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EU Is Not the United States

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Europe is now struggling with the inevitable adverse consequences of imposing a single currency on a very heterogeneous collection of countries. But the budget crisis in Greece and the risk of insolvency in Italy and Spain are just part of the problem caused by the single currency. The fragility of the major European banks, high unemployment rates and the large intra-European trade imbalance also reflect the use of the euro.

European politicians who insisted on introducing the euro in 1999 ignored the warnings of economists who predicted that a single currency for all of Europe would create serious problems. The euro's advocates were focused on the goal of European political integration and saw the single currency as part of the process of creating a sense of political community in Europe. They rallied popular support with the slogan "One Market, One Money," arguing that the free-trade area created by the European Union would succeed only with a single currency.

Neither history nor economic logic supported that view. Indeed, EU trade functions well, despite the fact that only 17 of the union's 27 members use the euro.

But the key argument made by European officials and other defenders of the euro has been that because a single currency works well in the United States, it should also work well in Europe. After all, both are large, continental and diverse economies. But that argument overlooks three important differences between the United Sates and Europe.

First, the United States is effectively a single labor market, with workers moving from areas of high and rising unemployment to places where jobs are more plentiful. In Europe, national labor markets are effectively separated by barriers of language, culture, religion, union membership and social insurance systems.

A second important difference is that the United States has a centralized fiscal system. Individuals and businesses pay the majority of their taxes to the federal government in Washington, rather than to their state or local authorities.

When a U.S. state's economic activity slows relative to the rest of the country, the taxes that its individuals and businesses pay to the federal government decline, and the funds that it receives from the federal government increase. Roughly speaking, each dollar of decline in gross domestic product in a state like Massachusetts or Ohio triggers changes in taxes and transfers that offset about 40 cents of that drop, providing a substantial fiscal stimulus.

There is no comparable offset in Europe, where taxes are almost exclusively paid to, and transfers received from, national governments. The EU's Maastricht Treaty specifically reserves this tax-and-transfer authority to the member states, a reflection of Europeans' unwillingness to transfer funds to other countries' people in the way that Americans are willing to do among people in different states.

The third important difference is that all U.S. states are required by their constitutions to balance their annual operating budgets. While "rainy day" funds that accumulate in boom years are used to deal with temporary revenue shortfalls, the states' "general obligation" borrowing is limited to capital projects like roads and schools. Even a state like California, seen by many as a poster child for fiscal profligacy, now has an annual budget deficit of just 1 percent of its GDP and a general obligation debt of just 4 percent of GDP.

None of these features of the U.S. economy would develop in Europe even if the euro zone evolved into a more explicitly political union. Although the form of political union advocated by Germany and others remains vague, it would not involve centralized revenue collection, as in the United States, because that would place a greater burden on German taxpayers to finance government programs in other countries. Nor would political union enhance labor mobility within the euro zone, overcome the problems caused by imposing a common monetary policy on countries with different cyclical conditions or improve the trade performance of countries that cannot devalue their exchange rates to regain competitiveness.

The most likely effect of strengthening political union in the euro zone would be to give Germany the power to control the other members' budgets and prescribe changes in their taxes and spending. This formal transfer of sovereignty would only increase the tensions and conflicts that already exist between Germany and other EU countries.

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