but does not belong to it. In other words, it is better to be Sweden than Greece. I always thought it was clear that the main argument for the eurozone (not a strong argument) was that it would reinforce the case for a federal structure for Europe.

Now the E.U. faces the problem that a member is on an unsustainable budget path and may not be able to refinance its sovereign debt. What should the E.U. do? If it lets Greece fail, and/or boots the nation out of the eurozone, very serious consequences could ensue. Although Greece is small relative to the major E.U. countries, its failure would undermine confidence in the euro.

More importantly, a Greek failure could set off speculative attacks on the other weak European economies, the so-called PIIGS, for Portugal, Italy, Ireland, Greece and Spain (which a colleague insists we should call the GIPSIs rather than the PIIGS.) Spain and Italy are respectively four times and six times the size of Greece. Their fiscal situations are precarious as well, and Spain in particular has been severely affected by the downturn.

If the E.U. does do something to help Greece, the policy challenge is to prevent it from creating moral hazard. Help for Greece might make the other GIPSIs think they can be less disciplined in dealing with their own budget problems. The latest news from Brussels suggests the E.U. is willing to help if Greece adheres to a very strict revenue-raising and budget-cutting regime that would put it on a sustainable fiscal path. It may be that the new (old) socialist government in Athens can get away with some serious reforms--think Nixon in China. If it imposes enough austerity it may address the moral hazard issue.

Unfortunately, there is another issue--time consistency. A time-consistent policy is one that can be sustained over a long period of time even as circumstances change. Adhering to such a policy may require actions that are not optimal in every period. In contrast, time-inconsistent policies are those that change when circumstances change. If I am on a diet, then the time-consistent policy is to stay away from beer and pizza. But if I am really hungry (especially since I'm dieting) and pass by the pizza parlor, then the optimal policy in that moment is to stop in and have bite, wash it down with a beer, and then resume the diet.

The Greek goddess Circe understood this. She instructed Ulysses to tie himself to the mast and stuff his sailors' ears with wax so as not to be lured by the sirens' call. But does the European Union have the means to enforce Greece's diet over the long run? I think not. Every member of the eurozone is free to make its own choices about the size of the public sector, labor market rules and retirement rules.

In Greece the average retirement age is 61 and legally can be as low as 58. The pension benefits are quite generous and the government is loath to change them. The public sector is huge and public-sector wages have increased dramatically in recent years. In Spain complicated labor laws distort its labor market and hamper its ability to adjust in the recession. There is little the E.U. can do to help fix problems that stem from the choices of national governments.

Many observers have likened the E.U.'s problems with Greece to U.S. problems with California and New York. Both states have large structural deficits and dysfunctional legislatures that cannot or will not deal with the issues. The two problems are not dissimilar, but there is a fundamental difference. The federal structure for which Alexander Hamilton fought gives us a framework for dealing with these issues--for discussing which problems require federal solutions and which don't.

It also provides us with some built-in stabilizers. The $787 billion stimulus package includes the biggest transfers of federal funds to states in our nation's history. Nearly $280 billion is expected to flow to or through the states. Much of that funding has conditions attached. Whether or not you are a fan of the stimulus, it is clear that our federal structure gives us a mechanism to dampen shocks to the member states. The Europeans are a long way from having this kind of commitment to their union.

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