

# **Whither the EU?**

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## ***An Evolutionary Perspective: Places that Fail***

- institutions driven by survival in competition with other societies
- warfare: absent outside interference somebody eventually gets lucky and wins
- China: hegemony
- Europe: Britain siding with the weak
- places fail because too many bad things happen at once
- strong institutions can withstand many shocks
- the role of groups is crucial

## ***Consequences of Failure***

- costs of failure plays an important role in the literature on bankruptcy
- Weiss [1990] direct costs about 3% of book value of debt; Warner [1977] direct costs about 1% of value prior to bankruptcy
- Nikolaos et al [2014] about 2% annual excess deaths in Greece due to crisis
- Syria, French and Russian revolutions?

## ***What Happens After Failure?***

- Russia

Imperial → Revolution → Communist; welfare comparison of imperial versus communist Russia?

- Rhodesia/Zimbabwe

white rule → civil war → majority rule; low welfare became even lower welfare

- El Salvador

dictatorship → civil war → democracy; welfare probably improved

- United States

British rule → war → domestic rule; resulted in very strong institutions

## ***Causes of Failure***

- proximate cause: war or revolution
- unexpected example: unification of Germany in 19th Century  
driven by revolution of 1848
- underlying causes?
  - weak institutions (almost by definition)
  - outside intervention (Ukraine...)
  - recession
  - debt (French revolution; Argentina; Greece)

## ***Sources of Failure***

- secular decline (Olson)  
cumulation of small defects  
in Olson – interest groups that eventually strangle the economy
- bad luck (evolutionary)  
bad coincidences  
economy weak; opponents especially well organized; unusual weakness of government; disease
- evidence?  
Olson gives some, but in fact interest groups seem to wax and wane

## ***Decline of the Roman Empire***

- Germans
- recession
- disease

as many theories as there are historians

yet each one of these things and several in combination happened many times during the course of the Empire and it recovered

historians always talk about how the “real decline” started at such and such a date, then there is some false period of prosperity before things really go to hell

- looks a lot more like these “causes” wax and wane until too many things go wrong at once

## *The Theory and the EU*

- the basic theory says “strong state institutions live long and prosper, weak ones do not”
- the EU has particularly weak state institutions
  - weak governance (high degree of consensus among member states required)
  - limited (but not non-existent) ability to force compliance of member states
  - no direct tax authority
  - no police or military
  - no common language or education



## ***The Political Problem of EU Institutions***

the voters and politicians of every member state view the EU as a menu of options

- free trade
- free movement of labor
- agricultural subsidies
- development funds
- member state contributions to the EU
- bank guarantees

each would like to be free to select from the menu of options

“we'll have free trade, no banking regulation, development funds, no contributions, our citizens can move freely, but other eu citizens are not welcome here, we want deposit insurance but can't be bothered to pass the enabling legislation...”

## ***The Contradictions of Schengen***

- border free movement for citizens but not (some) non-citizens
- non-citizens have no rights in Schengen only in the host state
- but the EU has no control over citizenship which is decided entirely by the host state
- like the fiscal problem one day it doesn't matter until one day it does

## *The Game of Democracy*

- as part of the monetary union the EU as a collective guaranteed the debt of member states
- creates the same problem as guaranteeing bank debt
- Brazil had the same problem – provincial governments set spending and the Federal government was responsible for the resulting debts
- the US does it the opposite way: states are responsible for their own debts and do not get bailed out by the Federal government
- the EU recognized the problem and imposed limits on budget deficits

## *The Game of Democracy: Who Won in Greece?*

primary surplus (from the ECB)

2014	0.352
2013	-8.344
2012	-3.670
2011	-2.962
2010	-5.253
2009	-10.270
2008	-4.978
2007	-2.156
2006	-1.63

as soon as the time to repay came the government that made the agreement was thrown out of office and replaced with a government that refused to repay

when the city of Detroit in the U.S. went bankrupt it didn't paralyze the political system in the U.S. for months on end – and nobody suggested that the solution was for Detroit to issue its own currency

## ***The Raw Power of the EU***

- no Army, no police, no tax collectors
- brought Greece to its knees by closing the banks
- not many people realized that the monetary union was a deal with the devil
- removed a democratically elected prime minister (Berlusconi) and replaced him with their own man (Mario Monti)
- also by threat of financial ruin
- to my knowledge (since the end of reconstruction in 1877) the Federal Government of the United States has never removed the Governor of a State and replaced him with their own choice

## ***The Political Institutions***

the EU isn't a state and nobody wants it to be  
people view themselves as “Italian, German, French” not as “European”  
voters generally like the current system and do not want stronger  
central authority

but the system is not stable

- members states discontent with their menu have referendums on whether to stay
- the recent parliamentary election was supposed to help
- European commission President is now elected through parliament

but Greece, immigration all dealt with the group of heads of state with the commission and parliament playing essentially no role

## ***Social Solidarity***

- social solidarity of groups isn't something “mainstream” economics has traditionally dealt with
- historically (see Marx) when economics has dealt with groups it hasn't done an especially good job
- difference between the strategic and non-strategic aspects of group behavior
- social interaction within many groups occur because of the nature of economic activity in these groups, because of commonality of knowledge and interest, exchange of ideas and learning, and so forth

## *Groups and Approval*

group members seek approval from other group members

approval isn't so different from other economic commodities - people like to talk, share ideas, be approved of, tell stories, hang-out etc.

- can be traded in markets or through barter
- we have measurements: value of cell phone bandwidth and television bandwidth
- obviously some people are more valuable to you than others (extreme example: people who don't speak a language you know are pretty useless to you)



## ***Challenges of Social Solidarity***

- a puzzle: the tax system does not transfer that much income
- we tax the middle class and pay the same people back with government services and subsidies
- good example: Sweden – child care, health care, transportation, etc. etc.
- economists look and see inefficiency
- but this type of government behavior is ubiquitous
- so maybe we should look deeper?
- taxes are hard to avoid or use punitively
- benefits can be selectively withheld – hence used to induce “socially desirable” behavior

## ***Rent Seeking and Interest Groups***

- social solidarity or self-serving?
- Telecom Italia
- the Spanish shouldn't own it because it poses a national security threat?
- rightly dismissed as silly and self-serving
- but the logic of the argument should not be thrown out
- familiar argument: subsidize the automobile industry to have excess capacity in case we need to build tanks (also aerospace, merchant marine)
- just because an argument is self-serving and benefits a particular group does not make it wrong
- or right

## ***Groups and Polarization***

- tipping point of polarization - people forced to choose sides (Iraq)
- leads to conflict and chaos; prevents economic progress by keeping people from forming economic alliances
- strong central authority keeps this in check (looks what happens when the strong central authority collapses - India, Africa, Yugoslavia, etc.)
- yet if there is too little polarization it is a threat to the central authority (dictators in particular often encourage a moderate amount of polarization) - play both ends against the middle, divide and conquer
- some benefit from polarization
  - so: how do we prevent monopolization and prevent conflict?

## *Wither the EU?*

- either the institutions will become stronger or the EU will fail
- every member state (UK, Switzerland currently) wants to pick among a menu of options rather than accept the package
- all of the weaker economies would like to be able to undertake borrowing guaranteed by the stronger economies (“end of austerity!!”)
- the point is that no member state wants the entire package and unless they are forced to comply, if each chooses a different set of menu options there is no “EU”
- the one simple and low-cost thing the EU could do but doubtless will not:
  - make English the official second language and subsidize English language and European indoctrination in the schools