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We need more Europe. Which Europe? Hints from strategic games

By Luciano Andreozzi and Roberto Tamborini on June 21, 2017

One of the "consensus views" drawn from the hard lessons of the global crisis exploded in 2008 is that in Europe, and in the Monetary Union (EMU) in particular, the crisis was exacerbated and prolonged by some deficiencies in the original design of the EMU as a supranational institution with the overarching purpose of generating and distributing collective benefits from integration and policy coordination (e.g. Baldwin and Giavazzi (eds.) 2015, 2016). The most prominent problems brought to the forefront by the crisis are two. The first is that the system fails to prevent member countries from pursuing policies in the pure national interest notwithstanding social and economic costs due to mutual negative spillovers (what game theorists call "non-cooperative policies"). The second is that no one thinks for the EMU as a whole at the supranational level either (with the exception, by statute, of the ECB); the EMU is just the statistical average of what the single countries are doing. Therefore, another element in this consensus view is that, in order to overcome the flaws emerged during the crisis, institutional reforms are necessary which should ideally be aimed at fostering integration on the grounds of economic policy and governance (see the so-called 'Five Presidents Report' (Juncker et al. 2015), and the Commission's *White Paper about the future of the EU*, 2016).

Suppose we agree that we need "more Europe". The next question is: Which Europe? Even at the scholarly level, let alone the political level, one finds at least three different lines of thought. The first is that the EMU supranational framework has proved to be too weak, unable to *constrain* governments properly. The typical symptoms are seen in the persistence of the deficit bias in fiscal policy, public debt growth, transmission of public finance distress. Hence, the recipe is one of tightening the system of rules and sanctions that should harness governments' (mis)behaviour. The so-called "Fiscal Compact", and other measures taken under the pressure of the crisis, may be seen as steps in this direction. The second criticism is instead that the rules were designed to control for the negative externalities of fiscal profligacy but not for those of fiscal austerity, which accounts for the deeper and longer recession in the EMU than elsewhere. A related allegation is that the rules failed as substitute for explicit policy

coordination. A third view is that the EMU as a supranational institution lacks "*incentive compatibility*" with the *legitimate* role of democratic governments as representatives of social preferences over policies and their outcomes. A role naturally intertwined with the long-lasting question of the "democratic deficit" of Europe. The second and third view converge towards the idea that tightening the existing regulatory system has pushed the EMU in the wrong direction, and that reforms should take incentive compatibility with national (different) social preferences seriously.

The direction of reforms (if any) will eventually be a political decision reflecting some balance of interests and power across governments. In a recent study (here) we have sought to investigate the problem of "Which Europe", and possibly find an answer, with the tools of strategic games. What we have found sheds some light on the supranational design that may possibly be voluntarily subscribed to by democratic governments on behalf of their citizens.

Think of two sovereign, independent, but *interdependent* countries. In the first place, we have studied why non-cooperative (NC) policy choices may arise. Each country is characterised by a socially relevant variable y and a policy instrument x that can fully offset adverse shocks to y – this we call "good" policy. Suppose $y < 0$ is a fall in employment. Then $x^* > 0$ such that $y = 0$ may be "whatever works": e.g. a labour market reform that increases wage flexibility as well as more public investment. We do not discuss policies *per se*: we just assume that a "good" one exists with no better alternative (though convenient, it is not necessary that x is the same for both governments).

Interdependence consists of each country's y depending on the other's Hence if country 1 fails to adjust its own y, also country 2 suffers a loss on its own y. Clearly, the ideal situation is the one where each government chooses its own x^*. The key assumption is that x bears a social cost, let it be a degree of policy aversion. Though economists in the European institutions tend to convince governments and citizens of the contrary, no costless policies exist. Any policy choice has costly side effects that should be taken into account. Thus each government pursues its own optimal trade-off between a limited use of x and the consequent loss over y. NC polices, characterised by less than full adjustment of y in both countries and reciprocal negative spillovers, arise not because of interdependence *per se* but because of the cost of the "good" policy. Each government can complain that things would be better for all if *the other government* did its duty with x, but as long as *the other government* does not cooperate, there is no point in being cooperative (already heard this story?)

Are there supranational regimes (SRs) that realise an improvement relative to this deadlock? Improvement here means a combination of larger use of x and lower loss of y so that *both* countries are better-off. The problem here is not how SRs come into existence (EMU already exists), but rather how they may be robust for incumbent countries having the "exit option" of the NC regime.

In this perspective, the most important difference among available proposals is between "*technocratic*" and "*political*" regimes. In a Technocratic Regime (TR), each government subscribes to a treaty that confers upon a supranational entity (a technocratic agency (TA)) the entitlement to enforce the use of "good" policies independently of the social preferences of the single countries about such policies. TRs may be *decentralised* or *centralised*. An example of the former is the rule-based fiscal regime of the EMU, with the Commission in the role of TA entitled to enforce the rules, but governments fully responsible for policy implementation. An example of the latter is the monetary regime of the EMU, with the ECB in the role of exclusive TA responsible for policy implementation for the EMU as a whole. Similar to this is an interpretation of the "European Minister of Finance", envisaged in the Five Presidents Report, as an independent non–political agency.[1] Among the political regimes, one that we call "Europe" acts a fair mediator of social preferences of the two countries, and indicates to each government the policy choice *x* that minimises the *sum* of the well-being losses of the two countries.

Our strategic games offer two interesting hints. The first is that the technocratic regimes which do not take social preferences into account are systematically dominated, so that the single true alternative is between Europe and exit. Note that this is true for *both* countries, even for *the least* policy averse. The fundamental reason is that if countries perceive the exit option as a means to freely pursue national optimal policies, then no viable, i.e. incentive compatible, supranational regime can be designed where national social preferences are totally ignored. A serious symptom can be read in the drift towards disguised, *de facto* "politicisation" of EMU policymaking during the crisis by way of the disorderly enlargement of the so-called "intergovernmental method". "The crisis has pushed the heads of state and government to assume greater responsibility because ultimately they have the democratic legitimacy to take decisions" (President N. Sarkozy, December 1, 2011). This means that insisting on more "fiscal police" instead of "fiscal policy" is not recommendable.

The second hint is that key to the choice between Europe and exit is the degree of structural asymmetry of the two countries, in particular their relative degree of policy aversion. Europe dominates exit for both countries only within a limited range of asymmetry. Here we find an interesting counterintuitive result. It is the *less* policy-averse country, say country 1, that opts out for exit as country 2 exceeds a critical threshold. In fact, Europe, by striking a balance between the preferences of the two countries, assigns $x > 0$ to each country in such a way that *x required from country 1 is higher* than it would choose by itself. This asymmetric sacrifice is tolerable up to a point. Beyond that point, country 1 minimises its well-being loss by opting out for a non-cooperative policy with a *lower x*, which will make country 2 suffer more. Therefore, the exit option for the more

[1] This interpretation is transparent in the words of the Presidents of the Bank of France and of the *Bundesbank*, François Villeroy de Galhau and Jens Weidmann (2016).

policy averse country is non credible, and may be based on the underestimation of the losses generated by playing non-cooperative out of Europe *vis-à-vis* the gains created by Europe.[2] On the other hand, in the long run, the strength of the European solution, especially when "legitimacy" or "ownership" are important elements, cannot only hinge on the prohibitive costs of exit. A solution may be the progressive reduction of asymmetries. The so-called "structural reforms" in a variety of fields, that play a central role in the Commission strategy, can be consistent with this aim. However, the actual efficacy and viability of this long-standing, restless, strategy is open to question, the more so the more the reforms involve entrenched social preferences. More deeply, should supranational institutions be conceived as means to reduce national differences or as a means to cope with national differences?

The strategic choices of governments that emerge from our study may hopefully provide some guidance in the debate about the EMU institutional reforms, in a historical juncture such that the exit option seems more and more attractive for an increasing number of European peoples, and further steps in the wrong direction may seriously jeopardise the integrity of the Union.

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[2] See this Economist article for this argument applied to Brexit.