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Why the sovereign debt crisis could lead to a federal fiscal union: the paradoxical origins of fiscalization in the United States and insights for the European Union*

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ABSTRACT
This paper shows that the emergence of the federal power to tax is the result of a sovereign debt crisis at the state level. I analyse the fiscal history of the early United States (US) to demonstrate how the institutional flaws of the Articles of Confederation, mainly the central budget based on contributions from the states, so-called 'requisitions', led to a sovereign debt crisis on the state level, which triggered taxpayers' revolts in 1786/1787. This social unrest, in turn, was perceived by the political élite as an endogenous threat to the union and paved the way for the fiscalization of the federal government, i.e., the creation of a fiscal union with the federal power to tax based firmly in the Constitution of 1789. This analysis concludes with four insights for the European Union (EU).

KEYWORDS Euro crisis; EU economic governance; fiscal federalism; fiscalization; fiscal union; US power to tax

> Sir, if we have national objects to pursue, we must have national revenues. If you make requisitions and they are not complied with, what is to be done? It has been well observed that to coerce the States is one of the maddest projects that was ever devised. A failure of compliance will never be confined to a single State: This being the case, can we suppose it wise to hazard a civil war?
> Alexander Hamilton[1]

1. Introduction

The lack of the ability of a federal government to raise revenues from its own sources has been identified as the main factor underpinning the lack of sustainability of a federation (Kincaid [2014]: 292–3; Riker [1975]: 111). In order to become viable, central governments must therefore at some point become

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financially independent. This lack of sustainability can also be applied to the EU, and indeed can be viewed as one of its main flaws (for example, Moravcsik claims that '(o)ne institutional weakness is the EU's insignificant fiscal capacity' [2001: 169]). While the idea of giving EU institutions the power to tax in order to overcome this weakness has been around for many years (see, e.g., Eichengreen 1991: 25–26), taxing would be difficult to implement because 'it implies a fundamental transfer of sovereignty from the nation-states to European institutions' (De Grauwe 2013: 169). It was precisely this same reason that, in eighteenth-century US, made it very difficult to give the federal government the power to tax. As Ferguson (1961: 290) accurately notes about the struggle for the federal power to tax in the late 1780s: '(n)othing testifies more to the audacity of the founding fathers than their demand that the people relinquish what they had fought Britain to preserve (…)'. The American states needed a trigger to agree on such a 'fundamental transfer of sovereignty'. This paper shows that the sovereign debt crisis constituted just such a trigger and activated the causal chain that ultimately led to the federal power to tax. The US can thus be seen as an example of successful fiscalization, a process that I define in the section on conceptualization, whereby the federal tax power was firmly based in the Constitution. It thus constitutes a benchmark for comparison with the EU.

A comparison can shed a different light on a polity such as the EU. The rationale for such a comparison lies in the fact that both cases are examples of the so-called 'coming together' type of federation, where previously independent states decide to pool part of their sovereignty to the higher level in order to better protect themselves against common threats (Riker [1964]; Stepan [1999]). A number of scholars have already compared the EU with the US from the point of view of federalism (Fabbrini [2007]; Hallerberg [2006]; Nicolaidis and Howse [2001]; Sbragia [1992]; Trechsel [2005]). Moreover, in the wake of the Eurozone crisis a number of studies has been conducted in which scholars have looked at US fiscal history in search of potential solutions for the EU (Bordo *et al.* [2011]; Hallerberg [2013]; Henning and Kessler [2012]; Kingreen [2017]; Sargent [2012]; Steinbach [2015]). In comparing these two polities, this paper therefore falls within a well-established tradition.[2] Comparing the EU with the US does not imply that one regards the EU as a federation – it only signals, as Burgess (2009: 30) demonstrates, that 'integration' is quite similar to the coming together of state units that were previously independent, just like in the case of the US. This is what, for instance, Kelemen does, when he compares the EU and the US at the same stages of the 'federal' development by showing that in many areas of the 'core state powers' the US early republic resembled the modern EU (Kelemen 2013).

Notwithstanding this rationale, there are many differences between the US in the 1780s and the EU in the 2010s, which have to be mentioned. On the one hand, fiscal discipline, banking crisis and monetary union, were all present in the EU, but not in the US. On the other, in the US there was a common cause of the debt of the states – a war, while it is not the case in the EU, where debt resulted due to the policies of individual countries (Steinbach 2015).

I show that the US in the 1780s faced a very similar problem as the EU in the 2010s – the sovereign debt crisis of its member states. However, the solutions chosen to solve this problem were fundamentally different: whereas in the US this debt crisis triggered the process of *fiscalization* of the federal government, in the EU we witnessed only attempts to reach such solutions by the EU institutions (see, e.g., European Commission 2012: 31–34) and the member states (Macron and Gabriel 2015). In the place of a EU tax power, the European sovereign debt crisis instead accelerated the process of regulation of the fiscal policies of the member states (Genschel and Jachtenfuchs 2013). As a result, an accountability challenge has been created for the EU institutions involved in the economic decision-making (Dawson 2015).

This paper sheds light on the mechanism of the emergence of a federal power to tax, making two main contributions to the theoretical and empirical literature. In reference to the former, it introduces the concept of fiscalization, which defines the emergence of a tax power on the part of central government, and of a 'fiscal union', a concept which is often used, but is rarely defined.[3] Concerning the latter, it develops the US-EU comparative federalism literature. As Thomas Sargent remarked in his Nobel Prize lecture, 'The fiscal institutions of the EU today remind me of those in the US under the Articles of Confederation' (2012: 3). However, the US-EU comparative federalism literature has largely overlooked this critical juncture period in the US, from 1776 to 1789, when it was governed by its first constitution – the Articles of Confederation, and has focused instead on the US federal fiscal policy after the Constitution was ratified (Bordo *et al.* [2011]; Henning and Kessler [2012]; Gaspar [2015]).[4] As a result, there is little research on how such power to tax emerges. For instance, even though Bordo *et al.* (2011: 26) conclude their comparative study of five federations with the idea that the economic crisis in all of these countries increased the fiscal capacity of the central government and 'instituted a system of transfers and equalization payments', these authors did not study how the federal government acquired such fiscal capacity in the first place. This paper sets out to rectify these gaps in the scholarship by answering the following research question: What are the conditions under which the federal power to tax is likely to emerge? This paper proceeds as follows: in the next section I present the theoretical and conceptual framework of analysis. Then, in Section Three, I investigate the fiscal history of the early US and provide empirical evidence for the main argument of this paper. Finally, in Section Four I conclude with some lessons for the EU in forging a federal fiscal union taken from the US confederation.

2. Theoretical and conceptual framework of analysis

I build on the theory of federalism developed by William H. Riker (1964, 1975), in which he cited threats as necessary precondition for striking a federal bargain and creating federal union. This paper follows this main Rikerian claim, but in so doing it takes into account economic motives and consequently will argue that internal economic threat is a necessary condition for the emergence of a fiscal union. Thus, I will analyse the perception of the political élite that led to what I call (again – following Rikerian terminology) a fiscal bargain and creation of a federal fiscal union, where federal government was given power to tax. I do this by showing leading figures' perceptions and by outlying the economic situation that led to such perceptions, giving special emphasis on the economic depression and fiscal crisis in the US states in the mid-1780s. I use process tracing as my main method.

In conceptualizing the fiscalization process, I build on Riker's classic definition of federalism: 'Federalism is a political organization in which the activities of government are divided between regional governments and central government in such a way that each kind of government has some activities on which it makes final decisions' (Riker 1975: 101). Thus, I define the concept of fiscalization as follows:

> Fiscalization is a process through which a certain level of government (supranational/central or state level) expands its power to raise its own sources of revenue, and in so doing it decreases the level of vertical fiscal imbalance.

The concept of vertical fiscal imbalance (contributions/transfers as a percentage of total revenue) has usually been used to analyse the financial (in)dependence of the member states of the union from the central government (Rodden 2002: 672). In this paper I use it to show the financial (in)dependence of a central government from the member states and the consequence of such dependence for the viability of the union.

For the purposes of this paper, the fiscalization process is limited to the central government – by central I refer to either federal (US) or supranational (EU) levels of government – and, if successful, it leads to the emergence of a federal fiscal union. I have added an adjective 'federal' in order to differentiate such a fiscal union from many other uses of this concept (Fuest and Peichl 2012).

3. Fiscalization in the US – how did the federal power to tax emerge?

This section provides the background to the American fiscal history of the pre-Constitution period, showing the origins of federal tax power and the consequences of the lack thereof. The period can be divided into two phases. The first, 1774–1781, concerns the First (1774) and Second (1774–1781) Continental Congress, which were attended by representatives from the North

American British colonies (after 1776 – states). Congress' main aim was to co-ordinate the actions of the colonies in their struggle against Britain. This struggle – which turned into the American Revolution – started as the result of taxes which the British imposed on the colonies without their consent, by means of the British Parliament, where the colonies were not represented. The First Congress formed the 'Continental Association' in 1774 to co-ordinate the boycott of British goods. As a result of the unresponsiveness of King George III to the colonists' petitions, Congress went on to draft the Declaration of Independence in July 1776, followed by the American Revolutionary War, which lasted until 1783, when Britain was finally defeated. Congress drafted the first US constitution, the Articles of Confederation, already in 1777, but this was not ratified until 1781. This is when the second phase of the period started, the phase which concerned the Confederation Congress of 1781–1789. Despite their different legal grounds, the Continental and Confederation Congresses had one thing in common – a lack of power to levy taxes.

The first Continental Congress gathered in September 1774. At that time it was a loose association of the representatives of the colonies, as a real government did not exist. There was no federal executive or judiciary. Congress did not have any tax powers and in financing its activities it relied on three main sources: printing money ('bills of credit'), contributions from the states, called requisitions, and borrowing (both domestic and foreign). The states were extremely reluctant to provide Congress with financial means; as a result, the main component of its revenues was 'paper money' ($38 million out of $68 million of the total income between 1775 and 1783) and loans of $19 million (Dewey 1968). It is not surprising that Americans were reluctant to give the power to tax to the Congress, since they were accustomed to deal only with their respective colonial governments. However, it was given some, albeit limited, competences (the establishment of post offices, co-ordination of states' war efforts, and later the creation of a Continental Army, among others), and these activities had to be financed in some way. At this stage, the Congress could only make recommendations to the states – it did not have any power of coercion. Thus, in order to finance its expenditures, it had to ask for requisitions from the states, and the classic free rider problem emerged; consequently, the states failed to meet their obligations. For instance, between November 1777 and October 1779 Congress asked for four requisitions amounting to $95 million, but the states provided just $54.7 million. Moreover, from three calls between August 1780 and March 1781 amounting to $10.6 million, the states provided just $1.6 million. In total, before 1784, the states contributed only $5.8 million in specie value, i.e., cash in the form of gold or silver coins, to Congress, which fell far short of the amount needed to finance its expenditures (Dewey 1968: 44–45). As Baack shows (2001: 654), before 1781, requisitions provided only 4 per cent of Congress's revenue.

As a result, between 1775 and 1779, Congress was forced to authorize as many as forty issues of bills of credits amounting to over $241 million (Dewey 1968: 36). Moreover, instead of rendering the Continental bills of credit, states were making their own issues. The result was a strong depreciation in the value of the national currency. In fact, there was such a fear in Congress that the currency would not be accepted that it asked states to enact laws that would treat anybody who refused to accept Continental bills of credit as 'an enemy of his country' (Dewey 1968: 39); this time the states followed its recommendation.

At the beginning of the 1780s, there was a common understanding among the states that this system simply was not working and some proposals for establishing a national tax were put forward in Congress. In 1781, Congress recommended a 5 per cent duty on imports. However, this proposal required constitutional amendment and, under the Articles of Confederation, the unanimous consent of all the states was required. All but one state agreed on such a measure. This was Rhode Island, which objected to such a duty on the grounds that the burden for commercial states from the North would be higher; that Congress could spend its revenues on any expenditure for an indefinite period of time; and that collectors would only be responsible to Congress and not to the states. In addition, proposals on a land tax, poll tax and excise tax failed in both 1781 and 1782. A proposal from 1781 that had been rejected by Rhode Island was put on the table again in 1783 as a national tariff. This time the concerns of Rhode Island were addressed – state, and not national, officers were to collect the revenues and the tariff was designed for a 25-year period in order to pay only for the national debt.

Thus, its aim was strictly limited and the revenues coming from this tariff could not be spent on anything else. It took several years for the states to deliberate this plan, but finally, in 1786, all the states but one agreed on it. This time, New York vetoed the proposal, and, as a result, the Congress was still fiscally powerless (Studenski and Krooss 2003). Congress proved unable to amend the Articles in the 'vital particular upon which all else depended – federal power of taxation', which showed its inherent difficulty of securing unanimous agreement to any proposal (Ferguson 1961: 334, 337). This simply confirmed the perception that Henry Knox expressed a few years later, when he wrote in a letter to George Washington that 'Every State considers its representatives in Congress not so much the Legislator of the whole union, as its own immediate Agent or Ambassador' (Maier 2010: 14).

3.1. The argument

The sovereign debt crisis that emerged in the mid-1780s had its roots in the long and expensive Revolutionary War. As Congress did not have any tax power, and as the borrowing (on the credit of the states) and the policy of monetary financing the expenditures of government had reached its limit (inflation was so enormous that the term 'not worth a Continental' was coined, which referred to the national currency), the fiscal burden of financing the war efforts fell on the states. In a majority of these, at least two-thirds of tax revenues were devoted to the payment of war bonds. In order to pay off these debts, between 1781 and 1790 states imposed heavy taxes that 'averaged three or four times those of the colonial era' (Holton 2005: 445). One historian estimated the increase of the average per capita tax burden to be even sevenfold (Brown 1993: 33–34). What is more, during this fiscal crisis, unlike in the EU, there was not yet a monetary union, and so states were free to use monetary means to finance their needs, such as devaluation of their currencies. Moreover, this monetary financing only accelerated fiscal stress on the citizens – depreciation of the paper currency was so serious that Benjamin Franklin said it acted 'among the inhabitants of the States … as a gradual tax upon them' (McCusker and Menard 1991: 373). Yet despite these monetary tools, the states still had to use unpopular taxes to pay off the debts (Sylla 2006: 73–95).

I argue that the sovereign debt crisis of the states in the mid-1780s triggered the chain of events, which paradoxically led to the fiscal bargain and the emergence of the federal power to tax. The federal budget based on contributions created a system in which states had to tax heavily in order to pay off the debt in 1780s. These taxes and the general perception of injustice led to popular unrests, such as the one led by Daniel Shays, a revolutionary veteran who rebelled against the tax policy of the government of Massachusetts in 1786/1787. This kind of rebellion was seen as an existential threat for the young republic and 'had convinced many Americans that constitutional reform was imperative.' (Klarman 2016: 72). The perception of such threat helped the Federalists (or the Nationalists, as they were sometimes called) to convince the political élite from almost all the states that the federal power to tax was inevitable for the peaceful existence of the union. Indeed, as one historian observes: 'Shays's Rebellion was consciously exploited by leading Nationalists in search of a common danger to unite the country' (Ferguson 1961: 249).

There are also alternative explanations on why the federal government was given the power to tax and they usually evolve around Federalists' desire to restore public credit. True, if the only purpose of the élite was to avoid tax revolts, then the easiest way would be default, since the high taxes were imposed to redeem public debt.[5] But this option was ruled out. There is no agreement in the literature, however, why Federalists decided to restore public credit: for their personal gains (Beard [1913]; Holton [2005]), to kick-start the economy (Sylla 2011) or to strengthen the defence capacity of the new government (Edling 2003). Whatever the reasons behind the restoration of public credit, the fact remains that it would be very difficult to achieve without fiscalization. In turn, the tax revolts created conditions under which the states were willing to agree on such fiscalization.

In the majority of the states, people who were often Revolutionary War veterans were now turning their arms against state governments because of the heavy tax burdens (Brown [1993]: 32–138; Perkins [1994]: 137–96). Ferguson brilliantly demonstrates how widespread both the actual unrest and the fear thereof (that is to say, the perception of a threat) were: 'Madison saw Shaysism emerging in Virginia. (…) Mobs besieged the legislature of New Hampshire and stopped courts in eastern Connecticut; an "insurrection" was put down in Vermont. Trouble was expected in New York, where the militia was readied to intercept refugees from Massachusetts' (Ferguson 1961: 249–50). There was a risk that such tax revolts, like Shays's Rebellion,[6] would spill over to the other states and would put the very existence of the union in jeopardy. Hamilton was convinced that the cause of this social unrest laid in the onerous tax burden of the state legislature – he wrote that 'the insurrection was in a great degree offspring of this [tax] pressure' (Chernow 2004: 225). In order to prevent such social unrest from happening again, action had to be taken with regard to its cause – by relieving the heavy state tax burden. Paradoxically, this relief was done by granting the federal government the power to tax, which then helped to lighten the burden of states' taxation. This paradox was possible for several reasons.

First, it was expected that a tariff will be the main federal tax, and it was in the interest of majority of the states that this tax on imported goods will be taken by federal government, because only few coastal states with ports could impose, and benefit from, a state tariff. As citizens of non-coastal states were also consuming imported goods, they were effectively paying taxes of coastal states (which were included in the price of those goods). Importantly, the coastal states, like New York, that had the most to lose from the introduction of the federal tariff and the abandonment of state tariffs, also had the most to gain from the provision of a 'common defence' for which revenues from federal tariff would be spent, as they were most exposed to a danger of foreign invasion. Therefore, the agreement of the coastal states was achieved by connecting tariff and military expenses.

Second, it was expected that the federal government will be able to collect more revenues from the tariffs, than states were able to do separately, because the tax competition will disappear, and one tax rate throughout the country will be established. Indeed, as Table 1 shows, when the federal government took over the power to levy tariff (custom duties), the total revenue increased by 600 per cent within a decade. Third, this revenue was expected to pay for national debt and in so doing to free the states from this burden. It was important, because funds borrowed by the Congress (domestic bonds, debt certificates, and foreign loans) amounted to 32 mln pounds

Table 1. Customs receipts in four major ports.

State	1785–1788	1792–1795
New York	$ 603,000	$ 4,653,000
Philadelphia	622,000	4,299,000
Baltimore	346,000	1,829,000
Charleston	404,000	1,064,000
Total	$1,975,000	$11,845,000

Source: Edling and Kaplanoff (2004: 739).

sterling and were much larger than those borrowed by the states – their indebtedness equalled 23 mln pounds sterling.[7]

Fourth, states were no longer obliged to collect money for the federal government, neither for the current federal expenditures, nor for the 'common defence', the most expensive spending item of a government that time. Finally, the anticipated federal tax, the tariff, was an indirect tax and was thus paid only by 'monied' men who could afford imported goods and for that reason was not expected to cause social unrest. Therefore, for those five reasons, such a paradox was possible – in order to tax less, the states had to give a power to tax to the union. As a result, transfer of fiscal power resolved the issue of high taxation, a source for internal threat undermining a new Union.

The states had different levels of debt, which reflected both their level of involvement in the war and the amount they managed to pay off afterwards. Certainly, these differences played an important role in the states' reaction to Hamilton's debt assumption plan, proposed once the Constitution was ratified and the federal government could use its fiscal capacity (Steinbach 2015: 1114). However, what is crucial to my argument is not so much the level of debt of the individual states *per se*, which was much higher compared to the debt from the previous conflict – the Seven Years' War, 1756–1763 – as 'the net financial burden (…) was up to ten times greater per capita' (Perkins 1994: 137), but the level of direct taxation. In this regard, almost all the states imposed significantly higher level of direct taxation, which in the 1780s on average provided two-thirds of states' tax income, but were diminished by at least 75 per cent in majority of the states (and three of them abandoned it completely) just few years after the Constitution was ratified, and '(b)y the early 1790s, after a decade of heavy and unpopular taxation, state taxes had returned to the low level of the colonial period.' (Edling and Kaplanoff 2004: 723, 734).[8] It was fiscalization of the federal government that allowed for such a tax relief.

The social unrest, especially Shays's Rebellion, was perceived by the American élite as a threat, including the most important figure, the 'Father of the Nation' George Washington: if such a rebellion could take place in New England, it could easily happen in Virginia, where plantation owners controlled the state governments and small farmers had little say in politics. John

Jay was not the only one who was reporting to Washington that the situation in the summer of 1786 was so serious that it may lead to some revolution of extraordinary consequences for the young republic: 'Our affairs seem to lead to some crisis – some Revolution – something I cannot foresee, or conjecture'.[9] As a prominent historian of that period points out about the US in 1788/1787: 'The situation amounted to a crisis of unprecedented importance of the young republic. For those caught up in that frame of mind, the entire future of the United States was at stake' (Maier 2010: 17).

Washington was one of those 'caught up' in the conviction that this crisis was a threat to the future of the US and only a more energetic federal government (and the power to tax was one of the most important authorities proposed for this new government) could provide a permanent solution. As he wrote to Henry Knox, a man who was reporting to him about the 'Lamentable' developing of the 'Insurgents of Massachusetts' in December 1786:

> If the powers are inadequate amend or alter them, but do not let us sink into the lowest state of humiliation & contempt, & become a byword in all the earth—I think with you that the Spring will unfold important & distressing Scenes, unless much wisdom & good management is displayed in the interim.

He also feared that Britain would take advantage of 'disorders' which have arisen in these states: 'That G.B. will be an unconcerned spectator of the present insurrections (if they continue) is not to be expected.' Moreover, he wrote that '(t)here are combustibles in every State, which a spark may set fire to' and in Virginia, the most populous and affluent state, an American equivalent of Germany in the EU, 'disposition to support, and give energy to the fœderal system is discovered' and so 'it seems very desirous of a General Convention to revise and amend the federal Constitution'.[10] I argue that it was the tax-motivated political turmoil that convinced the élite in 1787 to 'revise' the Constitution – the Articles of Confederation, so soon – only six years after it was ratified. Indeed, we have a lot of evidence to suggest that Washington decided to attend the federal convention in Philadelphia after learning about Shays's Rebellion from the Knox's letters.[11] It was, in fact, Washington's presence that was crucial to the success of the convention in drafting the Constitution that was later ratified by the states (he had been elected to the role of president of the convention). And within the Constitution, the principal transformation was the federal power to tax, as Hamilton reminded his fellow New Yorkers during the battle for ratification: 'I have applied these observations thus particularly to the power of taxation, (…) because it is the most important of the authorities proposed to be conferred upon the Union'.[12]

The key to my argument, and it is in line with Riker's theory, is not so much the 'objective' economic or military situation of the period, but the perceptions of the key actors. I argue that these perceptions in 1786/1787 centred on a sovereign debt crisis followed by heavy state taxes that led to popular unrest, which was perceived as an internal threat. This threat undermined the status quo and triggered the emergence of the federal power to tax. Hamilton was not the only person to warn against the dangers of the tax rebellions – he was afraid that the social unrest, like the rebellion of debtor farmers in Massachusetts – the 'tempestuous situation' as he called it, would lead to 'tyranny' or 'despotism' in the state, and that these 'convulsions' might spill over to other states.[13] The fact that '(…) the situation in Massachusetts was an extreme case if a widespread problem' shows that those fears were justified (Maier 2010: 15). By linking the debt and power to tax, I have shown the mechanism of the emergence of the federal power to tax: 'As the states laid hands on the public debt they undermined the basis for a constitutional enlargement of federal powers' as a leading historian observes about the situation in the mid-1780s (Ferguson 1961: 221). However, the way in which the states decided to pay off this debt – through onerous direct taxation – changed the political dynamics and paved the way for the enlargement of the federal powers. As a consequence, it can be said that the process of fiscalization of the central government had begun. Importantly, fiscal policies of states' governments fuelled the feeling of injustice and consequently had caused widespread social unrest, whereby the cause of such a feeling of injustice lay in 'state legislatures, many of which imposed disastrous austerity policies simply to pay wealthy bondholders' (Mihm 2013: 342). I claim that in this way states helped to spark the process of fiscalization of central government. As Brown (1993: 234) accurately observes: 'state taxation holds the key to the Framers' decision to reconstitute the Republic rather than amend the Articles of Confederation'.

Such a 'reconstituted' union would have a more 'energetic' federal government, which could levy taxes (and pay for 'common defence' and other duties that states had had to pay for until now) that were not such a burden for the average citizen. Simplifying greatly, there were two types of taxes: direct and indirect. For centuries, people were much more concerned with the former type – they feared the knock of a tax collector on the door, asking for tax payment in cash. Indeed, heavy direct taxes had been the main cause of Shays's Rebellion. Indirect taxes, on the other hand, were usually feared less, as they were included in the price of goods, and, in general, they could be avoided by not purchasing those goods. The first clause of Section 8 of Article I of the Constitution gave the federal government virtually unlimited power to tax: 'The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence (…)'. However, during the Ratification it was widely assumed that the tariff would normally be sufficient to cover federal expenditures. And so it was – until the Civil War tariff provided over ninety per cent of the federal revenues; between 1801–1812 and after 1817 it was the only federal tax (Einhorn 2006: 111, 117; Woźniakowski and Steinmo [2017]). This tax had the advantage of being an indirect tax; it was collected at the ports from merchants, who then included it in the prices of the goods they imported.

The internal crisis led the Framers – the delegates in the Constitutional Convention – to the conviction[14] that giving the power to tax to the new federal government is absolutely essential. As Klarman (2016: 145) puts it: 'The consensus among delegates for empowering Congress to levy taxes (…) was so strong that little discussion was devoted to the subject.' Although the delegates did not waste their time deliberating on a principle on which nearly all of them agreed, they did discuss the details of this principle. Two proposals proved to be especially controversial: a ban on taxing the slave trade and direct taxation. The precise nature of the fiscal bargain was a result of the negotiations regarding those two issues, and the sectional interests of the Southern and Northern states had to be compromised for the sake of the Union.

The ban on taxing the slave trade was proposed on August 6, 1787 by the Committee of Detail, under the influence of the Southern states, which feared that such a tax would mainly affect their export-driven slave economies. This proposal met with the resistance of the other states. To resolve the issue Gouverneur Morris proposed to merge this issue with the two other contested proposals presented by the Committee's drat constitution: on a requirement of two-thirds majority for the commercial regulation in both houses and the ban on taxing exports, to be sent back to the Committee and be negotiated as a package. As Morris envisioned: 'these things may form a bargain among the Northern & Southern States' (citation from Edling 2014: 39–40). Indeed, it only took two days for the Committee members to struck a bargain: the ban on taxing exports prevailed, but the requirement of a two-thirds commercial regulation was struck out (a concession for the North), and the Congress was allowed to legislate on the slave trade, including taxes on imported slaves, after 1800 (later, it was changed for 1808, and a limit of 10 dollars per slave was introduced for import duties).

Another example on how this fiscal bargain came about was the direct tax clause. Here, it was connected with representation – any direct taxes would have to be appropriated among the states based on their population, where slaves would be counted as three-fifths of a person. The same principle would be applied in counting the number of representatives from each state in the House of Representatives. As a result, the compromise between the two distinct groups of states was found and a fiscal bargain was struck (Edling 2014: 38–41).

A detailed analysis of the arguments surrounding perhaps the most controversial clause of the Constitution – the federal power to tax – and which were used during the ratification process is beyond the scope of this paper (see however: Woźniakowski 2017). It is, nevertheless, worth noticing that there was such an agreement among the élite of the US about the need for a federal power to tax, that even the Anti-Federalists, who were opposed to the new Constitution, supported it. For instance, Brutus, one of the main Anti-Federalists, believed that this mode of taxation would be safe because by its nature it placed a limit on the degree of burden that could be imposed (otherwise, smuggling or a decline in tax revenues would ensue).[15] Einhorn (2006: 149) has indeed shown that the tariff was widely seen as an appropriate tax for federal government.

To sum up, the sovereign debt crisis during the post-war economic recession in the mid-1780s was one of the main reasons behind the drafting of the Constitution and it was the single-most important cause of the federal power to tax clause. The social unrest in form of the tax protests of 1786–1787 constituted an internal threat for the new union. As Maier points out, '(p)opular unrest in the fall and winter of 1786–1787 brought those fears [of a dissolution of the democratic union] to a peak' (2010: 15). Indeed, the élite, including George Washington and Alexander Hamilton, feared that people would turn away from such a union if it only seemed to bring them economic hardship. This fear over protests united the élite who formed a coalition in favour of a strong federal government: 'the movement for constitutional revision derived much of its impetus from conservative fear of social radicalism' (Ferguson 1961: 337). The federal tax power was viewed as the most important mean of preventing such crises from threatening the existence of the union in the future, because of a less intrusive nature of a federal tariff, as opposed to the direct taxation used by the states.

4. Conclusions or insights for the EU

I have shown that in a classical fiscal union such as the US, the federal government has fiscal capacity, but it does not have the power to regulate the fiscal policies of the states. In the EU, we can observe the reverse situation: the EU budget is small (about 1 per cent of the EU GDP) and it relies almost exclusively on contributions from the member states, but the European institutions in the last few years have acquired a good deal of power to regulate national fiscal policies, but no fiscal power as such. Paradoxically, by not agreeing to give the EU fiscal power so that they could protect their fiscal sovereignty, member states gave up more of this very fiscal sovereignty to the central institutions, than states in classical federations, for example in the US. As a result, a Euro Area country that is hit by an asymmetric economic shock is not only deprived of using an exchange rates policy, but, in addition, it cannot boost its economy by public spending, because it is legally obliged to keep its deficit low. And because there is no European fiscal power – there are no automatic financial transfers from the European budget that could help to absorb such shocks.

Both the US in the 1780s and the EU in the 2010s experienced a sovereign debt crisis in their member states. I believe that there are four lessons or insights that the EU as a whole, and the Euro Area in particular, can learn from the US experience of resolving this crisis by the creation of a federal fiscal union. First, paradoxically, fiscalization tends to be proceeded by a sovereign debt crisis. Second, fiscalization can trigger the democratization of central institutions. Third, any proposed fiscal union should be proceeded by a wide debate, involving the citizens of the member states. Finally, the main opponents of fiscalization should be offered clear benefits that will result from giving up some of their tax power. I elaborate on those insights below.

(1) Paradoxically, fiscalization tends to be proceeded by a sovereign debt crisis. If states are the only bodies with the power to tax, they will end up paying for polices which should be (or are) allocated at the central level, such as defence or bailouts of large banks, and as a consequence, they can run up huge debts. As a result, the states impose high tax burdens on their citizens (or cut spending) to pay off those debts. The high tax burdens can lead to tax protests (such as the Shays's Rebellion in Massachusetts in 1786/87). If present (or perceived as a threat) in a majority of the states, this kind of social unrest can threaten the very existence of the union. One solution to such a crisis may be the creation of a more 'energetic' union, with fiscal capacity, which could be used to provide union-wide public goods, such as common defence.
(2) Fiscalization can trigger the democratization of central institutions – in line with the rule 'no taxation without representation'. If such wide power is given to the central government, this government must be reformed so that it represents both the people (in the US this is done through the House of Representatives) and the states (through the Senate), and different branches of federal government can check and balance each other, so that the power to tax is not used excessively. In the case of the EU, it may well be that solving its fiscal deficit (i.e., a lack of tax power) will ease its democratic deficit, when the European Parliament will be given the power to tax and so the principle 'no representation without taxation' will be addressed.
(3) Any proposed fiscal union should be proceeded by a wide debate, involving the citizens of the member states. The people of the union must agree on such a measure and arguments for and against a federal tax power should be presented, as they were during the great debate on the ratification of the US constitution in 1787 and 1788. Today, the European-level regulation of national fiscal policies creates a great deal of hostility towards the EU institutions among the peoples of Europe. By contrast, the use of fiscal capacity could enable the citizens to see the benefits of the EU once again. For instance, by using a tax that could

be only effectively levied at the EU level, such as financial transaction tax, which will not increase tax burden of the average citizen and may in fact reduce it – if the EU will manage to raise enough revenues and then use it to pay for expenditures that currently the member states have to pay for, like unemployment fund or common defence. A similar mechanism was at play in the US, when the federal government, once given the power to tax, raised six times more revenues than the states (see Table 1).

(4) The main opponents of fiscalization should be offered clear benefits that will result from giving up some of their tax power. That was the case with New York, which had the most to lose from fiscalization, but at the same time was most exposed to the danger of invasion and thus saw benefits from federal government taking over the military expenses. In the case of the EU, those most critical towards fiscal union, should see that, in the end, the benefits resulting from the fiscalization of the EU might exceed its costs.

In an attempt to tackle the threat to the union, which a sovereign debt crisis constitutes, the US in the 1780s and the EU in the 2010s opted for two fundamentally different approaches. The US went for the fiscalization of the federal government, in which the new Constitution granted central government the power to tax. A sovereign debt crisis at the state level was the single-most important reason for this. The EU, on the other hand, followed the paradigm of regulation of the fiscal policies of its member states. However, this paradigm may change, as we observe a growing number of reports and proposals calling for an adjustment in the way that the EU is responding to the Euro crisis, and, ultimately, to use Jean Monnet's famous formulation,[16] for an adjustment to the form that Europe will take, as it will be forged as the result of this response.[17] In fact, the voluntary and unilateral Brexit gave a further impetus to such proposals.[18] It remains to be seen, however, if it will have similar consequences for the EU, as the forced British exit from America had on the future of the US two centuries ago.

Notes

1. 'New York Ratifying Convention. Remarks, 20 June 1788', PAH V: 19.
2. See Tortola (2014), for an overview of this literature.
3. For instance Fuest and Peichl (2012) provide five different elements of a fiscal union - it is sometimes difficult to know which elements or definitions scholars use when they write about a 'fiscal union' or 'fiscal integration' (see e.g. Daniele and Geys 2015).
4. See, however, Steinbach (2015) for an analysis of the pre-Constitution events related to the mutualization of sovereign debt.
5. I am grateful to Max Edling for this suggestion.
6. For the history of this rebellion see Richards (2002).

7. In total borrowed funds covered 33 per cent of the total cost of war, while fiat (paper) currency - 67 per cent (28 per cent in Congressional monies, and 39 per cent in States' monies), Perkins (1994: 103): table 5.4.
8. '[It] is known that the State taxes have generally been very inconsiderable' as Secretary of the Treasury Oliver Wolcott declared in 1796 (citation from Edling 2014: 52).
9. 'To George Washington from John Jay, 27 June 1786', PGWCS IV: 130–132.
10. 'From George Washington to Henry Knox, 26 December 1786', PGWCS IV: 481–484.
11. See Maier (2010: 11–26), where she provides excellent analysis of the letters Washington was receiving about the popular unrest from John Jay, James Madison and Henry Knox, among others, which confirmed his fears that the union is on a brink of collapse.
12. 'The Federalist No. 33', PAH IV: 466.
13. 'The Federalist No. 21', PAH IV: 397–398.
14. For instance, when Edmund Randolph presented the Virginia Plan, which opened up the Convention, he started with the analysis of the situation of the Union. Four out of six problems he identified concerned revenue: 'inefficiency of requisitions'; 'rebellion (…) as in Massts.' led by Daniel Shays; urgency of foreign debt; and 'the havoc of paper money' (RFC, I: 18–19).
15. 'first includes impost duties on all imported goods; this species of taxes it is proper should be laid by the general government; many reasons might be urged to shew that no danger is to be apprehended from their exercise of it. They may be collected in few places, and from few hands with certainty and expedition. But few officers are necessary to be imployed in collecting them, and there is no danger of oppression in laying them, because, if they are laid higher than trade will bear, the merchants will cease importing, or smuggle their goods. We have therefore sufficient security, arising from the nature of the thing, against burdensome, and intolerable impositions from this kind of tax', Brutus V, New York Journal, 13 December 1787, DHRC XIX: 415.
16. 'Europe will be forged in crises, and will be the sum of the solutions adopted for those crises'
17. See for instance: Macron and Gabriel (2015), where French Economy Minister and German Vice-Chancellor called for the creation of a Eurozone budget with the tax and borrowing powers.
18. See, for instance, a common statement of French and German foreign ministers issued few days after the referendum when the UK voted to leave the EU, where they called for establishing fiscal union by 2018: 'these [fiscal] capabilities should start by 2018 at the latest to support investment in the member states most severely hit by the crisis' (Ayrault and Steinmeier 2016: 9). Most recently, the High Level Group on Own Resources, composed of members appointed by the European Council, the Commission and the Parliament, in its final report emphasized that 'the withdrawal of the UK from the EU and the discontinuation of the 'British rebate' (…) provide a unique window of opportunity to review how we measure the real costs and benefits of the EU' (Monti *et al.* 2016: 7).

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Abbreviations

DHCR	Kaminski, J. P. *et al.* (eds) (1976-), *The Documentary History of the Ratification of the Constitution*. Madison, Wisconsin.
PAH	Syrett, H. C. (ed.) (2011), *The Papers of Alexander Hamilton: Digital Edition*, Vol. IV-V, Charlottesville: University of Virginia Press.
PGWCS	Abbot, W. W. (ed.) (1995), *The Papers of George Washington*: *Confederation Series*, Vol. II-IV, Charlottesville: University of Virginia Press.
RFC	Max Farrand (ed.) (1911), *The Records of the Federal Convention of 1787*, Vol. I-IV, New Haven: Yale University Press