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Greece vs. California – Comparing Fiscal Crises within the Monetary Unions

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California is not Greece – but why not? The answer to this question seems simple. To be precise, there are two simple answers. First, California is not Greece because the U.S. state is a vastly successful economy, on its own among the ten biggest economies in the world, good at producing blockbusters, software and computer lifestyle products that cannot easily be replaced by cheaper providers in emerging markets. Unfortunately for California, the private riches goes with public poverty. A populist political system allows voters to act collectively like a schizophrenic person: hedonistic and lavish as regards their own private expenditure, prudish and insanely stingy when it comes to state expenditure for public goods. However well the private economy did before the crisis, it seemed to make Californians just more inclined to starve the beast that is their state government. It has forced the executive repeatedly to resort to creative accounting and outright forging of figures to pass a budget.

Compared to that, Greece's problems with budgets are straightforward to fix as they are not systemic: make the better off obey the law and pay their taxes, a move which would even be popular with those many not very well-off Greeks. Eurostat, the EU's statistical agency, alerted everybody who cared to listen since the early 2000s that Greek budget figures cannot be trusted; it is now allowed to look into the government's books like an independent auditor. Being a less competitive and not very well governed political economy can explain why Greece is poorer than California. But it can explain neither why the country is broke nor why its government cannot raise enough revenue for its expenditure.

The second simple answer may get closer to the heart of the problem. In the U.S., there is a central (federal) budget and a central bank that financial market investors safely assume would bail-out California. It happened to the public sector in New York when the city was over-indebted and taken into administration; it happened to the private sector in New York in 2007-08 when one investment bank after another was thrown a life line; in each case, the Federal Reserve Bank and the Treasury worked out the sharing of the costs between them.

By contrast, member states of the European monetary union insisted until November 2009 explicitly that there would be 'no bail-out'. The European Treaty even had an article stating that. But then, Greece was rescued: another Treaty article was found trumping the no-bail-out clause, a Special Purpose Vehicle was created in May 2010 that can issue bonds and give credit guaranteed by other member states, Greek (and other) bonds have been purchased by the European Central Bank. In return, the Greek government must implement reforms that should strengthen its economy, at least in the eyes of private investors. While the second answer thus points in the right direction, it is far from simple.

One could add other facts that make it more puzzling why California is not Greece. California amounts to about 18 percent of the U.S. GDP while Greece amounts to less than 3 percent of the euro area's income. Only the GIPS combined (Greece, Ireland, Portugal, Spain) would come close to a dangerously big figure that could, as such, overstretch fiscal capacities. These fiscal capacities are not necessarily weaker in the Euro area, especially not in the present situation. The federal fiscal deficit in the United States amounted to 9.6 percent in 2010 and is projected to remain above 9 percent in 2011 by the IMF. The combined (and weighted) fiscal deficit of the Euro area, by contrast, was 6.4 percent in 2010 and is projected to go down to 4.3 percent in 2011.

In a recent talk at the LSE, Barry Eichengreen, the prolific economic historian at Berkeley and spot-on commentator on European affairs, has expressed more skepticism about the fiscal future of the United States than about the Euro area. Professor Eichengreen is probably right, but it would only mean that California could become Greece and the United States less well off after all. He certainly did not mean to suggest that the Euro area would automatically do better and the Greek problem go away.

What is the Greek problem of the Euro area anyway? The EU has decided to treat it as a sovereign debt crisis, although one could plausibly argue that it is a banking crisis in disguise – the fear of a second 'Lehman moment' does not allow Greece to default on its debt. But even now there is only a finite fund for liquidity support, no pooling of fiscal resources which would allow one region to be automatically stabilised when hit by a shock. Given its open current and capital account, a country is then forced to pro-cyclical stabilisation measures, i.e. austerity in a recession. The monetary union did help Greece because the European Central Bank bought its bonds. But being part of a Single Market and a monetary union did not help. The missing bit, fiscal union, makes a crucial difference.

The substitute for a central budget — or at least common debt management through a Eurobond — is supposedly more stringent economic governance. This entails more intrusive surveillance, procedures that can now lead to fines not only for 'excessive' deficits, but also for excessive debt and excessive imbalances (read: current account deficits), any procedure being harder to reject by the Council of ministers; and budget plans now being scrutinized before they go to national parliaments. All this is to instil a sense of discipline and mutual responsibility in national political economies.

The problem is that this has been tried before and failed. Public policy thus reinforces what market responses do to a country anyhow, namely take pro-cyclical austerity measures in order to restore fiscal balance. That this doesn't work has been amply demonstrated by the Irish government. At first, it was praised for its boldness even though it was just adding more foolish measures to the really fatal one of taking over all debt held by its banks. When — surprise, surprise — growth rates did not resume, the financial markets took against Irish bonds, just as they had against Greek bonds.

If the Euro crisis since December 2009 has shown anything, it is that disciplinarian measures cannot substitute for the real thing, namely some budgetary resources that draw on the community of taxpayers. This is all the more important in Europe where public poverty is more likely to create private poverty, even in Ireland. A pooling of budgetary resources projects a sense of political union while an IMF-style fund is just a financial instrument. None of the reforms taken so far will make Greece like California, namely give it the protection of political union that is then not even tested by the markets. Rather, they threaten to make all member states to become Ireland, a country that manages to save itself into poverty and not even enjoy private riches.

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