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SUBSIDIES, MARKETS, DEBT AND FISCAL FEDERALISM:
WHAT THE EUROPEAN NORTH OWES TO THE EUROPEAN SOUTH

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SUBSIDIES, MARKETS, DEBT AND FISCAL FEDERALISM: WHAT THE EUROPEAN NORTH OWES TO THE EUROPEAN SOUTH

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Subsidies, Markets, Debt and Fiscal Federalism: What the European North owes to the European South

Almost twenty years ago, I defended a doctoral thesis on fiscal federalism (Ashta, 1998 [1996]). It was a descriptive thesis within public law, on the borders between constitutional law, public finance, international economics and taxation. Certainly, since it was in French, it was little read. To understand a take-away from that thesis in one line: fiscal federalism is the glue which keeps federalism from breaking apart. What is true of federations is also true of confederations and economic unions. It is also true of any society where people want to live together, right to the micro-level. Little did I realize that one day we would need to give simple lessons to rich nations: if you want to create a society, you need to create a win-win situation. Everyone must gain! And gain in their way!

The gains from uniting are common knowledge. This knowledge was first put together in the Federalist Papers (Hamilton et al., 1787-88 [1982]). These advantages are not only military (less fighting between member States; smaller army since common borders don't need to be patrolled), but also economic (public expenses shared, economies of scale in public expenses, getting the best people from a bigger population). Add to this the great cultural benefit of sharing knowledge, customs, religions, music, poetry and adventure. Thus, federalism allows diversity and autonomy while allowing control and participation in a greater society. Keeping it together requires everybody to gain from all these advantages.

The most visible advantage which motivates countries to get together are the gains from trade. Ever since Adam Smith (Smith, 1776), we have known that two countries can gain from trade if there are absolute advantages. These gains from trade were further expanded by Ricardo (1817) to comparative advantage situations. Thus, it was established that all countries can gain from trade if barriers are reduced.

History, of course, has shown that the gains from trade lead to dynamic changes in advantages. Evidently, if a country has an initial comparative advantage in an industry with potential, it will position itself in that industry and its advantages will multiply. And of course, countries which are further up in the stage of development will always position themselves in sectors which would allow them to maintain their lead. And if this country has a larger population, or even access to a larger market, it will have economies of scale which smaller less developed States cannot possibly have.

Just as a big strong man will always win against a small frail person, the big strong nation will always win against the small frail nation. In other words, industrial goods produced by more developed nations with large populations would always have an absolute and comparative advantage against any industrial goods produced by a small lesser develop nations. Thus, in a market competition situation, the small less developed nation will always lose. Understanding this, small people should reject the big and form a society of their own where their union gives them strength. If the big giants want to keep the small and frail with them, they have not only to stop bashing them up, they also need to provide them some advantages. Similarly, if the big developed nations keeps getting all the gains from trade, they must share these gains (the incremental profits from the markets of the smaller nations) with the smaller nations.

And this is where fiscal federalism comes in. Fiscal federalism, as defined in my 1996 thesis, includes the sharing of tax powers as well as the sharing of tax funds. This sharing of tax funds, called equalization (péréquation by the French), is a way by which the richer stronger States share the advantages of federalism by providing money to the poor states (who cannot compete and keep losing) through a federal sharing mechanism. Different federal countries share in different degrees. In a Union where there is no federal taxation, there need to be transfers from rich States to poor States.

Within the European Union, indeed such subsidies were primarily given to the poorer countries when they were included in the Union, although some may have got aid even earlier to enable them to have the institutions which would allow the richer nations to exploit their markets. Thus, the European Union proceeded on a healthy basis. The North gained markets and provided subsidies to the South which was to compensate the opening of the markets and the loss of their industries. In return, the South continued their business as usual: fishing, agriculture, lazing or whatever they wanted to do, but sacrificed their little industrial employment since the subsidies were sufficient to pay the people who were laid off. To provide some identity to the laid off people, some of these unemployed were perhaps disguised as public workers. This would be an experiment in sharing work and happiness. The Greeks, perhaps more than any of the States, are exemplary in keeping their traditions and ways and using the "subsidies" appropriately. They clearly understood that these were equalization payments and not really subsidies.

Industrious people have a major character defect: they are inherently jealous of people who are capable of such happiness with less work and less money. Evidently, the spoil from larger markets is not sufficient for them. They also want the people from poorer countries to behave like them and compete with them in industries, where it is evident even to morons, that there is no chance for them to win. Moreover, if they can keep the gains from larger markets without making equalization payments, what could be a better world?

This is what the European North proceeded to do. When new members States from East Europe came in, they should have provided new equalization subsidies in return for new gains from trade. However, they decided to be smart and turned the argument: the existing poorer states of the European South had benefitted long enough from subsidies to catch up. Therefore, these were to be stopped and given to the newer members from the East who were even poorer. In short, subsidies to Greece, Portugal, Spain were to be stopped or at least reduced!

Did this actually happen? The figures below tell interesting stories. The first shows the net payments to Greece, in Euros per capita. We can see a clear rise, year after year, as Greece opened its economy till 1993, the year that the single market started functioning. Thereafter, payments reached a plateau rarely topping the 1993 benchmark, at around 4 billion Euros,

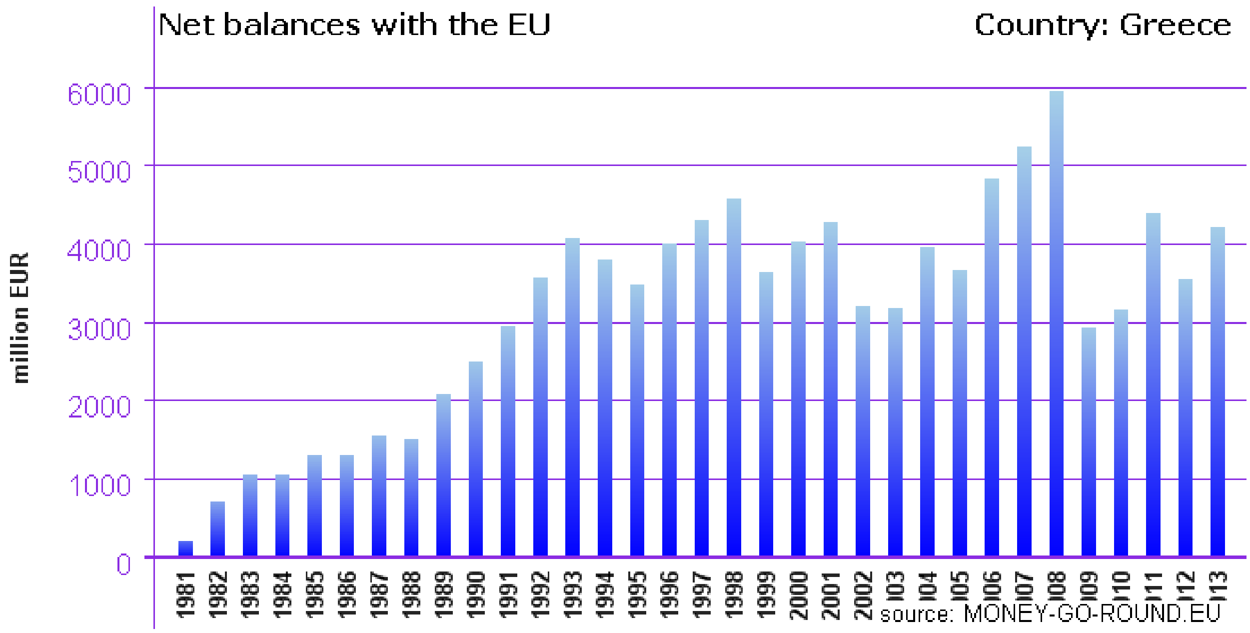
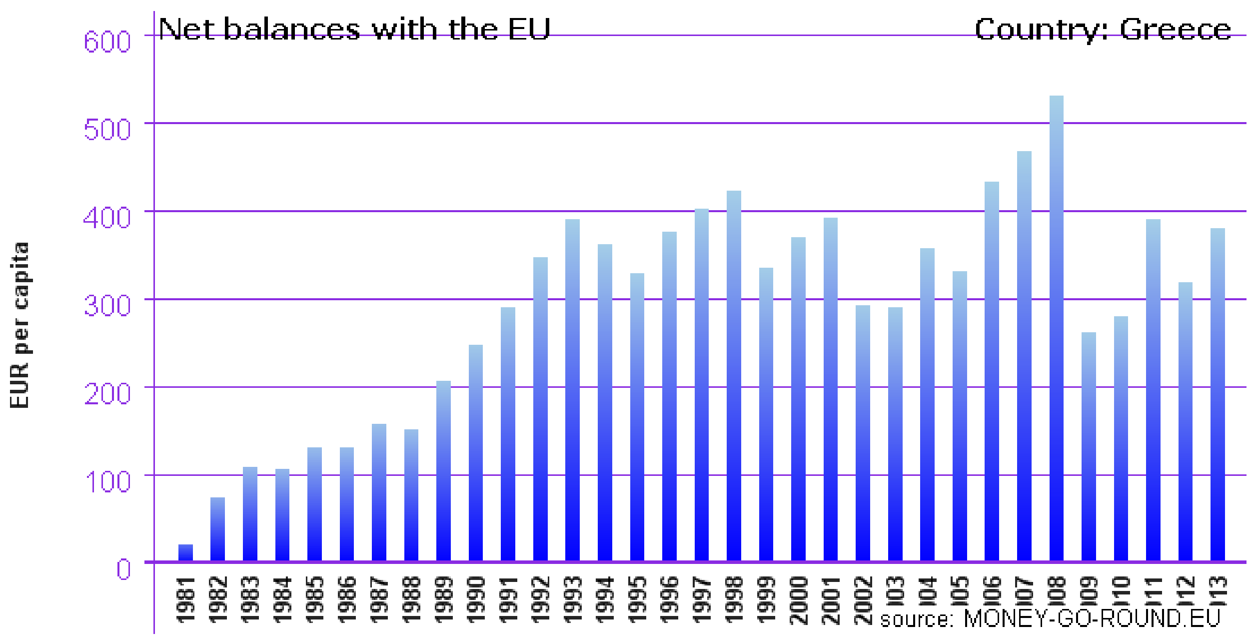


Figure 1: Operating Budgetary Balance in Millions of Euros
http://www.money-go-round.eu/Country.aspx?id=EL&year=2013&method=abs

The second figure corrects this for any population increase in Greece. The population rose by about 10% from 9.6 million in 1980 to about 10.5 million in 2013. As we can see, the story remains about the same: the 2003 plateau of 400 Euros per capita is even more rarely exceeded.

Figure 2: Operating budgetary balance with the EU per capita :
http://www.money-go-round.eu/Country.aspx?id=EL&year=2013&method=pcillion of



Now, let us look at the 3rd figure. How do these billions of Euros of subsidies compare to GDP of Greece? Now, here is a myth dispelling story. First, we can see that the Graph is totally inverted compared to the others. 1993 still remains a capstone year, but this is the year when the plateau of about 6% ends. After that payments to Greece as a percentage of GDP keep decreasing till reach a low of 1.5 % in 2009. How can you reconcile these figures with the previous graphs? There is only one explanation. Greek GDP increased drastically, and not just because of the increase in population. World Bank Statistics show that the Greek economy grew every year from 1994 to 2007. This dispels the myth that the Greeks did not use their subsidies productively or that they are lazy people. But it lends better support to our point that as a percentage of their income, the Greeks were getting less and less subsidies.

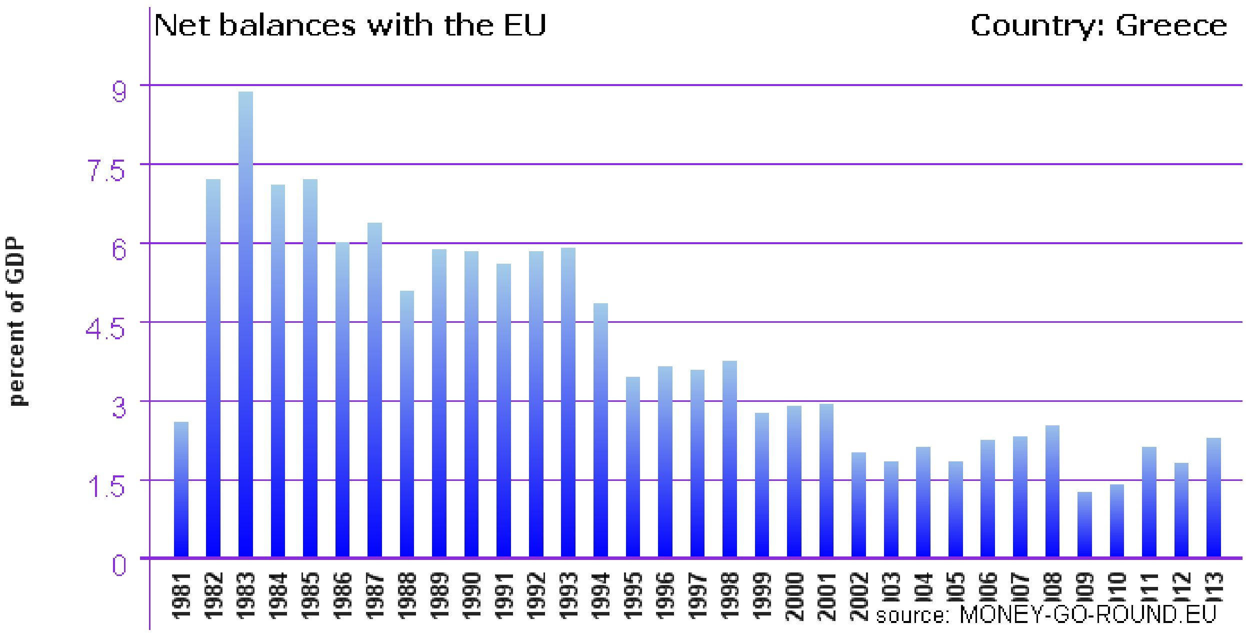


Figure 3: Operating Budgetary Balance as % of GDP: Source: http://www.money-go-round.eu/Country.aspx?id=EL&year=2013&method=gdp

If Greek GDP is going up, clearly it shows that the common market has helped Greece. However, it has also increased their imports. If the increase in imports are more than increase in exports and financed by debt, we are finally in a position to understand the picture. The increasing trade deficit of Greece should have been financed by increasing payments from Europe. The net deficit in trade and services of Greece increased from $15 billion per year to $39 billion per year in the 2005 to 2008 period.[i] The trade and services surplus of North European countries grew considerably. If we exclude services, the trade deficit in goods of Greece was even larger and growing (from $ 34billion to $ 64 billion). This increasing loss from trade to Greece corresponds to an increasing gain from trade to North Europe. It should have led to huge increase in subsidies to Greece and not to loans! This is the cost of being in the Euro where devaluation is not possible. Instead, the Greeks were given debt!

Perhaps Greece is not the only country for which our analysis will be true. Not for a moment did anyone pause to say that, logically, these countries should not only withdraw from the Euro, but also from the European Union. Obviously, these countries, if they withdrew, would have to restart industries that they had closed down decades ago. The cost to them would be huge. So, they hesitate to leave. But their equalization subsidies have stopped.

This fragile position in which the Southern states have been caught, has been exploited by the bankers of the rich. Just as bankers exploit farmers in The Grapes of Wrath (Steinbeck, 1939), the bankers are exploiting the situation of the agriculture based economies. Yes, the subsidies have been replaced by loans. Loans mean that they have to be repaid (and with interest). Will the North also be given loans from the South for their profits from access to markets that they continued to enjoy? No, in a one way transaction, the North and their bankers have used the fragility of the South to entice them into a Union in which they will slowly publicly rape the south. Their countrymen (perhaps not all) will use the women of the South as cheap prostitutes just as warring soldiers freely rape the women of the countries they conquer. In this rape, they can manipulate, through control of media, international public opinion in their favor. Thus, instead of the Southern States coming out as victims, they are being shown as bad debtors in dishonor.

If the Greeks are refusing to repay their debt, in this strange situation, I am proud of them. Just as I am Charlie, I am Greek. It takes nerves for a small David to show the Goliath that he will not accept the terms that are being imposed by a few fanatics who rant capitalist ideology, hiding behind the skirts of their prime ministers. These fanatics are probably not even representative of the people of their own nations.

See also:
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