

The Political Economy of Institutional Integration

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There is currently a lively debate on **Europe's institutional integration**

- The current financial, economic, and political crisis in the Euro Area has refocused attention on the goals and limitations of **European institutional integration**
- Critics argue that European institutional integration has gone too far and that the euro has failed (e.g., Feldstein 2012)
- Supporters attribute the crisis to incompleteness (a “half-built house”, Bergsten 2011), and ask for more integration (banking union, fiscal union, full political union, United States of Europe?)

...and there is an equally lively debate – connected with the EU debate - on the **institutional integration or disintegration of European states**

- On Sept. 18 Scotland voted 55%-45% *not* to become an independent country, after promises of major institutional reorganization within the UK. Relation between Scotland/UK and EU have played a central role in that debate.
- Catalonia may or may not vote on independence in the near future (without the approval of Spain's central government). Catalonia's relation with EU again a central issue.
- Relation with EU also at the center of the current crisis between Russia and the Ukraine over sovereignty and national borders.

Goals of this talk

- Present and discuss a few key ideas and open questions about the political economy of institutional integration
- Focus on the implications for Europe

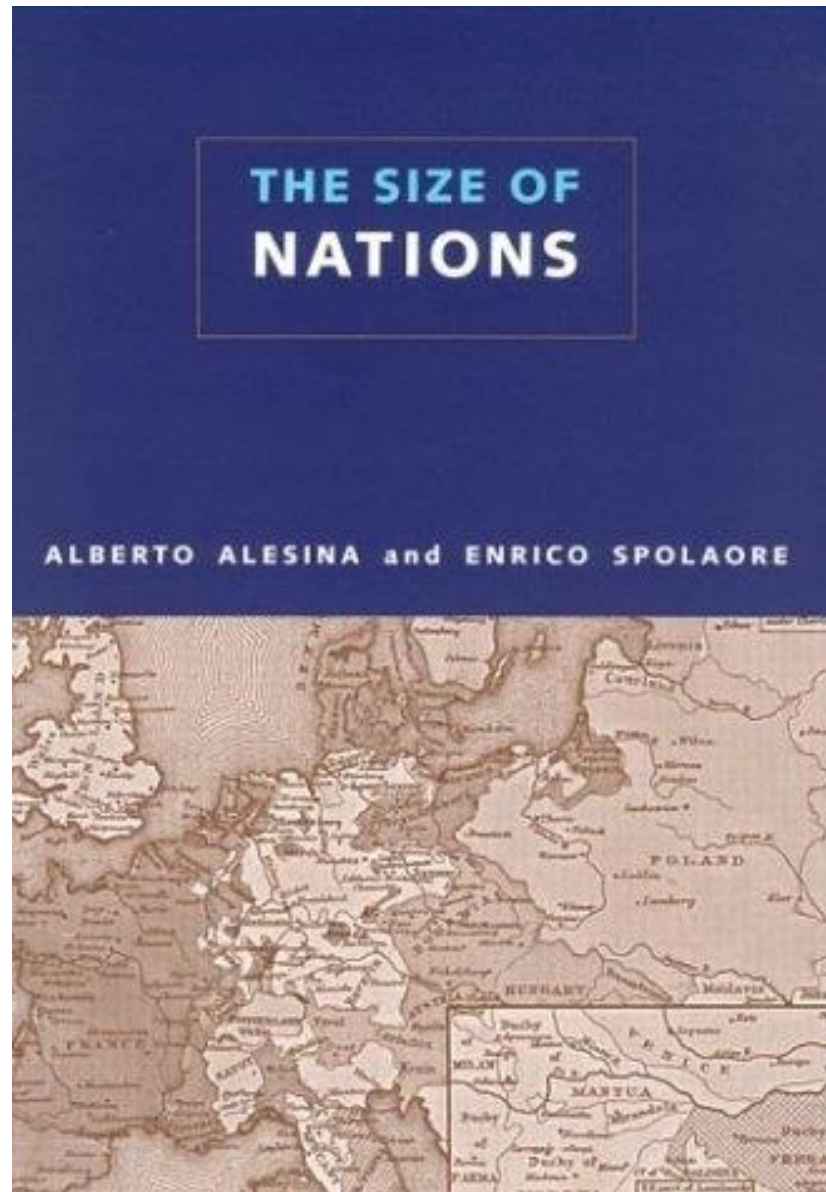
Main References

“What is European Integration Really About? A Political Guide for Economists” published in the *Journal of Economic Perspectives*, Summer 2013

“The Political Economy of European Integration” for the *Handbook of the Economics of European Integration*, edited by Harald Badinger and Volker Nitsch, to be published by Routledge.

“The Economics of Political Borders” for the *Handbook on the Economics of Public International Law*, edited by Eugene Kontorovich, to be published by Edward Edgar.

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A Key Trade-off

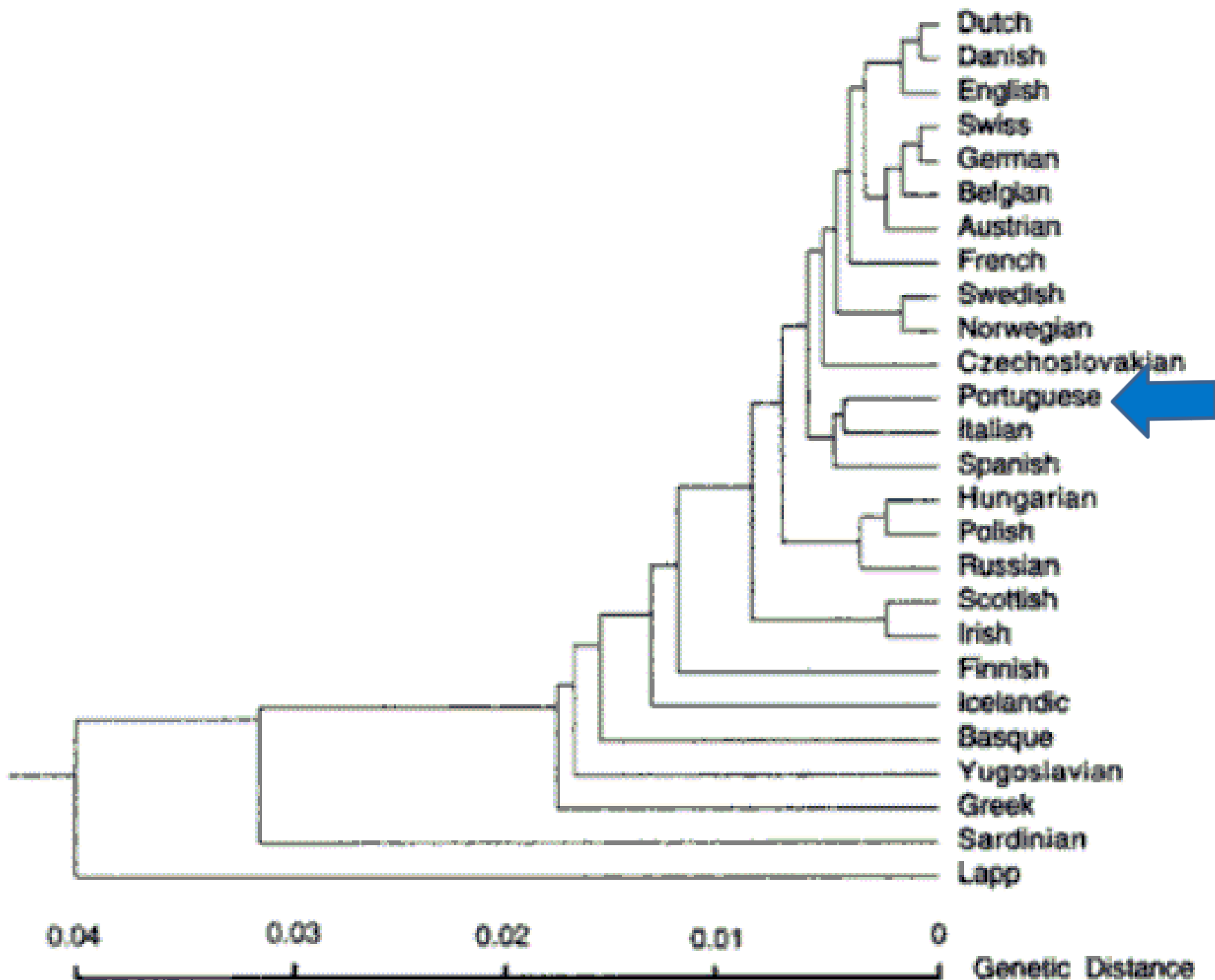
- Public goods (legal systems, defense and security, common currency) come with **economies of scale** (benefits from a larger size)
- but those benefits must be traded against the **costs of heterogeneity** (different preferences for public policies in larger, more diverse populations)

Costs and Benefits from Heterogeneity

- Large literature showing that ethnic and linguistic diversity affects the provision of **public goods** - which are **non-rival** and must be shared within a jurisdiction whether one likes them or not.
- E.g., Desmet, Ortuño-Ortín, and Wacziarg (2012) find that deep linguistic distances are good predictors of **civil conflict**, while even finer distinctions between languages matter for **economic growth** and **public goods provision**.
- In contrast, diversity comes with **benefits** when dealing with **rival** goods (trade, conflict across borders – Spolaore and Wacziarg, 2013).

How to measure heterogeneity within and across populations?

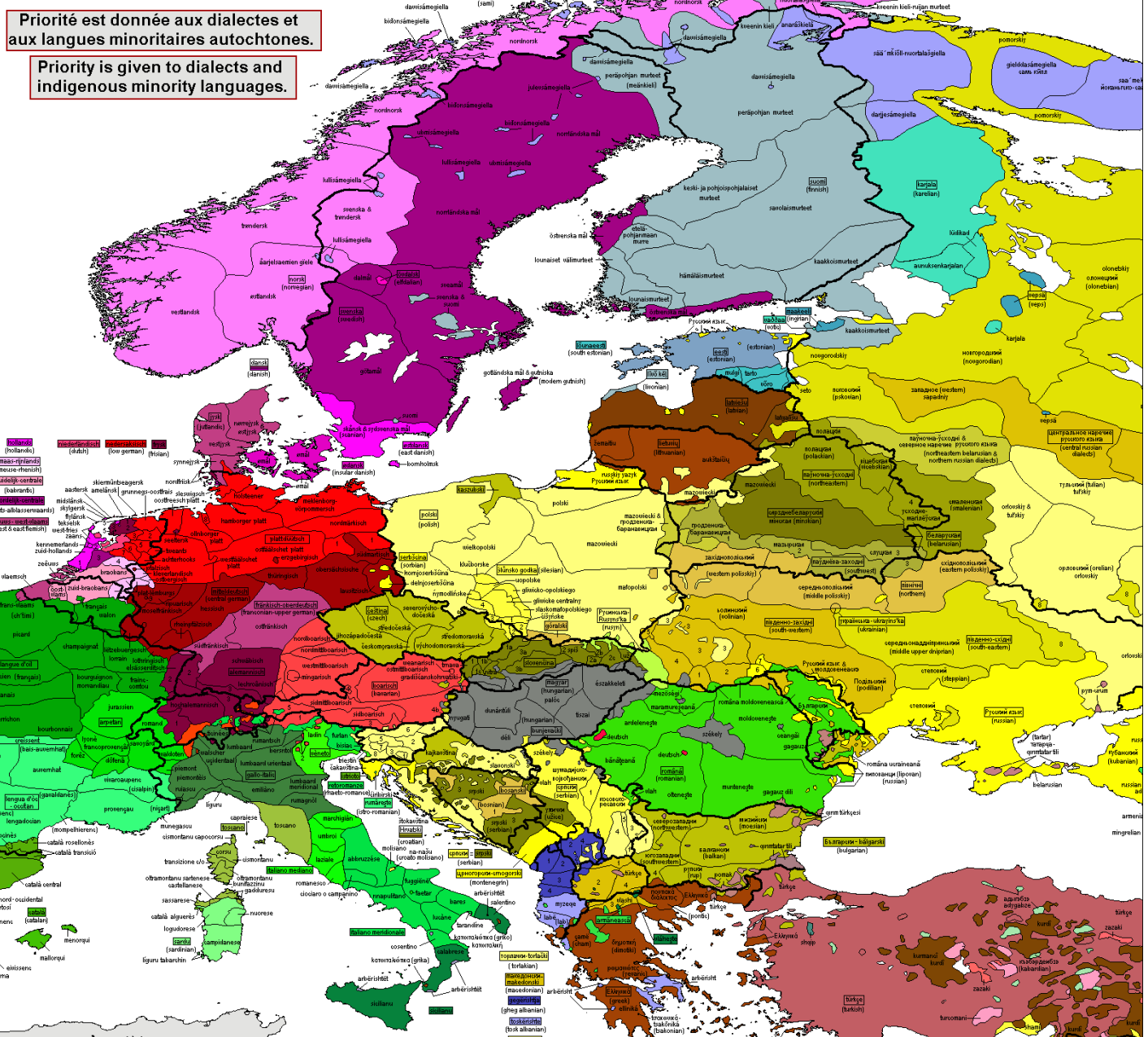
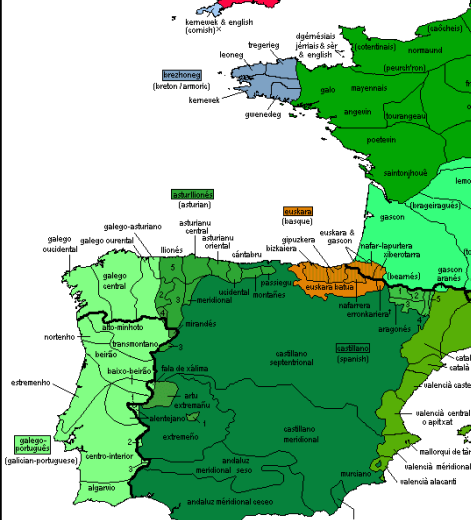
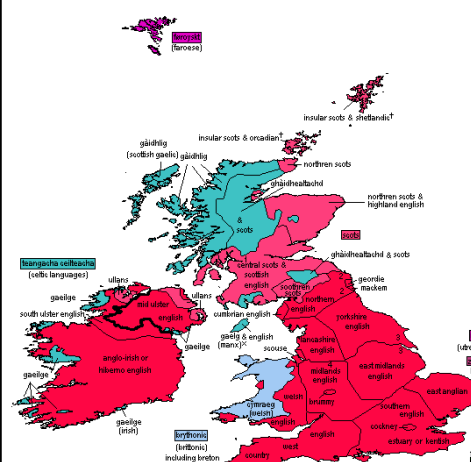
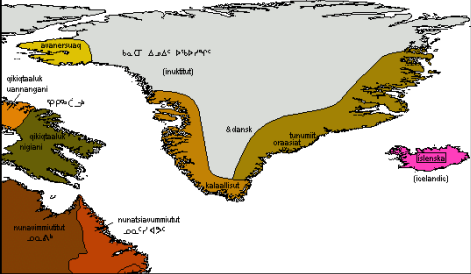
- Traditional measures - e.g., ethnolinguistic factionalization and polarization – are useful, but incomplete and problematic
- Newer approach: phylogenetic trees based on long-term **history of populations** - e.g., based on **genetic distance** (using *neutral genetic variation*) or ancestral cultural distances, such as **linguistic distance**



EUROPAKO HITZKONTZAK

Priorité est donnée aux dialectes et aux langues minoritaires autochtones.

Priority is given to dialects and indigenous minority languages.

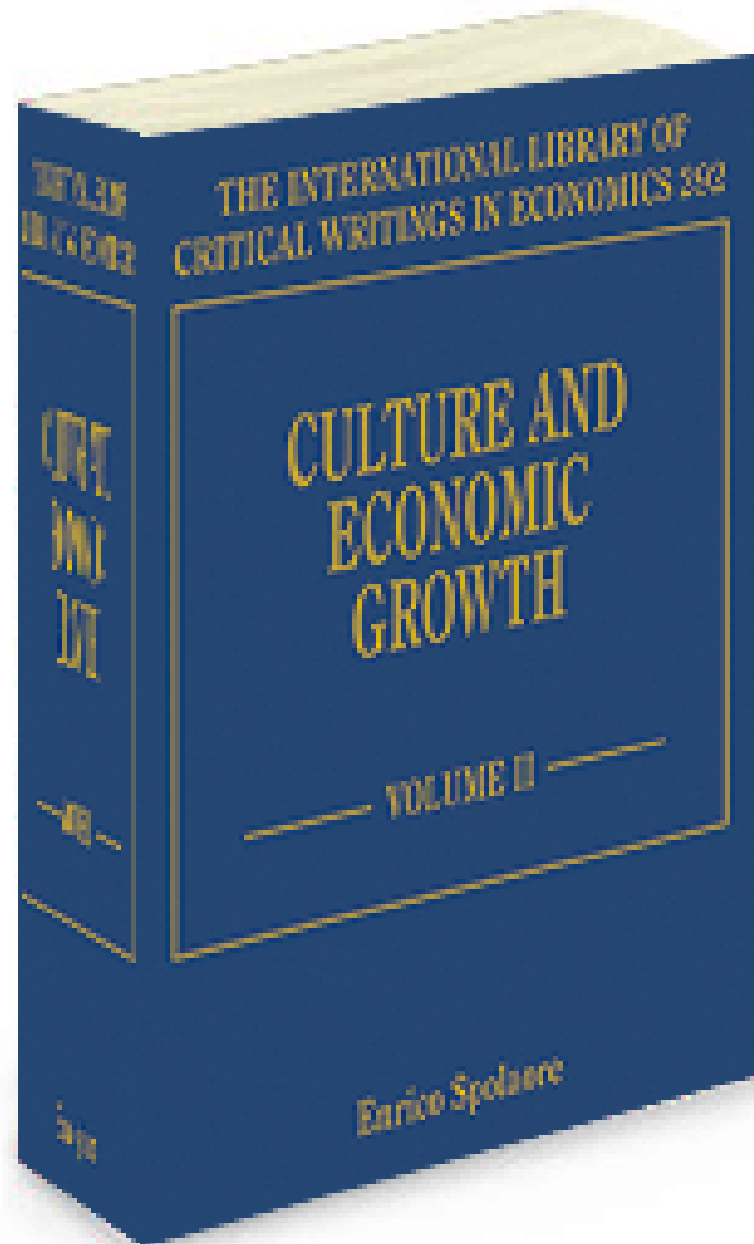


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ITALIC 				GERMANIC 		CELTIC 	
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From long-term history to culture and change

- How do deeper historical and cultural variables affect *current preferences* over public goods, policies, and institutions?
- How does heterogeneity of culture and preferences respond *endogenously* to *changes* in institutions and policies?
- These questions are part of a large and growing literature on culture and economics

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Endogenous Heterogeneity in Europe?

- Over time, **couldn't a federal Europe change political and social interactions and affect cultures and identities among Europeans, leading to a shared identity within a "European nation"?**
- This question is part of the broader debate on the persistent political and economic effects of historical and cultural traits, and the extent that culture itself can be changed by policies and institutions (for recent discussions, Bisin and Verdier 2010; Spolaore and Wacziarg 2013).
- In the long run, people can learn new languages, modify their cultural traits and identities, and transmit different traits to their children in response to changing incentives, including public policies.
- However, it is at best a gamble to hope that political integration of modern democratic nations will lead to cultural integration.

A European Federation?

- At the end of World War II, blame for the continent's ills placed on **fragmentation in independent and unconstrained nation states**, which had pursued costly protectionist policies during Great Depression and engaged in two major wars
- Solution: a European **federation** (the United States of Europe)? Spinelli, 1943; Churchill, 1946.

Early Steps and the Defense Community Fiasco

- 1950 Schumann declaration on coal and steel as “a first step in the federation of Europe”
- Formation of a European Coal and Steel Community
- The next step was a defense and political community, with a common army, a common budget, and common legislative and executive institutions - basically, a European federation.
- In 1952 the attempt to form European Defense Community and European Political Community collapsed: French parliament didn't ratify.

Why is Centralizing Defense and Security so Hard?

- Military force associated with means to ensure monopoly of legitimate coercion within a territory (sovereignty – Max Weber)
- Centralized security across large, diverse populations usually provided when **dictatorial rulers** who can ignore the heterogeneity costs of the populations they conquer, and/or when there are overwhelming benefits of scale from defense (e.g., **major foreign threat**) offsetting high heterogeneity costs (Alesina and Spolaore 2005, 2006).
- The two most successful federal republics, Switzerland and the United States, emerged in response to external security threats, and the unification of Germany in the nineteenth century resulted from conquest by Prussia (Riker 1964; Gilpin 2001).
- After WWII, Western Europeans, given their high heterogeneity, failed to form a federation even when faced with an existential threat from the Soviet Union, and relied on an international alliance (NATO), where issues of undersupply and free riding were in part addressed by the dominant role of the United States.

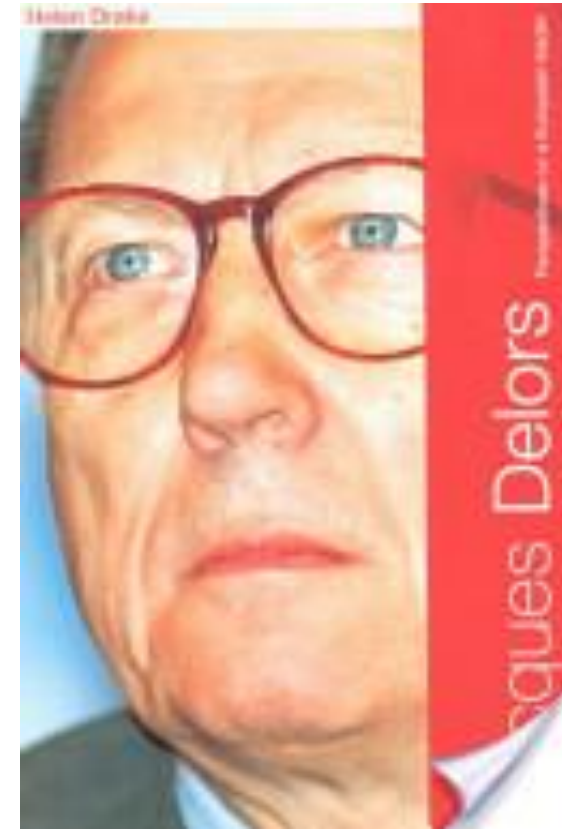
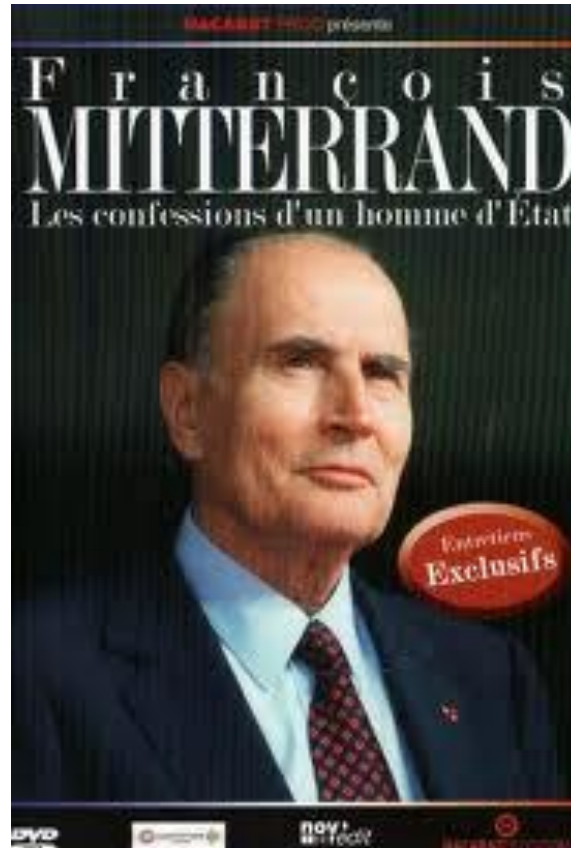
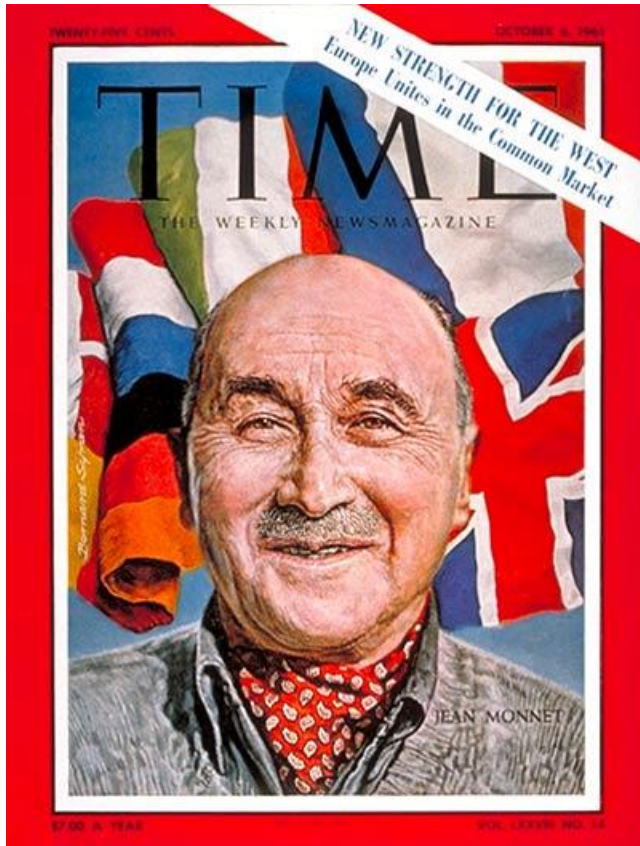
A Lesson in Political Realism

- From the successful creation of the Coal and Steel Community and the rejection of the Defense Community, Jean Monnet and the other supporters of European integration learned a lesson in political realism (Duchêne 1992).
- **Partial integration in narrowly defined areas**, such as coal and steel, **was feasible**, while more ambitious integration in broader areas such as defense and policy coordination would meet too much political opposition.

Towards an ever-closer union?

- The Treaty of Rome of 1957 establishing the European common market no longer referred to steps “toward a federation,” but included the vaguer objective of laying the **“foundations of an ever-closer union among the peoples of Europe.”**
- A clever idea, but also the **origin of the current problems** and predicaments

The Subtext: blame the French (just kidding/je plaisante)



Summary of Monnet's Strategy

- The euro, with its current problems and limitations, is the child of a long-standing European strategy of ***partially integrating policy functions in a few areas***, with the expectation that ***more integration*** will follow in other areas, in a sort of ***chain reaction*** towards an “ever-closer union.”
- Monnet's ***functionalist strategy*** became the main approach to European integration in the 1950s. The expectation was that deeper, more ***“political” integration would follow from integration in economic areas***, in part as a result of the pressure from inefficiencies and crises associated with incomplete integration.
- From this perspective, ***incompleteness*** was viewed ***not as a bug but as a feature***, as it was expected to lead to further integration down the road.

Successes and Limitations

- The gradualist strategy was successful, on balance, when applied to areas with **large economies of scale** and relatively **low costs from heterogeneity** of preferences and traits across different populations – for example, commercial integration.
- However, the functionalist approach, based on the **underestimation of heterogeneity costs** and the **unwarranted expectation** that more integration could solve the issues created by the previous steps, is at the roots of the current problems.
- In fact, **economic integration** and **political integration** are more likely to be **substitutes** than **complements**.
- A more effective strategy would require that each step towards European integration should be taken only if it is economically beneficial and politically stable **on its own merits**.

Monnet's method according to his collaborator George Ball

“There was a well-conceived method in this apparent madness. All of us working with Jean Monnet well understood how irrational it was to carve a limited economic sector out of the jurisdiction of national governments and subject that sector to the sovereign control of supranational institutions. Yet, with his usual perspicacity, Monnet recognized that **the very irrationality of this scheme might provide the pressure to achieve exactly what he wanted - the triggering of a chain reaction**. The awkwardness and complexity resulting from the singling out of coal and steel would drive member governments to accept the idea of pooling other production as well.”

Where was the chain reaction supposed to lead to?

Monnet was ambiguous:

- 1) To a sovereign federation (the United States of Europe)?
- 2) To a post-national world where sovereign states do not matter much (Europe as a post-federation)?

So, if 1) , euro would be the “currency without a state” *yet*, while if 2), it would be the “currency without a state” *ever*

EMU: the Chain Reaction at Work?

“[T]he road toward the single currency looks like a **chain reaction** in which each step resolved a preexisting contradiction and generated a new one that in turn required a further step forward. The steps were the start of the EMS [European monetary system] (1979), the re-launching of the single market (1985), the decision to accelerate the liberalization of capital movements (1986), the launching of the project of monetary union (1988), the agreement of Maastricht (1992), and the final adoption of the euro (1998).”
(Tommaso Padoa-Schioppa)

Incompleteness as a feature?

- Helmut Kohl in 1991: "It is absurd to expect in the long run that you can maintain economic and monetary union without political union."
- From the perspective of Monnet's method, such an "absurd" economic and monetary union without political union should create pressures for still more integration.
- The euro area lacked many institutions historically associated with a successful monetary union: a central bank that could really act as market maker and lender of last resort, a banking union, and a fiscal union.
- But this incompleteness could be rationalized as a natural and unavoidable feature of partial integration in Monnet's functionalist tradition

Limitations of Monnet's Chain Reaction Method I

Overestimation of Role and Power of Supranational Institutions:

-) The success of supranational agents' ability to take autonomous decisions can only be sustained in matters where the *extent of disagreement among national governments over policy outcomes is relatively low*, like the enforcement of trade liberalization agreements.

-) Success in those areas does not imply that supranational institutions and rules could also trump national institutions and rules in other areas with much *higher heterogeneity of preferences and interests*, like fiscal policies.

Limitations of Monnet's Chain Reaction Method II

General Problem: unrealistic assessment of the costs and constraints imposed by heterogeneity of preferences among Europeans governments and voters

Successful integration is more likely to take off in areas such as commercial integration, where heterogeneity costs are relatively low, and partly offset by the benefits from diversity.

As integration proceeds to other areas, after low-hanging fruits are picked, ***heterogeneity costs continue to increase along a convex curve***. At some point, those high costs become prohibitive, and the pressure from spillovers, inefficiencies and crises will no longer lead to further integration, but just to losses, and possibly even the collapse of the whole system.

Incompleteness as a bug after all

- The chain-reaction approach does not anticipate that heterogeneity costs and constraints can become binding and stop the process for good.
- Followers of this approach are therefore prone to setting up **incomplete and inefficient arrangements**, relying on the **overoptimistic expectation** that such inefficiencies can always be addressed at a later stage through additional integration.

Economic Integration and Political Integration: complements or substitutes?

- View that they are complement is questionable. The example of the German customs union (*Zollverein*) often mentioned in this respect is misleading, because the main force behind commercial integration was political integration pushed by Prussia's military power (Gilpin, 2001).
- In fact, international cooperation and political integration can be viewed as **substitute** ways to lower barriers to trade.
- If two regions can already agree to reduce their trade barriers with each other while remaining independent, they are going to obtain **smaller** additional gains from trade if they also form a political union with a unified domestic market (Alesina and Spolaore, 1997, 2003; Alesina, Spolaore and Wacziarg, 2000).

Economic integration and political disintegration are mutually reinforcing

- As international economic integration increases, the economic costs of being small are reduced, and hence political disintegration becomes less expensive
- In a world of smaller countries, international openness is more important
- Economic integration and political disintegration go hand in hand (Alesina and Spolaore, 1997, 2003; Alesina, Spolaore and Wacziarg, 2000, 2005; Spolaore and Wacziarg, 2006)

Figure 4. Scatterplot of the Detrended Number of Countries Plotted Against the Detrended Trade to GDP ratio (With Sub-Saharan Africa - 1903–1992)

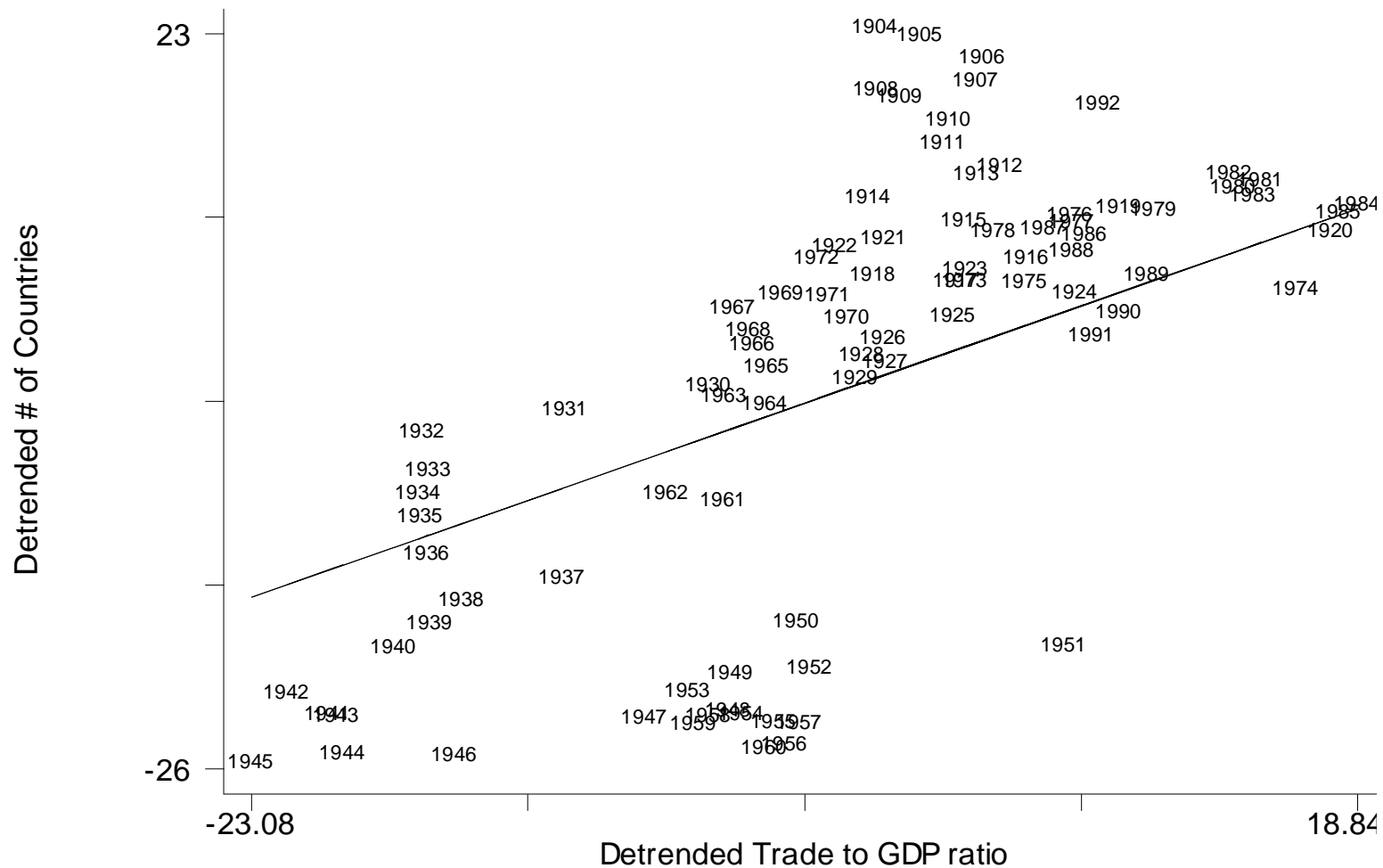
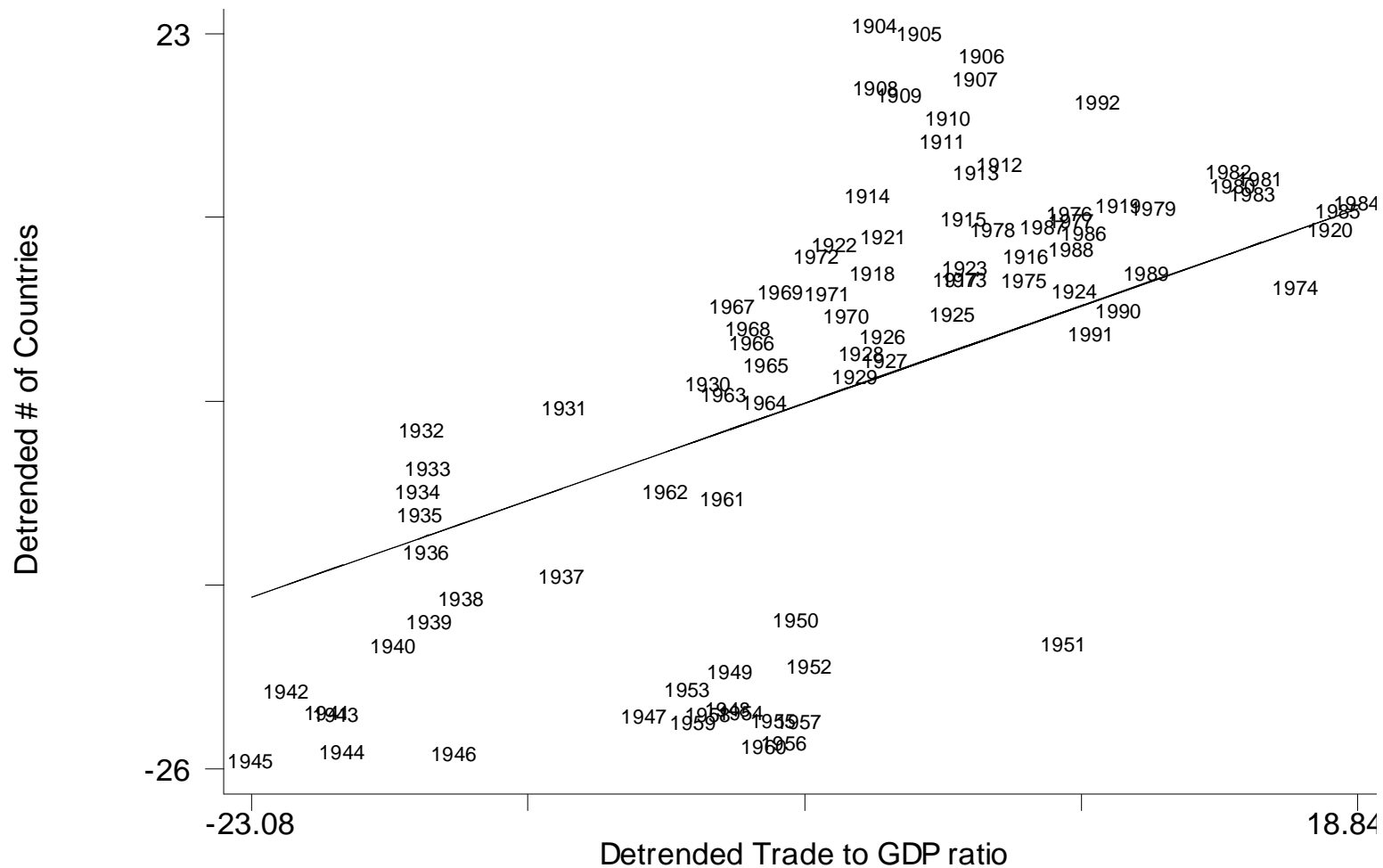


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Ending on a (moderately) positive/optimistic note

- European institutional integration greatly beneficial when applied in areas with relatively ***low heterogeneity costs and large economies of scale***, such as the formation of the single market.
- There is still potential for progress in such areas - e.g., financial integration.
- In order to “rescue” the European project, one must ***abandon the chain-reaction’s approach***, and focus on ***reforms that make economic and political sense by themselves***, not as “steps” towards an “ever-closer union.”
- Never again should ***heterogeneity*** and its costs be denied/underestimated – they should be ***analyzed/measured***
- Political integration in Europe is perhaps achievable in the long run ***if preceded*** by major cultural changes.