

# Externalities, Institutions and Public Perception - The Political Economy of European Integration Revisited

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Moving closer rather than drifting apart:  
Challenges to economic integration at the global and European level

Meeting in Brussels

DG ECFIN

November 28, 2016

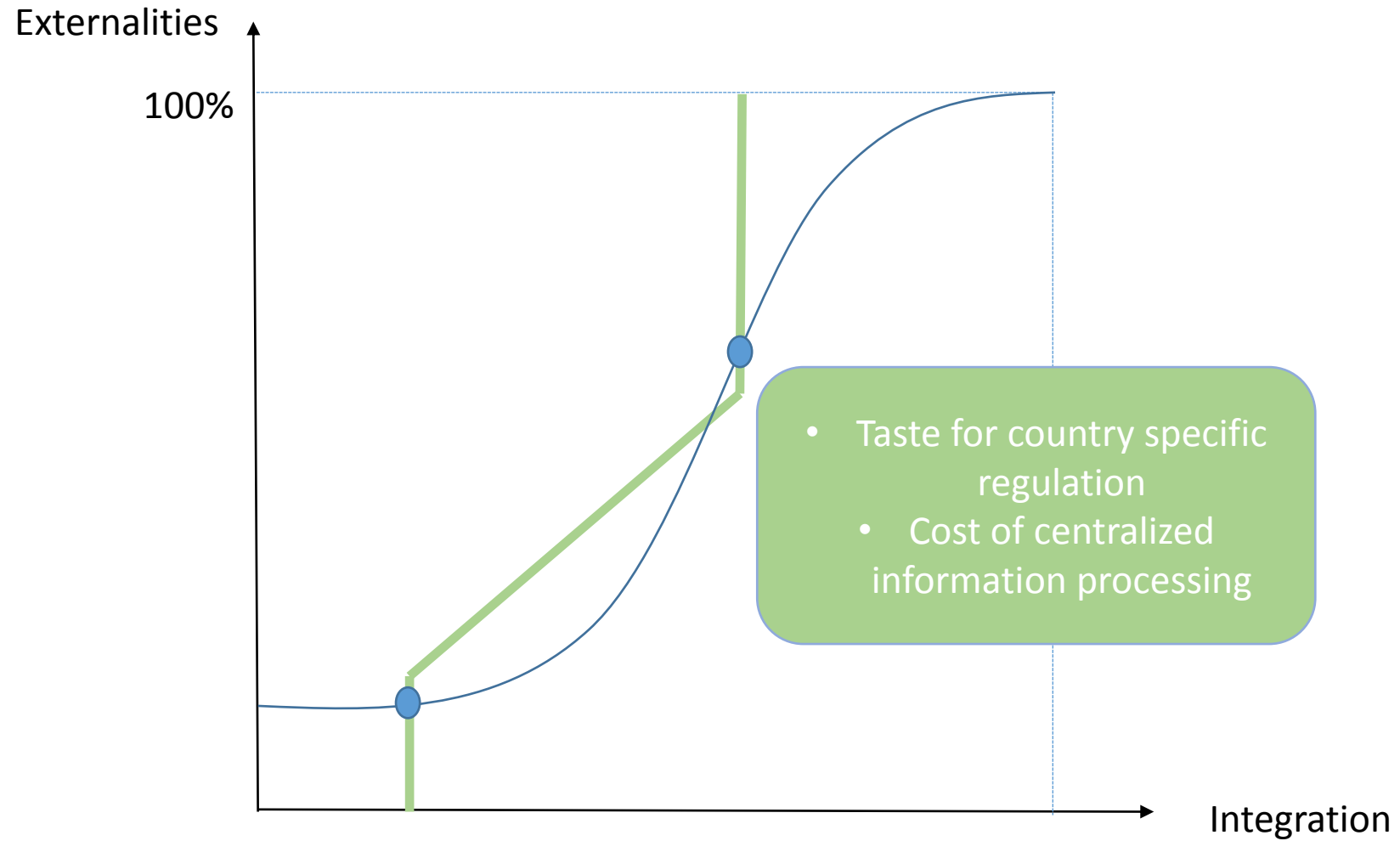
Questions:

What explains trends in (preferences for) integration?

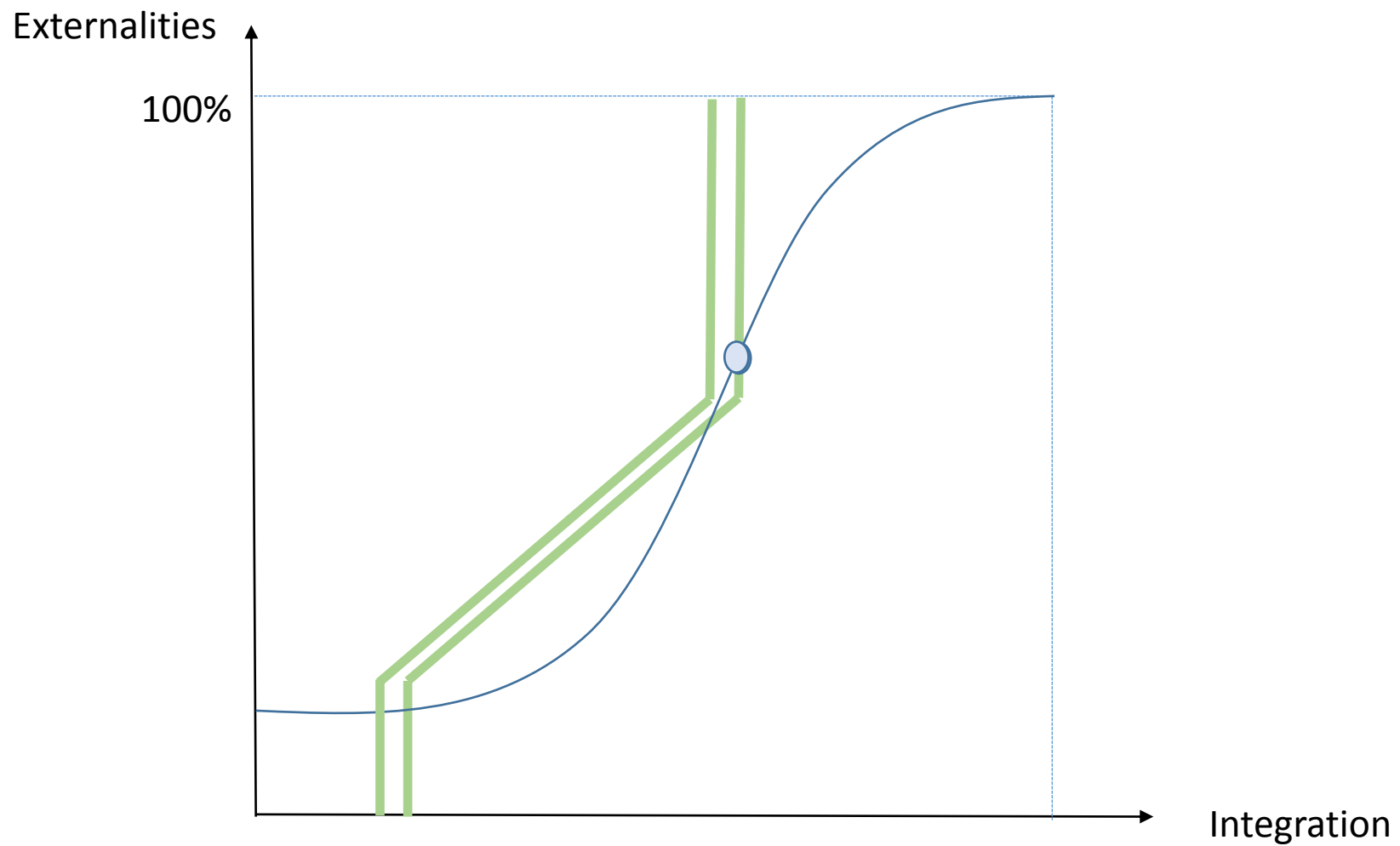
How can counterproductive unravelling be avoided?



# Equilibrium multiplicity



# Unravelling due to a small shift in taste



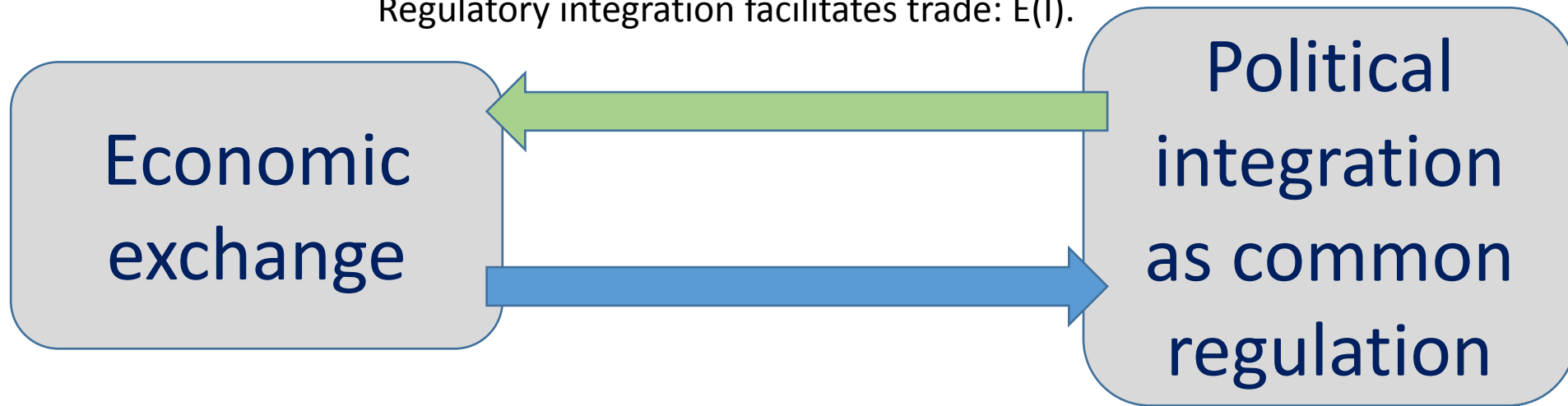
# Microfoundation

## A positive view of integration

Investment stage: Firms decide on export technology.

Cost realization.

Regulatory integration facilitates trade:  $E(I)$ .



Governments maximize consumer + producer surplus

Political integration (I) and economic exchange (E) are complements.

More cross border activity makes common rules more attractive.

# Export decision

two continua of goods that can be produced in both countries,  $[0, 1]$  and  $[1, 2]$ .

The cost of establishing the export option is  $k(i)$ , with  $k'(i) > 0$ .

Firm  $i$  is risk neutral and chooses the export option if

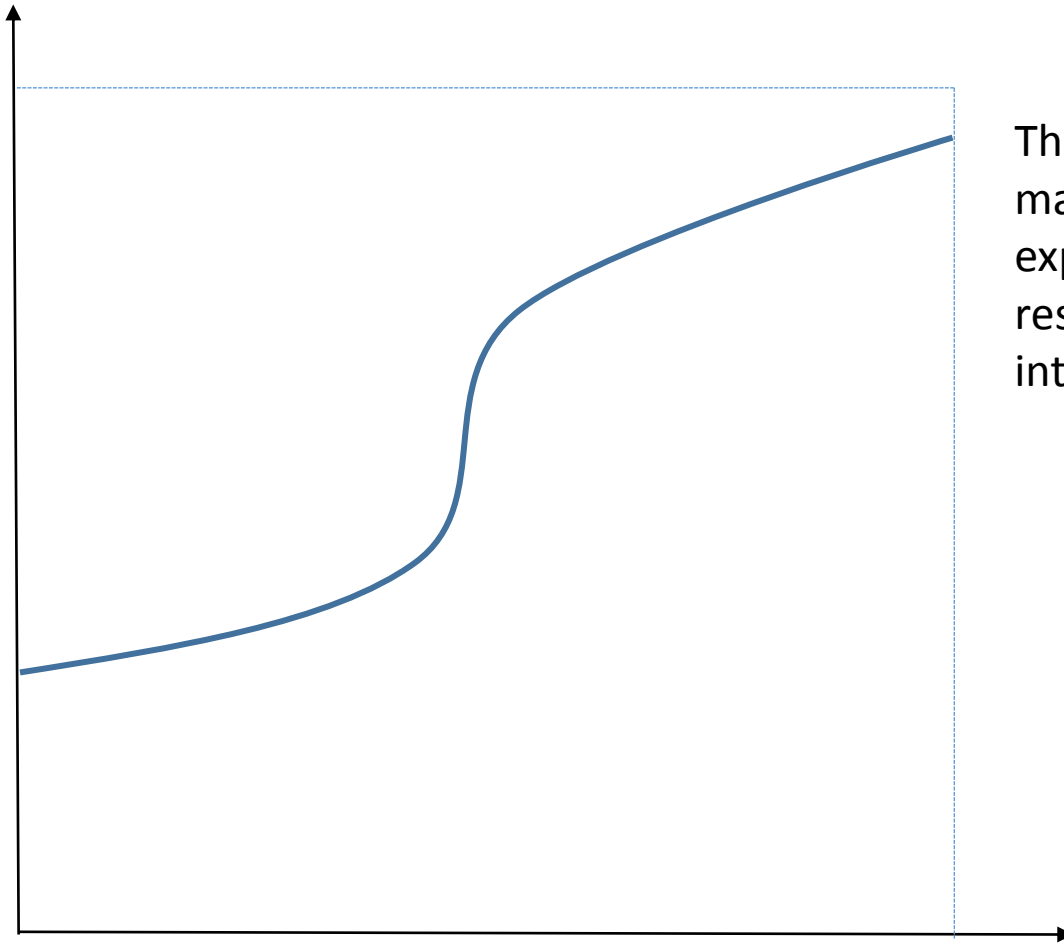
$$p \cdot \alpha \cdot I \geq k(i).$$

The marginal exporting firm is firm  $k^{-1}(pI)$ . Hence, the share of exporting firms is

$$E_l(I) := k^{-1}(p\alpha I).$$

$E(I)$

Economic  
Interaction  
100%



The blue  $E(I)$  curve shows many firms invest in the export technology in response to regulatory integration

Integration

# Political decision

$$\begin{aligned} S_X(I) &: = \int_0^{E_i} p\alpha I - k(i) di \\ &= p \cdot \alpha \cdot E \cdot I - K(E), \end{aligned}$$

$$\begin{aligned} S_C(E_l, E_{-l}, I) &: = \int_0^{E_{-i}} p(1 - \alpha) I di \\ &= p \cdot (1 - \alpha) \cdot E \cdot I \end{aligned}$$

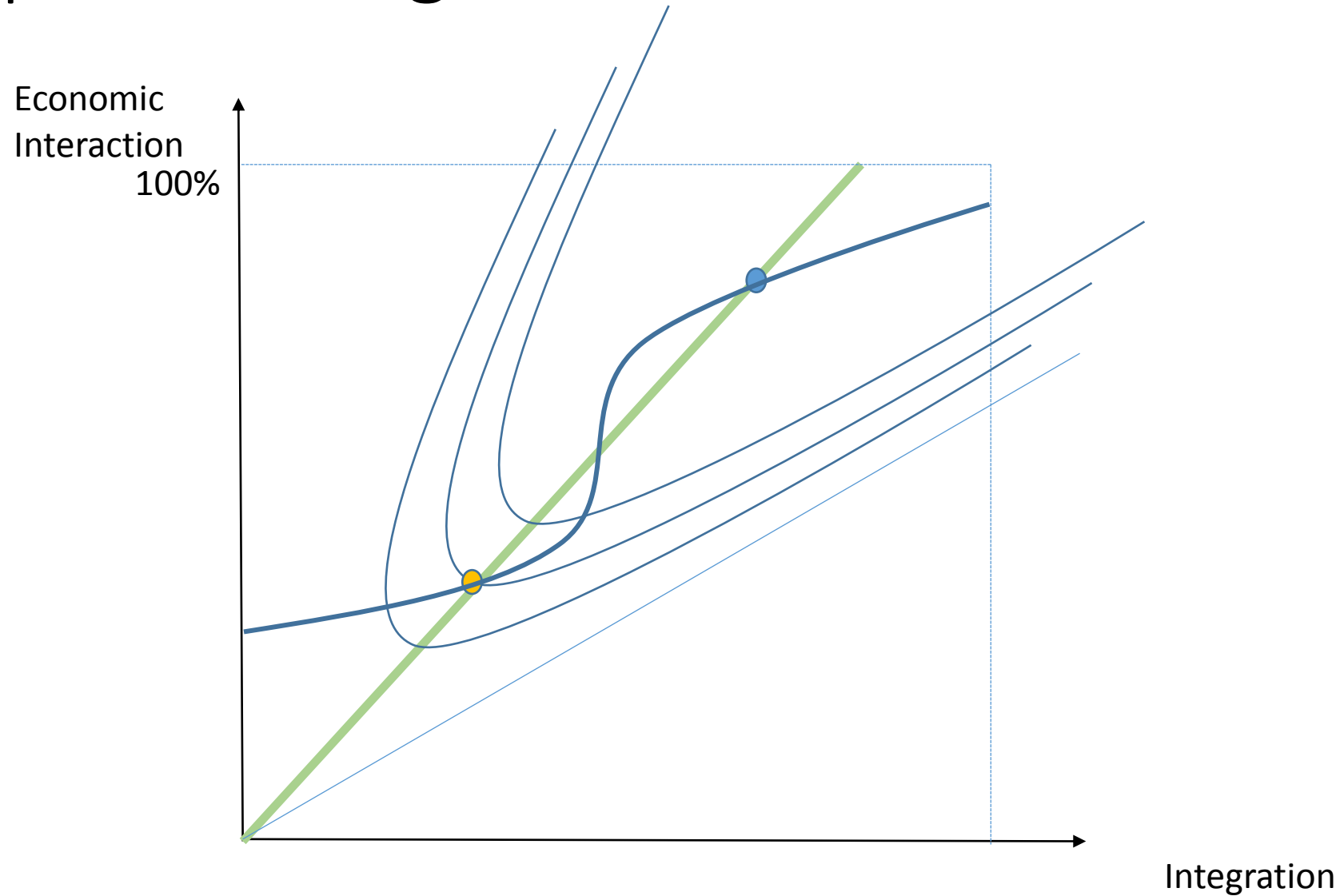
$$W(E_l, E_{-l}, I) := S_X(I) + S_C(I) - aI^2.$$

$$W(E, I) = p \cdot E \cdot I - K(E) - aI^2.$$

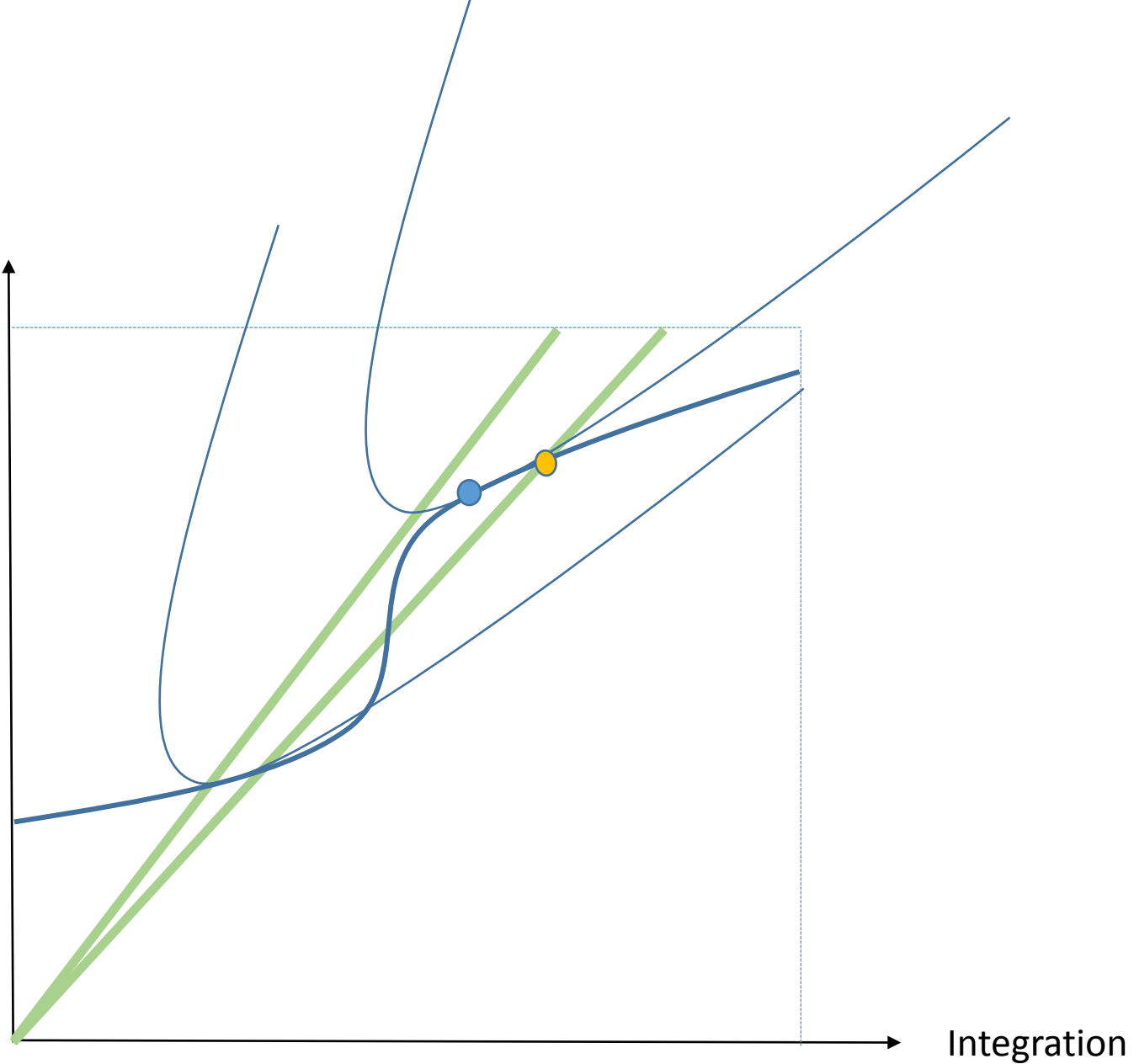
$$I(E) = \frac{p \cdot E}{2a}.$$



# Suboptimal integration with local learning



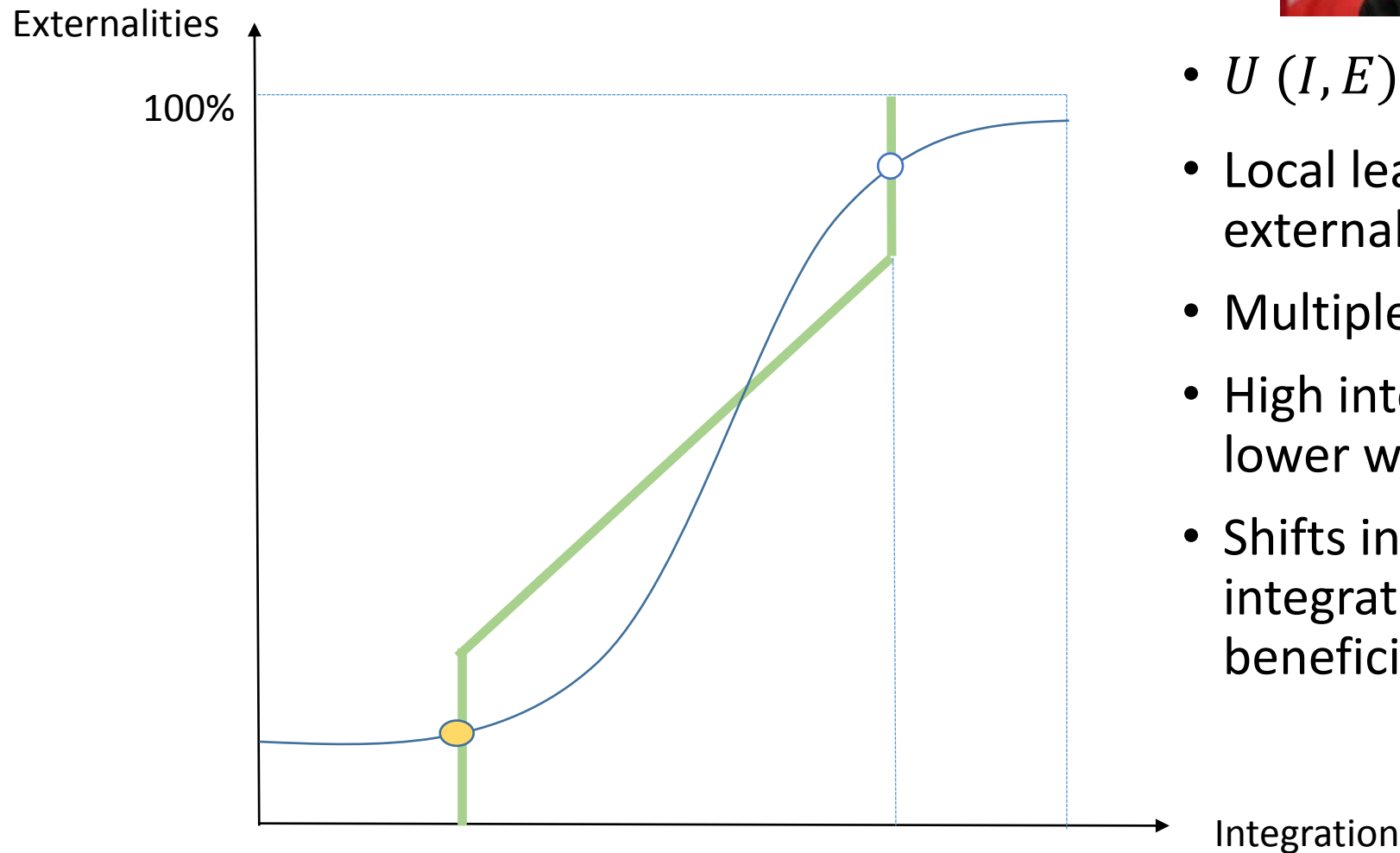
Economic Interaction



Integration

Unproductive unravelling

# A negative view of integration



- $U(I, E) = I - \frac{a}{2}I^2 - \min\{E - I, 0\}$
- Local learning: Policy adjusts to externalities.
- Multiple equilibria.
- High integration equilibrium yields lower welfare.
- Shifts in the preference for integration can have a major beneficial long run impact.

# An agnostic evaluation

- Both versions may have multiple equilibria.
- The welfare ranking differs.
- Small shifts in preferences may lead to large political trends in integration.
- If you believe in the positive view, then you should have **four priorities:**
  1. Common policies should better fit voter preferences.
  2. Common policy process should be more efficient.
  3. Policy outcomes must be properly attributed to actors (signal extraction).
  4. Resilience – strengthen preference for integration and political cohesion.

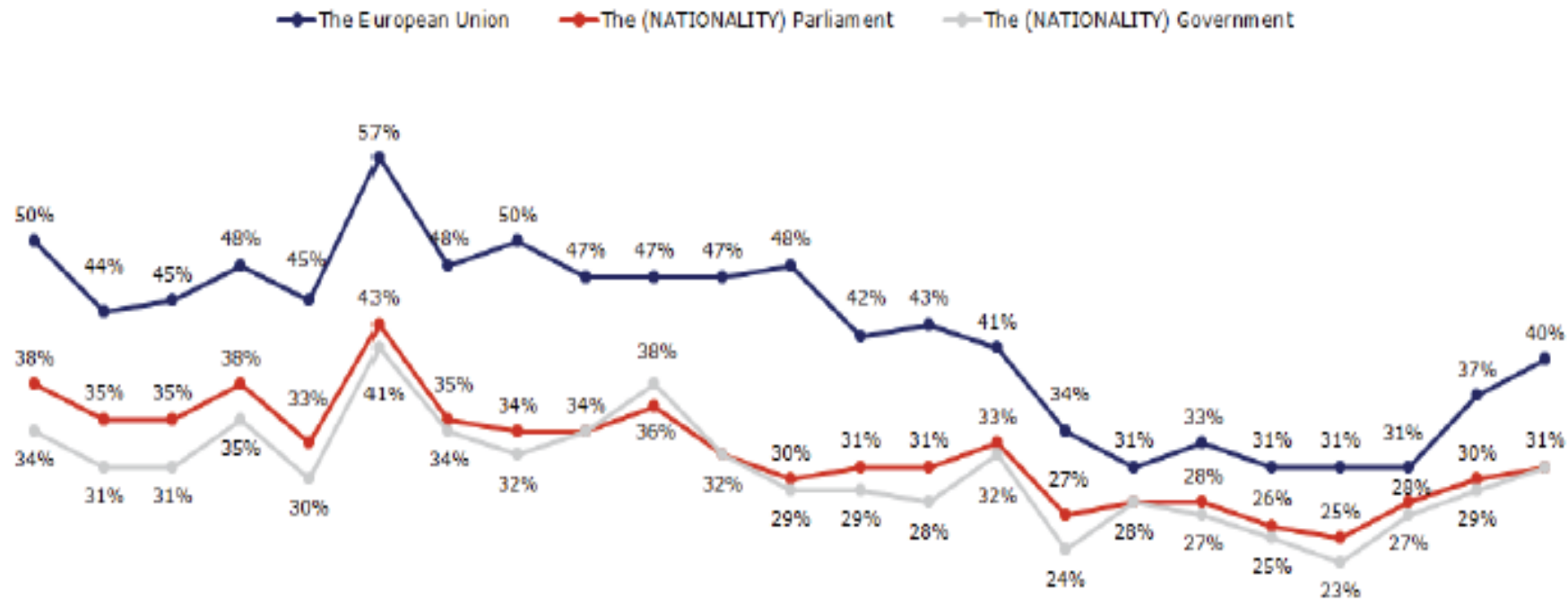
# Common policies must better fit voter preferences

Diagnosis I

We face a dislike for some „common“ policies rather than a dislike for political cooperation or integration per se.

# Trust in EU and national parliaments declined

QA8a. (...) For each of the following institutions, please tell me if you tend to trust it or tend not to trust it.  
Tend to trust - % EU



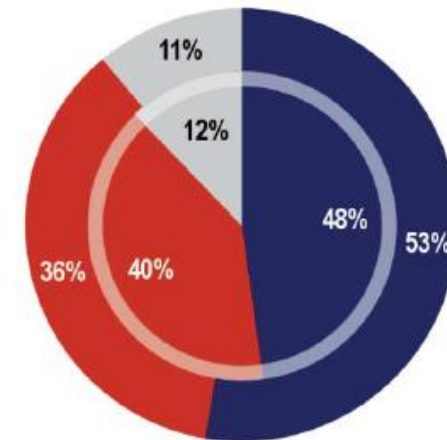
Aut. 2004
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Sp. 2014
Aut. 2014
Sp. 2015

# 2015: Median wants more decisions on the EU level

53 percent in favor of **more** decisions taken at the EU level in September 2015

QA21a.6. Please tell me to what extent you agree or disagree with each of the following statements.

More decisions should be taken at EU level



● Total 'Agree'

● Total 'Disagree'

● Don't know

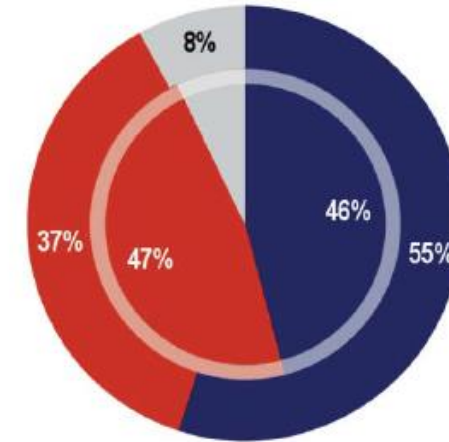
Inner pie : EB81 Sp.2014

Outer pie : EB83 Sp.2015

# Majority for a joint army

55 percent in favor of a joint EU army in September 2015

QA19. Thinking about the future of the EU, please tell me whether you are in favour or opposed to the following statement: the creation of an EU army



● Total 'In favour'

● Total 'Opposed'

● Don't know

Inner pie : EB81.1 Jan. 2014

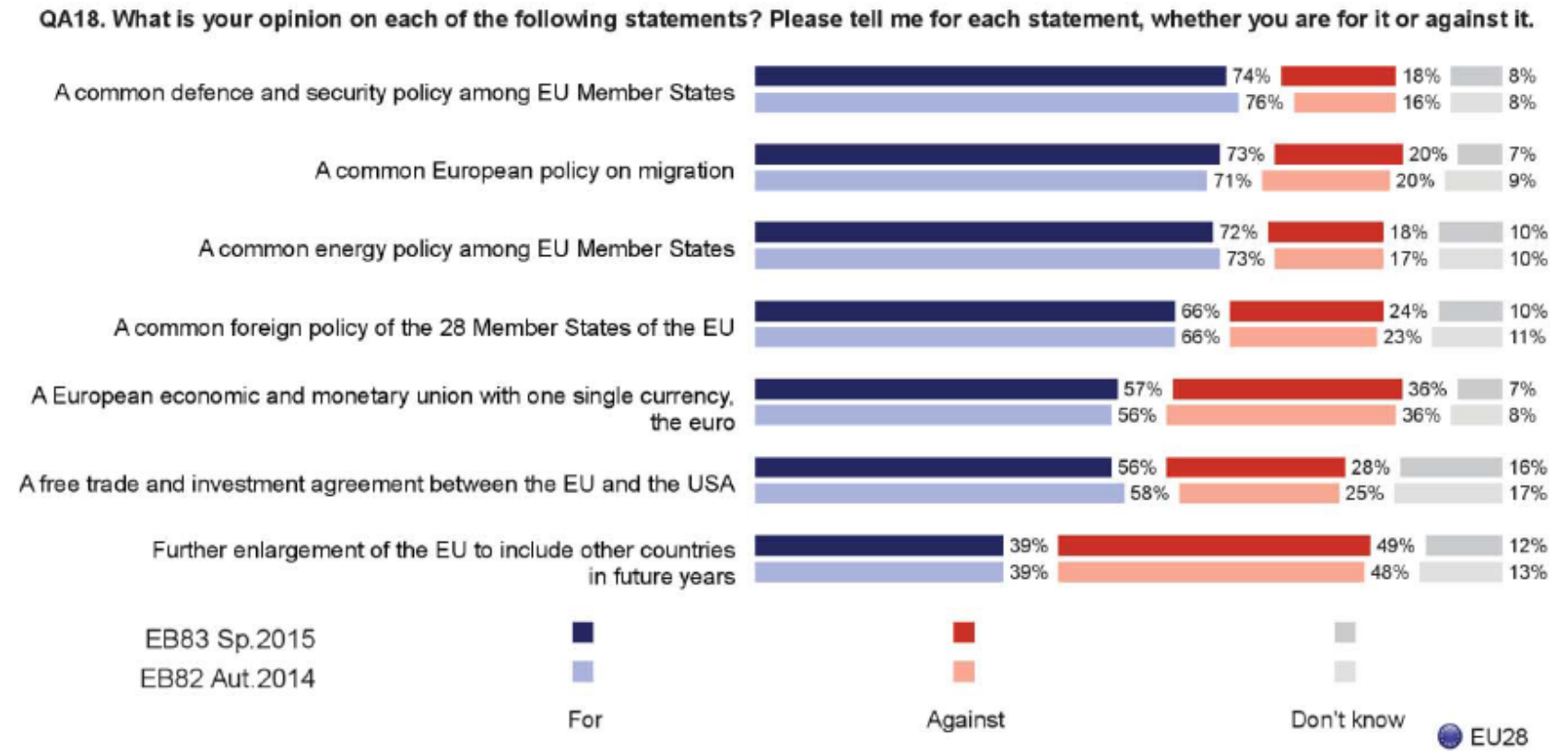
Outer pie : EB83 Sp.2015



# Substantial support for common policies

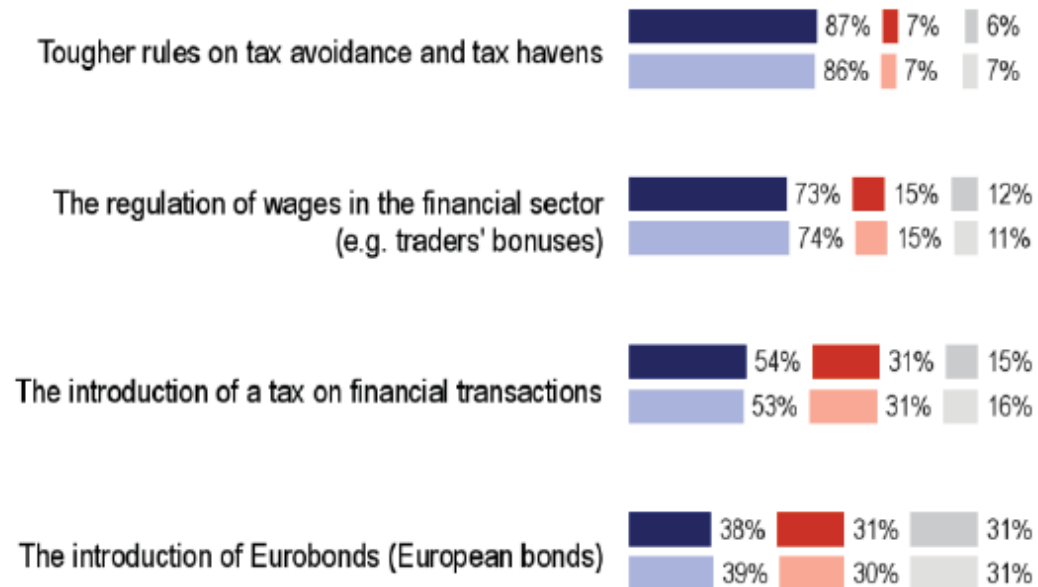
## It is about the direction of policies!

- 76 Percent for common security and defense policy
- 73 percent for common migration policy



# What people want: Capital taxation rather than international redistribution through Eurobonds

QC3. Thinking about reforming global financial markets, please tell me whether you are in favour or opposed to the following measures to be taken by the EU.



EB83 Sp.2015

EB82 Aut.2014



Total 'In favour'



Total 'Opposed'



Don't know

# Common policies must better fit voter preferences

## Diagnosis II

This is difficult to achieve in central areas because Europeans disagree on fundamental aspects of the union.

# Europe is about free markets, but Europeans do not agree about markets

Positive view of free markets 2007:

- Italy 73 %
- UK 72 %
- Spain 67 %
- Germany 65 %
- France 56 %

<http://www.pewglobal.org/2007/10/04/world-publics-welcome-global-trade-but-not-immigration/>

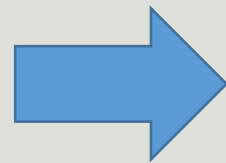
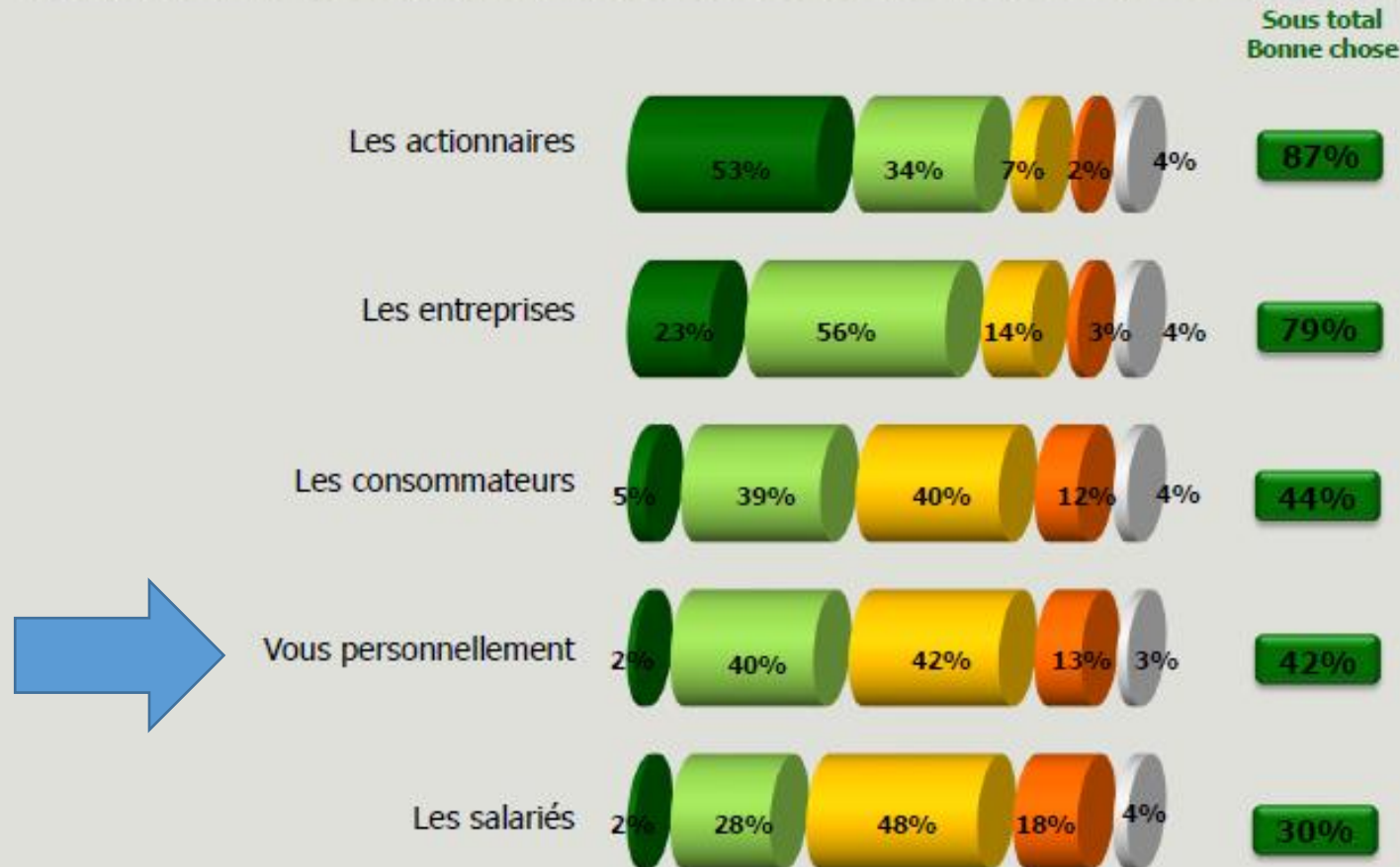
# BRIC are ahead of Britain and France



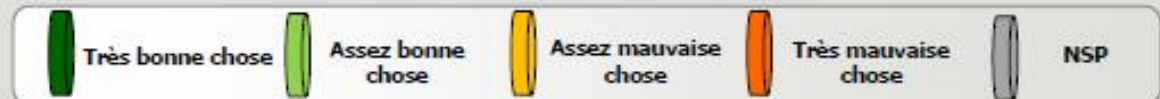
[http://www.economist.com/blogs/dailychart/2011/04/public\\_opinion\\_capitalism](http://www.economist.com/blogs/dailychart/2011/04/public_opinion_capitalism)

# France: Details

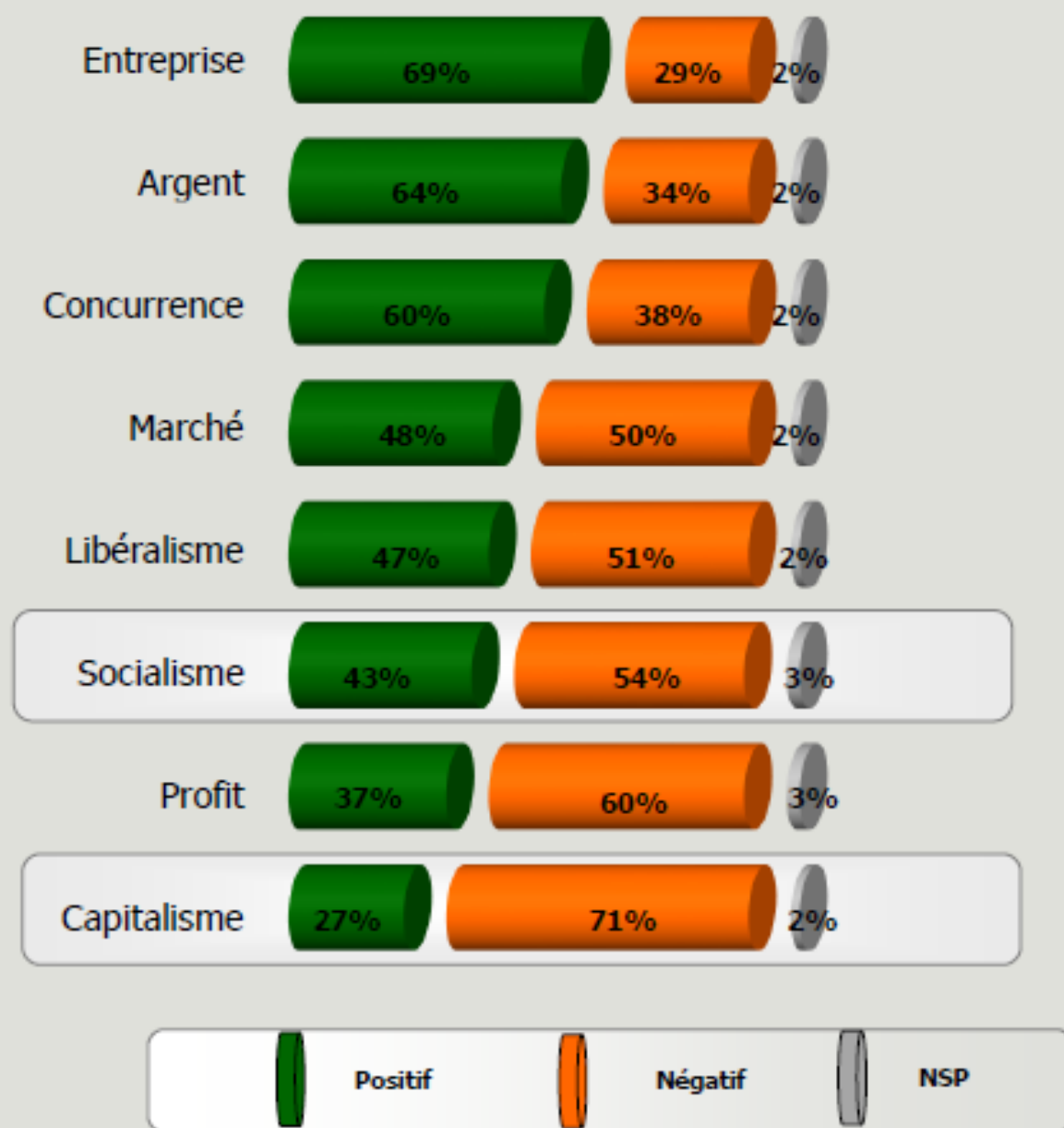
Q : Diriez-vous que l'économie de marché est une bonne chose pour chacun des acteurs suivants ?



<http://www.croissance-responsable.fr/wp-content/uploads/2010/11/Son-dage-les-Francais-et-l%3%A9conomie-de-march%3%A9-f%3%A9vrier-2010.pdf>



Q : Pour chacun des mots suivants, dites-moi s'il évoque pour vous quelque chose de positif ou de négatif ?



# Policy processes must be efficient

Diagnosis III

Communication and decision procedures: There is scope for improvement.

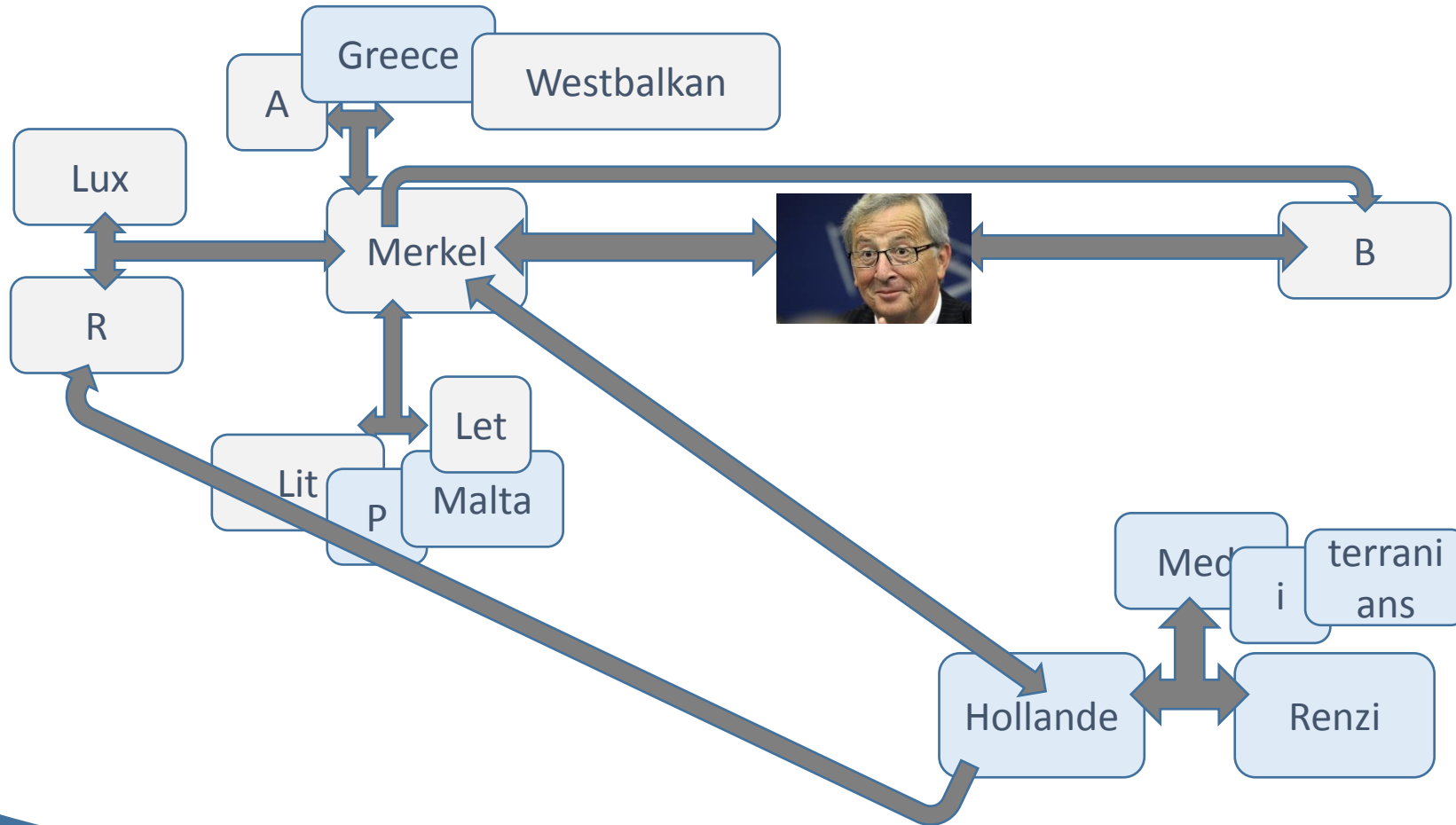


# Question and Method

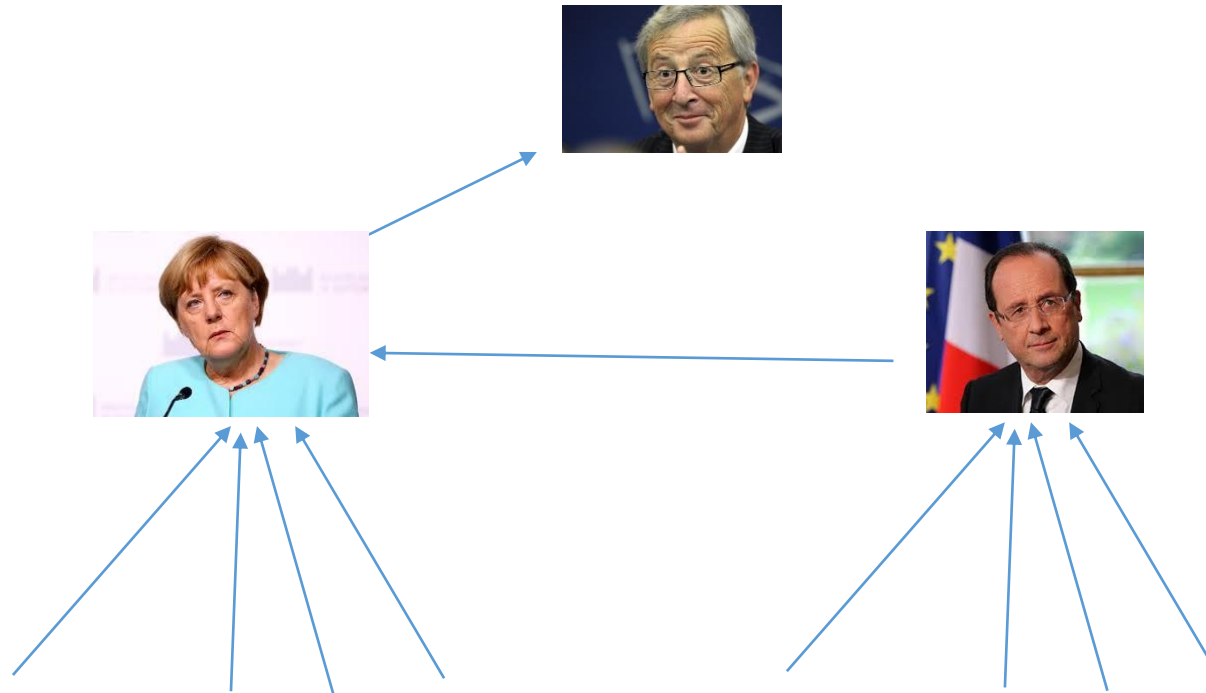
- Question: Could decision making in the EU become more efficient?
- Method: Analyze travel schedules of major policymakers and bureaucrats.

September 2016

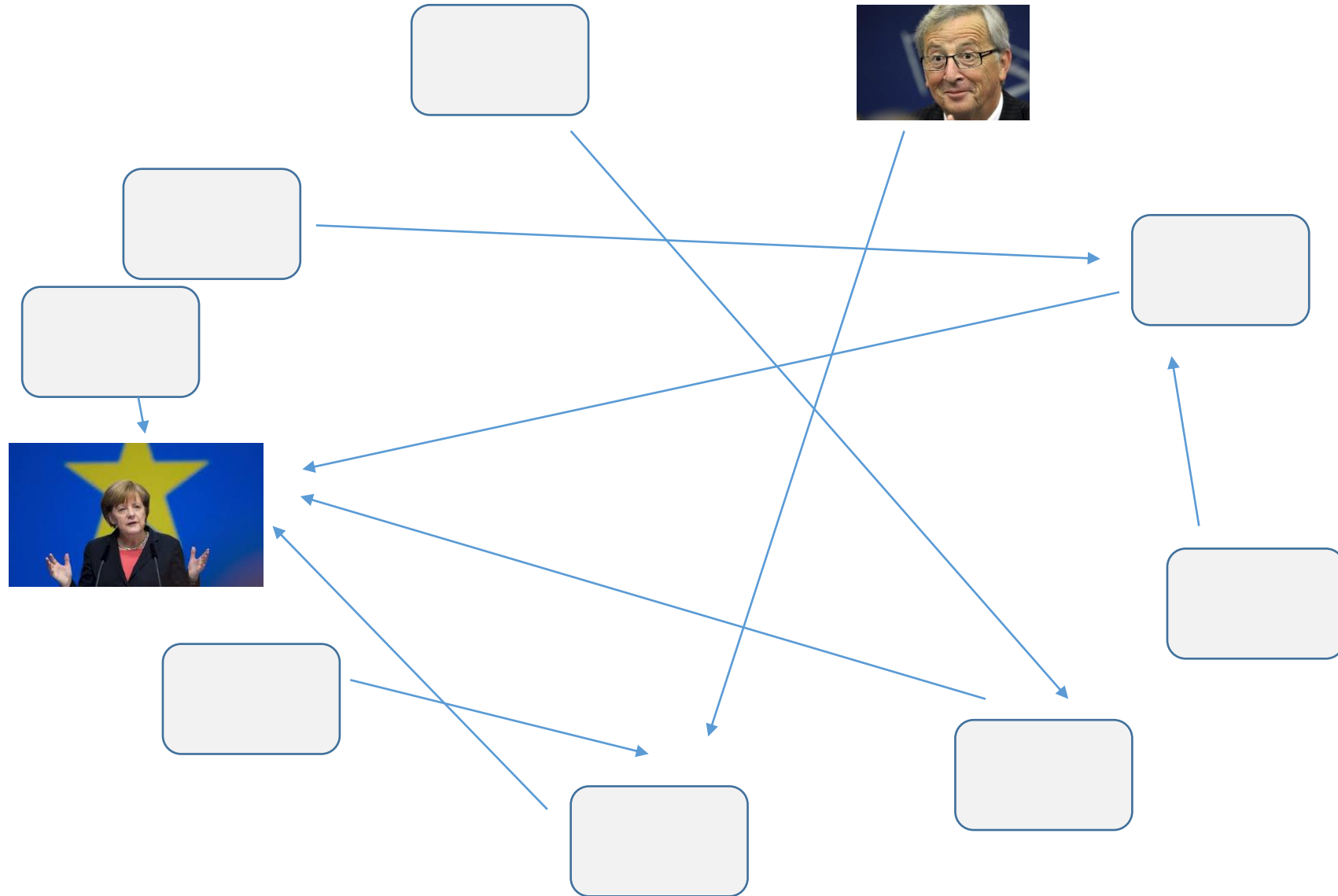
Bratislava



# Positive interpretation: Radner/Van Zandt



# Negative interpretation: Chaos



# The role of the Commission in all this? (ongoing work...)

- Commissioner Moscovici does not publish his entire agenda (or he has very few appointments).
- President Hollande does – and meets Moscovici.
- Commissioner Oettinger has a considerable home bias.
- ...

# Scope for improvement

- Establish a communication protocol that serves as a blueprint/ focal point.
- The ECB rotation scheme creates subgroups that have an incentive to communicate.
- A similar scheme could endogenously create a communication structure within rotation groups.
- Commissioners should act as moderators not ambassadors.
- Reduce the number of commissioners is one step.
- Denationalize the period of appointment.

# Policy outcomes must be properly attributed to actors (signal extraction)

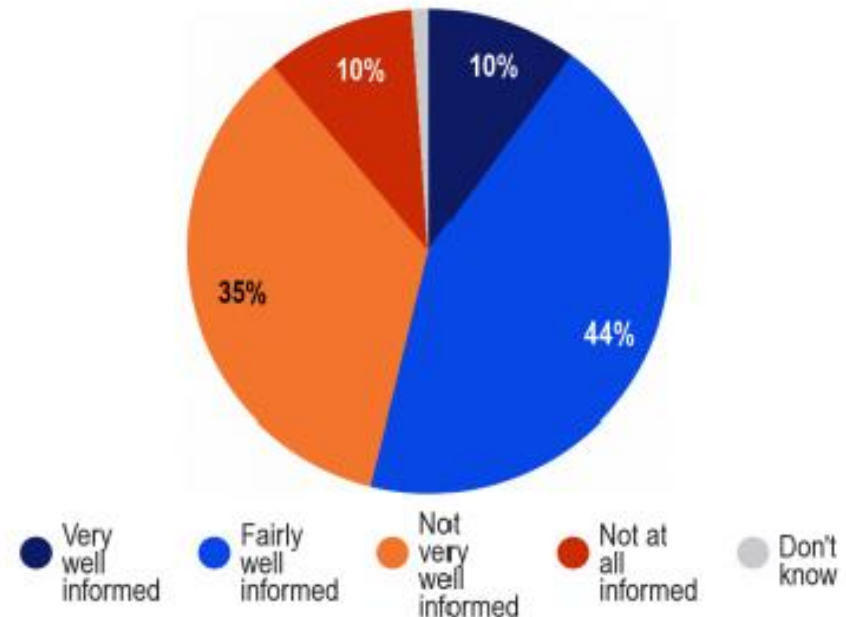
Diagnosis IV

Voters are very poorly informed about the functioning of the system.

# Signal extraction

- In 2013, 45 percent felt not very well or not at all informed about origins of the crisis.
- In 9/2015 only 54 % say that they do not understand how the EU works

QA21. How informed do you feel about the causes of the financial and economic crisis?

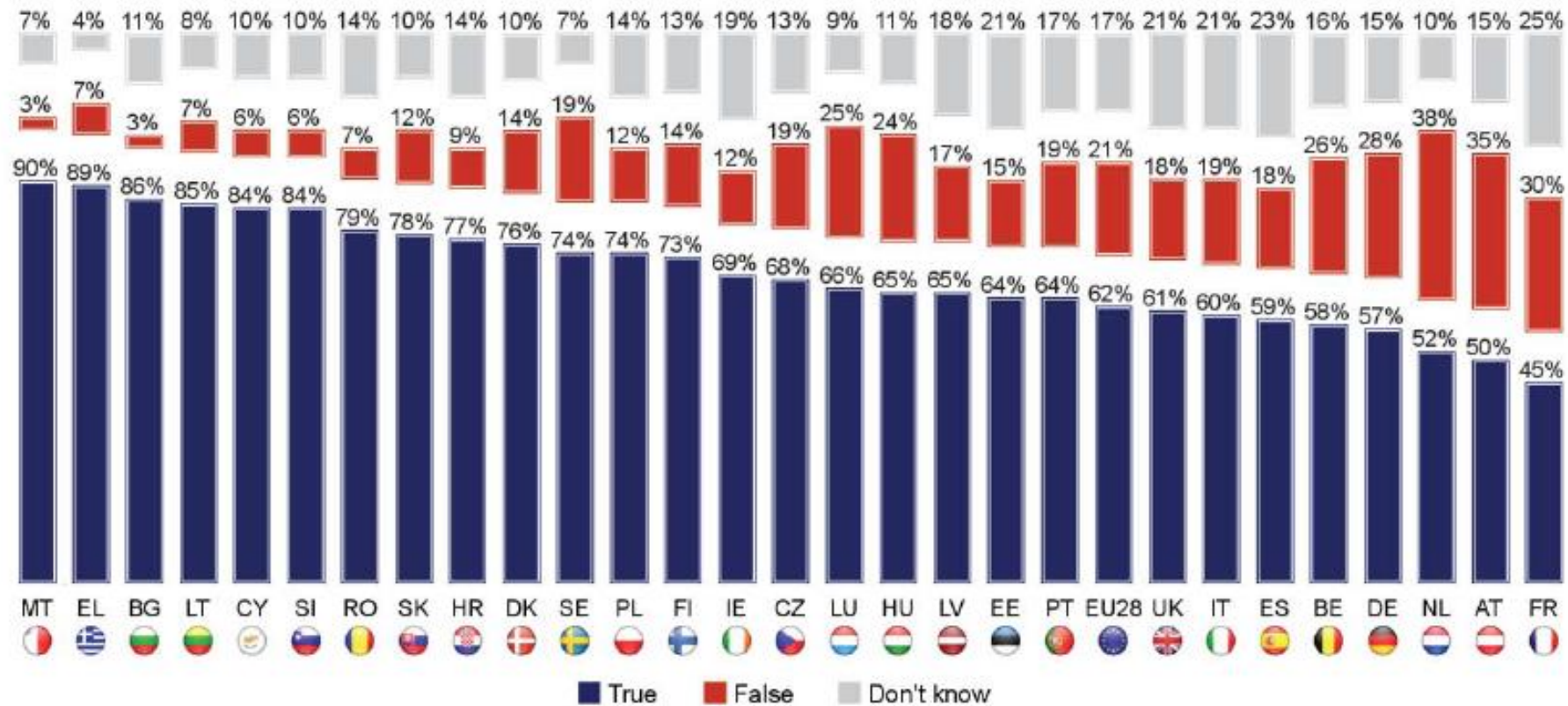




# Only 45% of the French know who elects MPs

QA17.2. For each of the following statements about the EU could you please tell me whether you think it is true or false.

The members of the European Parliament are directly elected by the citizens of each Member State



# Europeans are uninformed about single market

- QD5 In general, in respect of your rights within the Single Market, do you feel...? fairly uninformed 45%
- QD6.1 For each of the following sentences, would you say that it is true or false? You need a "work permit" to work in another Member State 43% yes 40 % no

# Summary

- Fragility: Trend towards more integration not for free
- Europeans not opposed to integration per se
- System dramatically lacks resilience
  - Many Europeans do not like markets and competition
  - Division along country lines
  - European politicians do not communicate effectively with each other
  - Europeans cannot extract information about sources of policy failure
  - Europeans know little about how Europe works



## Support for the Union and its policies: Four pillars

### **Common policies must fit voter preferences**

- Align policies with preferences
- Pay for reforms
- Broaden CSRs
- Elements of a common social policy
- Financial integration
- Tax coordination

### **Policy processes must become more efficient**

- Establish respect for common institutions
- Communication protocols
- Rotation schemes

### **Policy outcomes must be properly attributed to actors (signal extraction)**

- Education: Standards for treatment of EU institutions

### **Resilience due to preference for integration and political cohesion**

- Joint political debate
- Joint political competition.
- European Language Treaty
- Cultural mobility programs
- Education: Standards for treatment of EU institutions
- Quotas for advisory bodies

Backup

# Hypotheses

