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Interdisciplinary Conference: "Governing Europe in Times of Crisis"

Evolutionary Integration

A Future Approach to Governing Europe

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■ Categories

» **Type 1: Information sharing**

Communication, peer reviewing, and best-practice exchange

» **Type 2: Contingent policy making**

Decision in country A made dependent ex ante on decisions abroad

» **Type 3: Harmonization**

Similar policies in all Member States

» **Type 4: Centralization**

Shifting competences from the national level to EMU institutions

■ Enforcement

» **Soft:** Non-binding nature, based on insight and consensus finding

» **Strict:** Rule-based mechanisms with automatic legal sanctions

⇒ **Subsidiarity principle (Art. 5 TEU)**

Subsidiarity vs. policy coordination

- Incentive structure
- Availability of information
- Access to adequate instruments
- Democratic legitimacy

Subsidiarity → Diversity
(strength, not weakness)

Room for **learning and pioneering**
(strong case for peer-reviewing)

Integration is not an end in itself, ...
... but comes at extra **governance cost**

- ⇒ **Identification of common interests:
E(M)U-specific public goods**
- ⇒ **Systemic negative spillovers,
not pecuniary „external“ effects**
- ⇒ **EMU: Primacy of financial stability
(robustness of the monetary system)**

- Centralization/harmonizing: “More Europe”
 - » Scaling national competencies to EU level
 - » Promoting “European identity”
 - Vertical approach

- Decentralization/renationalizing: “Less Europe”
 - » National sovereignty/subsidiarity
 - » Competition among nation states via migration
 - Horizontal approach

- ⇒ **Dominance of the nation state model**
 - » Power politics/block building/mercantilism/macro-management
 - » Appeal to atavistic instincts (solidarity, national/European interests)
 - » Institutional framework linked to economic area

Crisis as an integration booster?

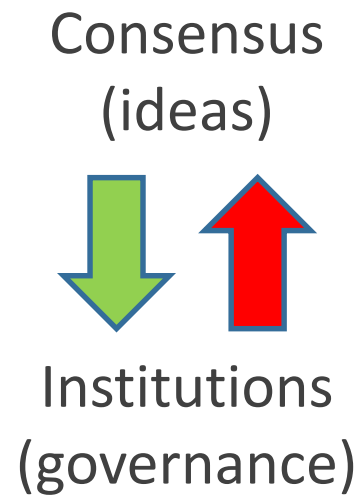
- Maastricht Treaty (February 1992)
- Stability and Growth Pact (July 1997), Reform (March 2005)
- Growth Strategy “Europe 2020” (June 2010)
- EFSF (June 2010)
- European Semester (September 2010)
- Euro-Plus-Pact (March 2011)
- Six-Pack (December 2011)
- Fiscal Compact (March 2012)
- ESM (October 2012)
- Two-Pack (Mai 2013)
- ...

Too many packs: Risk of overloading



Source: FAZ, 26th October 2011, p. 11

The core problem: Lack of consensus



Case study Euro Area

Stuck in the middle: The worst place to be



- Maastricht 2.0
 - » Rules
 - » No bail-out
 - » Fiscal discipline via capital markets
 - » Decentral macro stabilization by solvent member states
 - » No monetary government financing, hard currency
 - ⇒ **Diversity, competition**
- Fiscal/transfer union
 - » Discretion
 - » Mutualized debt
 - » Conditionality of fiscal support
 - » Macro stabilization on EMU level
 - » Monetary government financing, soft currency
 - ⇒ **Harmonization, deepening**

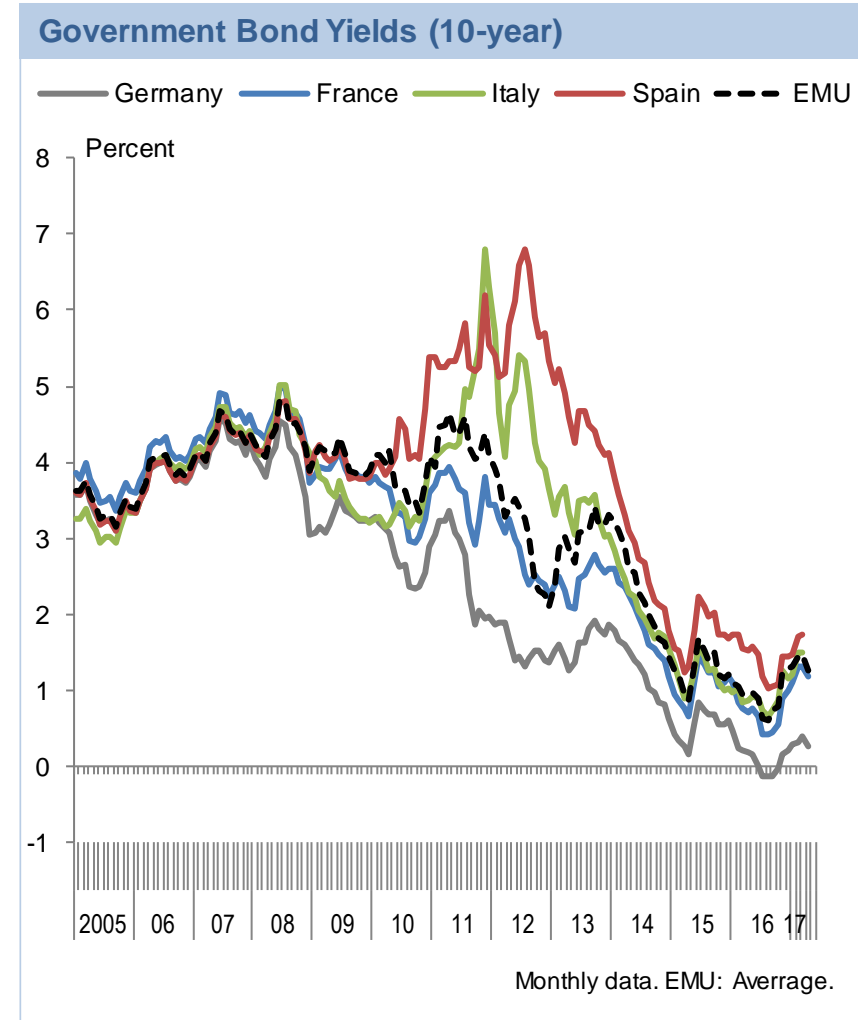
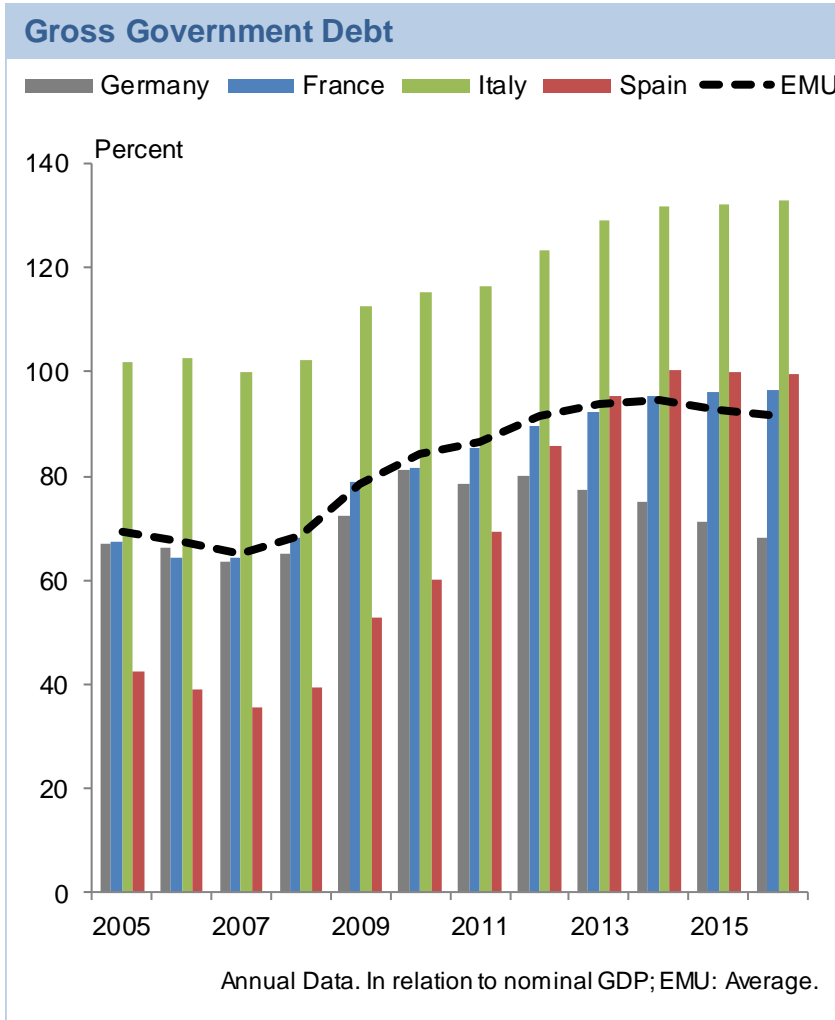
*Critical
rationalism*

*Rationalistic
constructivism*

The myth of conditionality (bail-outs vs. structural reforms)

Key insight for successful reform processes:
Ownership matters.

Historically high public debt levels, historically low government financing cost



Data source: Eurostat, European Commission.

Buying time did not work

Low refinancing cost:
Consolidation and reform efforts wane.

Diagnostic failure: Predominance of macro-management thinking

- Shock absorption
- Risk sharing
- Mobilizing fiscal space
- ...

⇒ EMU-budget

- » Expenditure-side (EMU-specific collective goods)?
- » Cyclical vs. structural problems?

Interest rates ...

- ... just another instrument for macro-management?
 - ... or the key price relation within the market system?
 - » Time preference
 - » Coordinating savings and investment
 - » Component of all prices for goods and services (relative prices)
 - » Impact on capital/production structure
- ⇒ **„Capital gives money time to cause trouble.“ (Garrison)**

- **Idiosyncratic: Entrepreneurial ventures**
 - » Wrong expectations of one market participant
 - » Happens every day, no systemic risk
 - » Liquidation, reallocation of resources

- **Pervasive: Expansionary monetary policy**
 - » Systematically wrong expectations of all market participants
 - » Financial crisis (debt crisis = flip-side of heavy capital stock distortion)
 - Fragile financial system
 - Excess debt positions destabilize monetary system

Three options of coping with debt-crises

■ Public bail-outs

- » Shifts private debt to public sector
- » Private debt crisis \Rightarrow sovereign debt crisis
- » No solution for fiscally distressed countries

■ Inflating the debt away

- » Takes a long time, promotes zombification
- » Puts the currency at risk
- » Not targeted towards non-performing loans

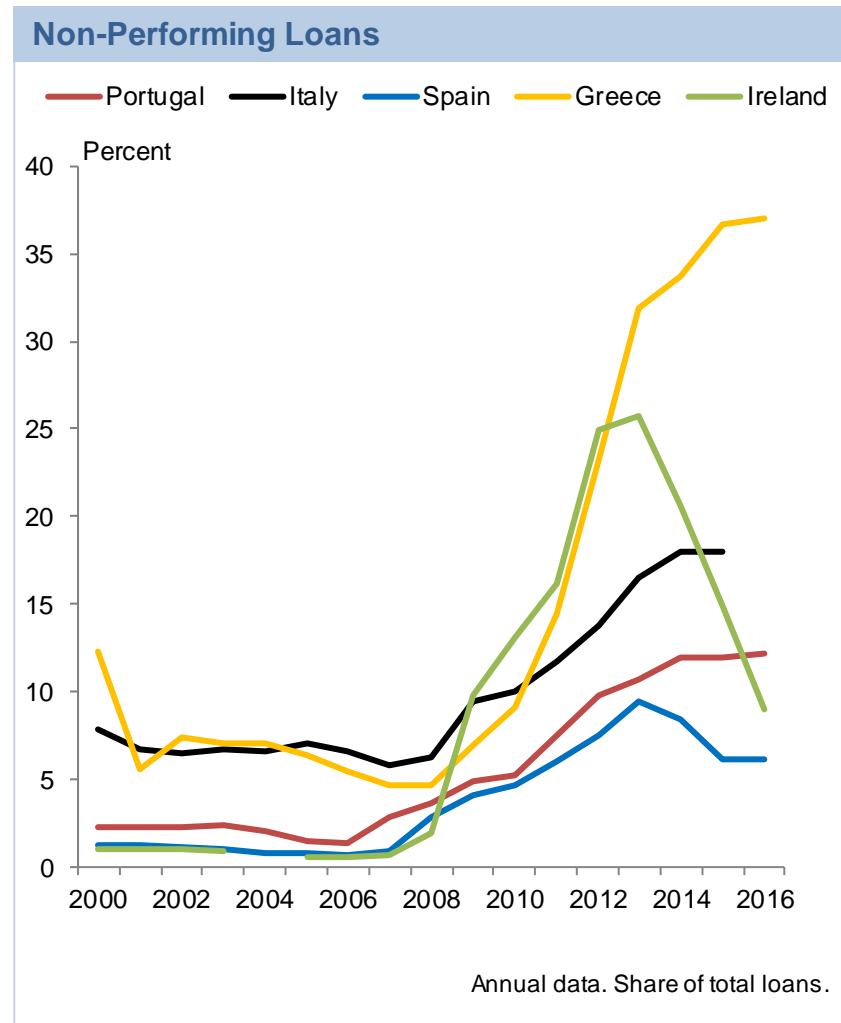
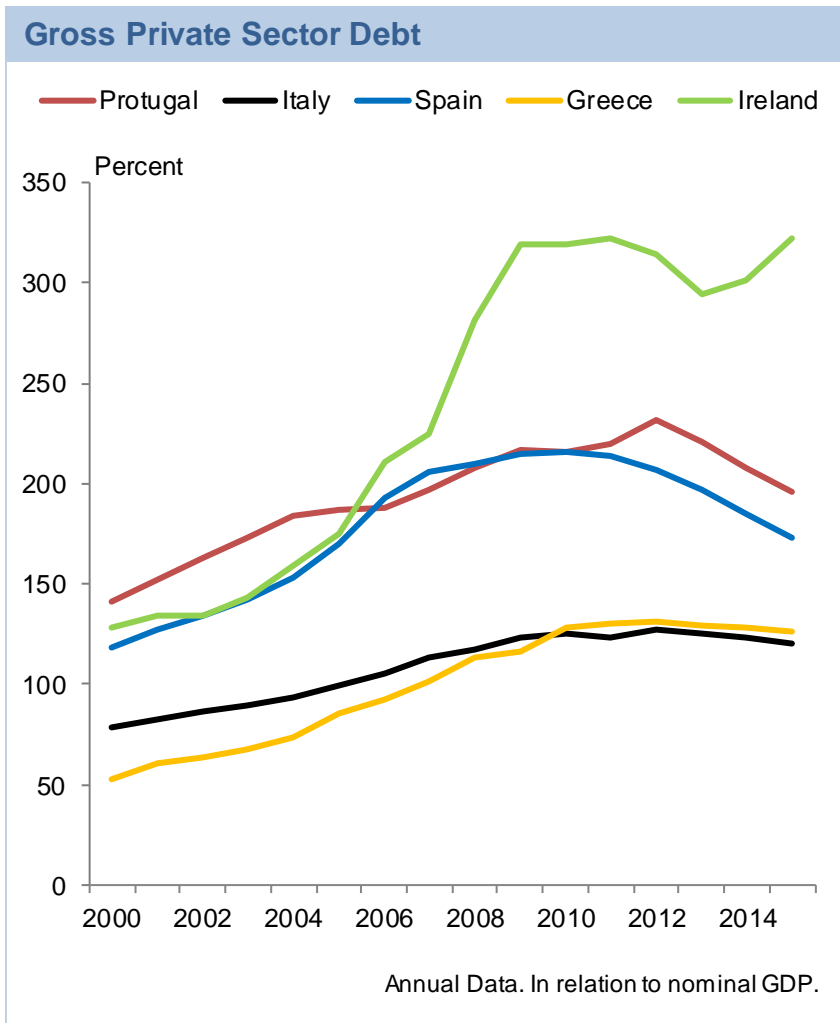
■ Liquidation

- » Tough (cold turkey) in the short-run ...
- » ... but targeted (and root cause oriented)
- » Puts capital at second (now first) best use

**Anti-capitalist
approach**
(harms principle of
accountability,
creates moral
hazard risks)

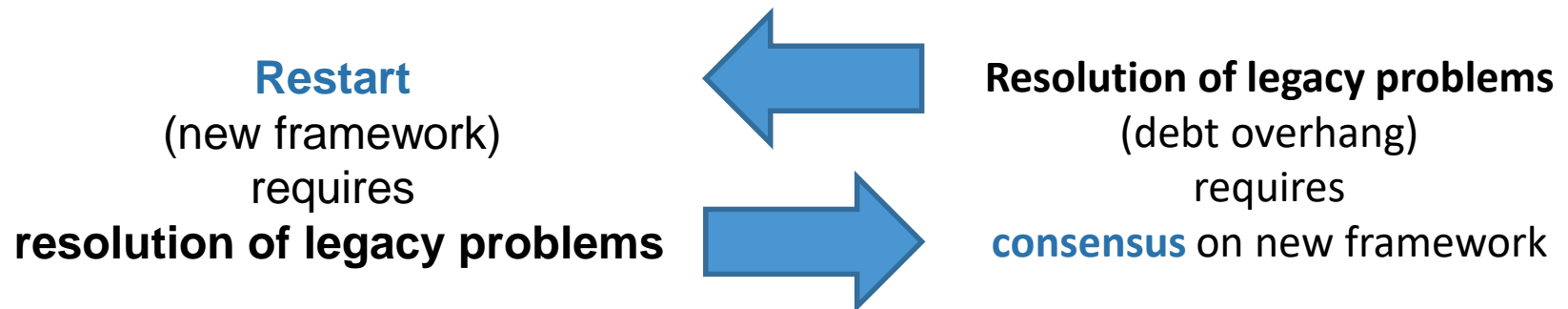
**Capitalist
approach**
(in line with free
market principles)

Flip-side of not liquidating (= “buying time”): High debt positions hamper credit channel



Data source: Bank for International Settlements, World Bank.

Hard to solve: The Legacy-restart-nexus



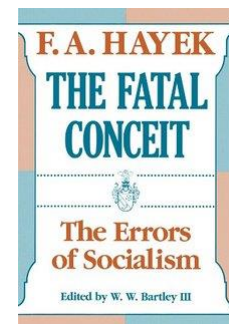
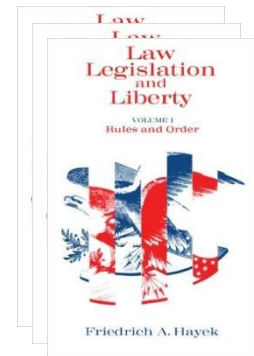
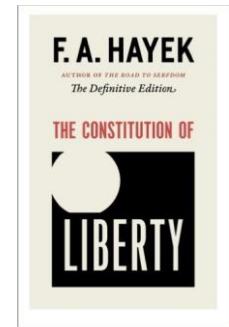
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- De-nationalized subsidiarity: “Endogenous Europe”
 - » EU as pioneer of evolutionary institutional area
 - » Free choice of legal system for civil contracts
 - » Transformation of social security systems to transnational associations (insurance principle)
- Diagonal approach
- ⇒ **Not people migrate to institutions,
but institutions come to people**

- **The Constitution of Liberty (1959)**
- **Law, Legislation and Liberty (1973/1976/1977)**
A New Statement of the Liberal Principles of Justice and Political Economy
- **The Fatal Conceit (1988)**
The Errors of Socialism



7,320,000,000 people

Spontaneous (= evolutionary) order

“Social structures of all kinds
were the result of human action,
but not the execution of any human design.”

Adam Ferguson (1782)

Instincts vs. extended order

■ Atavistic instincts

- » Solidarity, altruism
- » Aggression against outsiders
- ⇒ **Stabilizing small groups (families, tribes, clubs)**

■ Extended order

- » Contracts, exchange, money
- » Trust, reputation
- » Competition
- » Non-aggression, openness, voluntary cooperation
- ⇒ **Enabling anonymous societies**

⇒ **Efficiency** = Use of dispersed knowledge

⇒ **Fairness** = Supremacy of abstract rules

Mercantilist atavism: „Buy German“



Two types of rationalism

- Constructivist (naive) rationalism
 - » Descartes/Hobbes/Rousseau/Comte
 - » Legal positivism
 - » Scientism, utilitarianism

- Evolutionary (critical) rationalism
 - » Hume/Smith/Kant/Popper
 - » Limited knowledge of complex systems
 - » Human action
 - Means-end-calculus
 - (Implicit) rules (customs and traditions, social conventions, ...)
 - Learning (trial-and-error)

- ... is
 - » Success of passed on rules
 - » Selection via learning/adapting
 - » Freedom-dependent and an open-end process (value-neutral)

- ... is not
 - » Pursuit of desirable common goals
 - » “Social Darwinism”
 - » Laws of historic development (Comte/Hegel/Marx)

- „Tradition is not something constant but the product of a process of selection guided not by reason but by success. It changes but can rarely be deliberately changed. Cultural selection is not a rational process; it is not guided by but it creates reason. (...) **There is thus certainly room for improvement, but we cannot redesign but only further evolve what we do not fully comprehend.**”

Friedrich A. v. Hayek (1982)

European crisis due to lack of democracy?

Procedural rule about “how”,
not “if” collectivist decisions are to be taken

Majority consent needed?



- Pioneers of European integration
 - » Overcoming borders for human interaction
 - » Preserving (national) diversity

 - Institutions follow from consensus, not the other way around
 - » Institutions as result (short-cut), not driver of social evolution
 - » Missing (monetary) consensus as core problem of the EMU

 - Small groups vs. anonymous societies
 - » National/European “solidarity” is a myth
 - » Prevalence of abstract rules, lack of democracy not the key problem
- ⇒ **Diagonal Europe:**
Transnational competition as a discovery procedure

- “The ultimate yardstick of justice is conduciveness to the preservation of social co-operation. Conduct suited to preserve social co-operation is just, conduct detrimental to the preservation of society is unjust. There cannot be any question of organizing society according to the postulate of an arbitrary preconceived idea of justice. The problem is to organize society for the best possible realization of those ends which men want to attain by social co-operation. Social utility is the only standard of justice. It is the sole guide of legislation.”

Ludwig v. Mises (1957)

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