THE SEARCH FOR EUROPE
Contrasting Approaches

BBVA

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Trust amongst citizens is a fundamental feature which facilitates economic and financial transactions. Without it, we need often ineffectual, detailed regulation to prevent uncooperative behavior, cheating, and contract breaching. Without trust courts get overwhelmed and public policies are unfeasible. In Europe, the recent Greek crisis has reduced the level of trust amongst Europeans, especially along the North-South axis. Thus, it will become more difficult to engage in the necessary regulatory reforms needed in the Euro area, including a more integrated fiscal policy, a European level unemployment subsidy legislation and banking union.

RULES, COOPERATION AND TRUST IN THE EURO AREA

The argument

Mutual trust is a key element for the functioning of a polity to run smoothly. A large body of evidence shows that mutual trust promotes investment and growth, makes international trade easier, causes financial markets to work more efficiently, encourages citizens to participate in socially productive activity, and heightens their involvement in politics, a fundamental necessity for a working democracy[1]. Laws are followed not only because they are enforced but as part of a mutually beneficial social contract. With mutual trust, cooperation amongst individuals is easier to sustain. Thus, litigation becomes less prevalent and private contracts are more widely respected.

LAWS ARE ALSO FOLLOWED BECAUSE THEY ARE PART OF A SOCIAL CONTRACT THAT BENEFITS EVERYONE

On the contrary, when individuals do not trust each other, we have instead heavy involvement of courts in individuals' lives and invasive economic rules and regulations. These are poor substitutes; courts may be overused in a non-trusting and litigious society. In addition, lack of trust may also imply that courts are also untrustworthy, with the obvious costs associated with uncertainty of the legal system. Regulation becomes excessive when many contracts or many individual behaviors require detailed prescriptions in order to prevent cheating and litigation. In fact, in many cases it is impossible (or very hard) to eliminate cheating through legislation, and often, regulation involves heavy economic costs with mediocre achievement. The more complicated regulations are, the easier it is for corrupt bureaucrats to extract bribes to circumvent them.

1 For a classic treatment of the negative effects of lack of trust, see Banfield (1959) and, more recently, Fukuyama (1995)

Thus, regulations meant to enforce law-abiding behavior, such as honesty in paying taxes, may yield the exact opposite effect.

The available evidence suggests that individuals place more trust in society's members who are similar to themselves in terms of culture, ethnicity, and religion. In particular, mutual trust is stronger within a country than across citizens of different countries. In addition, citizens of certain countries are generally trusted more than citizens of other countries and patterns of mutual trust vary across countries.[2] Thus, trust across citizens of different countries in Europe travels less well than amongst citizens of the same country, even in the absence of any particular problem at the community level.

PEOPLE PLACE MOST TRUST IN THOSE WHO ARE SIMILAR TO THEM IN TERMS OF CULTURE, ETHNICITY, AND RELIGION: MUTUAL TRUST IS STRONGER BETWEEN CITIZENS OF THE SAME COUNTRY

The argument of the present chapter is that the larger and more long-lasting consequence of the recent Greek crisis in the Euro Area will be a sharp reduction in the level of trust across citizens of different countries in Europe. Traditional views or stereotypes about "lazy southerners," "ungenerous Germans," "rigid northerners," and "deficit-prone Mediterraneans" have certainly been reinforced in recent years. In addition, opinions about the progress of European integration have suffered. The problem is that when individual members of a polity (the European Union or the Euro Area) do not trust each other, the polity does not work properly.

The effect of this decline in mutual trust will be to make progress in fixing the obvious problems in the Euro Area more difficult. Decreasing trust in the European Union will be an obstacle in many policy areas. In this chapter, we consider two examples in particular: fiscal policy and deficit managements, and a European unemployment insurance policy. In both areas, substantial progress in mutual cooperation would be necessary and useful, but lack of trust (aggravated by the Greek crisis) will make them more difficult to implement. There will be an even heavier reliance on fixed rules, which are a second best (very far from the first best) solution of managing a common fiscal policy in a monetary union.

2 See data from the Word Value Survey and the review article by Alesina and Giuliano (2015)

Indeed, it is true that the Greek crisis has forced Euro countries to adopt new policies regarding bail-outs and common funds for this purpose. My sense, however, is that the more pronounced effect of the Greek crisis will be a step backwards in the process of building common economic institutions and a common area that is relatively regulation free and based on trust.

Trust and rules: what do we know?

Several papers have recently established that heavy regulation is often a poor substitute for trust; in other words, non-trusting countries tend to legislate onerous forms of regulation. A case in point is France. In this country, the level of trust as measured by World Value Survey is extremely low (given the high level of this country's GDP per capita), and regulation in this country is notoriously extensive.

More generally, Aghion et al. (2010) show that in countries where trust is low, regulation is higher. When trust is low, individuals prefer the inefficiency of regulation in exchange for partial "protection" against cheating and non-cooperative behavior. When trust is high, regulation is less necessary and people demand less of it. These authors provide a model with two equilibria, one with high trust and low regulation, and one with low trust and high regulation. Both are self-sustaining equilibria. Thus, if the level of trust evolves slowly, this model also explains why inefficient regulation may last for a long time.

These authors provide evidence on these points by showing that results hold using three different datasets: the World Values Survey, the International Social Survey Program, and the Life in Transition Survey. The World Values Survey poses general questions concerning attitudes towards competition or state intervention, in addition to trust, for about 80 countries. The International Social Survey Program contains specific questions on the regulation of wages and prices. The Life in Transition survey provides evidence on 28 post-Communist countries in Europe and Central Asia, and it has questions on preferences for market versus planned economies. Using all these surveys, the authors find consistent evidence that distrust leads to support for government regulation. The less people trust each other, the more they want the government to regulate social interactions. In addition, the authors look at the change in attitudes from 1990 and 2000 in transition economies relative to OECD countries. Liberalization of entrepreneurial activity in transition economies starting from a low level of civic trust demands greater state control of economic activity, thus eroding trust even more.

Francois and Ypersele (2009), using data from the General Social Survey (a well-respected and widely used survey for the US), found a strong positive relationship between individual trust and the competitiveness of the sector in which an individual works. Their idea is that competition mitigates incentives for free riding by imposing a costly shutdown on poor-performing firms, making employees more trustworthy.

Aghion, Algan, and Cahuc (2011) provide a model in which higher minimum wage regulation reduces the benefits to workers of trying to cooperate with firms. Therefore, more stringent minimum wage regulations crowd out cooperation between firms and workers. In turn, less cooperative firm-worker relationships increase the demand for minimum wage regulation.

Alesina et al. (2015) show that labor market regulation may be related to the general sense of trust in society. In countries with a low level of trust, individuals are willing to move geographically to search for the available jobs, and matching is efficient in an unregulated competitive market. In countries were trust is limited to one's family, individuals are reluctant to move. In order to prevent monopsonistic power of local firms, labor market regulation is viewed as a second best option relative to a completive labor market with geographical mobility. Unemployment and poor matching are accepted as the cost necessary to avoid moving from the only trustworthy environment of the family and the neighborhood. These authors show compelling evidence of these effects using a variety of sources.

Ample evidence also suggests that trust travels less well across countries than within a country. Guis, Sapienza, and Zingales (2004), for example, show how relatively low international trust explains home bias in financial investments. In addition, mutual trust amongst pairs of countries is related to their level of international trade in goods and FDI.

Therefore, a fall in the level of trust amongst Europeans may very well be associated with more demand for regulation and less integration. Indeed, this may be problematic because the European Union in general has a tendency for overregulation, as argued by Alesina and Perotti (1998). The authors, using the example of the (in)famous and fortunately now forgotten "Lisbon agenda," show how the European tendency to overregulate can lead to almost bizarre extremes. For instance, the Lisbon agenda prescribed a target for the share of children of various age groups who had to be in preschool institutions subsidized by the taxpayers, among hundreds of other goals. This is an example of how the lack of trust for countries to do what is best for them and Europe, combined with an innate tendency for Europeans to resort to state intervention, leads to at the very least an enormous waste of time, given that the Lisbon agenda is now forgotten. However in many other cases, as discussed below, the cost of excessive regulation goes well beyond a waste of time.

EUROPEANS ARE TRAPPED IN A DILEMMA: THEY ARE RELUCTANT TO MOVE TOWARD GREATER INTEGRATION, BUT ARE NOT WILLING TO GIVE UP THE EUROPEAN PROJECT

The crisis in Greece, and more generally the divergence of economic performance between northern and southern Europe, has put Europeans into something of a "trap," as argued by Guis, Sapienza, and Zingales (2015). The argument by the supporters of European integration was the so-called Monnet's doctrine. According to this view, every step, no matter which, in the direction of more integration would have created incentives to move further towards more integration in other areas. For instance, monetary union would have automatically created the incentives to move towards more fiscal integration and eventually toward political integration. In other words, the response of European enthusiasts to the critics, who had argued that a monetary union cannot work without a political union, was precisely Monnet's doctrine. Recent events and the accompanying reduction in trust amongst Europeans have put Monnet's doctrine on hold. Europeans are in a trap: on one hand, they are reluctant to move toward more integration (given that they do not trust each other and disagree on major policy issues such as fiscal policy); on the other hand, they are not willing to give up the current level of integration. According to recent surveys, enthusiasm for the European project remains, but the question is: can a monetary union in this trap survive?

Fiscal rules in a monetary union

When the Euro was introduced, there were two views about how fiscal policy should have been handled. One view was that since monetary

The German Parliament approves the ratification
of the Stability Pact on June 2012.

policy was not in the hands of the national monetary authority, fiscal policy had to be flexible to allow for anticyclical adjustments, allowing automatic stabilizers to do their job fully. Within the limits of how much discretionary fiscal policy can be used as an anticyclical tool (and these limits are indeed restrictive), the argument is theoretically solid. The other view was that rules had to be imposed to prevent countries that generated large deficits from imposing negative externalities (high interest rates, risk of defaults, potential bailouts) on other countries. Given the relatively low level of trust amongst the members of the Union, the second approach gained traction.

Here we have another example of regulation instead of trust. Since Europeans could not trust each other regarding fiscal policy (perhaps correctly so), they had to introduce regulations, like the Stability and Growth Pact, which was a sort of elaborately balanced budget rule with escape clauses.

Balanced budget rules are suboptimal because they interfere with anticyclical movements of deficits. They are, however, a second best solution when political disruptions generate large and persistent deficits.[3]

3 See Alesina and Passalacqua (2015) for a review of the literature on political influences on budget deficits and a discussion of pros and cons of balanced budget rules. On the latter point, with special reference to Europe, see also Wyplosz (2014)

Clearly, Europeans thought that some countries could not be trusted and that a regulation on the deficit was necessary.

However, as is well known, this regulatory policy did not work. Rules were not followed. In fact, Germany was the first country to break the stability and growth path in the early 2000s, but many other countries followed. After a round of deficit reduction policies in line with the criteria for joining the union, after year 2000, countries "relaxed". Despite the reasonably high level of growth in Europe at that time, deficits generally increased.

The reasons why Germany violated the rules can be debated. It could have been a way of helping the labor market and liberalization by Chancellor Kohl, or the aftershock of the reunification, or simply a slippage of the traditional rigorous German stance on the deficit. Be that as it may, Germany violated the SGP. This was the beginning of a host of other violations, including the extraordinary large one by Greece, a country that also cheated on its statistics to hide the mounting deficits.

This was the first blow to an already relative low level of intra-country trust within the Euro Area. The Greek crisis, which lasted several years ("Is it over?" one may ask), reduced mutual trust even further. The effect on the Greek-German relationship was particularly extreme. Fouka and Voth (2015) show that the sale of German cars dropped in Greece (after controlling for the effect of the recession and sale of other countries' cars), especially in places in Greece that had suffered more from Nazi violence. This is a rather worrisome result if it implies that ancient hatreds are revived by recent events.

Even the handling of the so-called austerity in Europe can be related to low (and declining) levels of trust. A vast body of recent research (see Alesina, Favero and Giavazzi (2015), Alesina et al. (2015), and the references cited therein) has established the following results regarding deficit reduction policies. First, and most importantly, spending cuts are much less costly than tax increases in terms of output losses. Second, well-designed fiscal adjustment plans, in multi-year periods by various pro-growth reforms (labor market liberalizations, etc.), may reduce the costs of fiscal adjustment to zero and in some case be expansionary.

European austerity did not follow these principles. Because of the fear of contagion from Greece and the lack of trust about the intention of countries to follow adequate policies, European institutions enforced austerity of any type at all costs. For instance, it would have been wiser to adopt spending cuts but avoid tax increases even at the cost of slowing down the pace of fiscal adjustments. When Europe could not emerge quickly from a recession, allowing tax cuts would have been desirable. These policies would have implied “trust” that countries were not simply on a continuing unsustainable path of fiscal deficits, but instead were designing appropriate multiyear adjustment policies. However, because of the Greek contagion (which also implied lack of market trust vis-à-vis other indebted countries) and the generalized mistrust, European institutions demanded any kind of deficit reduction policies immediately.

The collapse of trust in the markets was also a factor. European institutions mishandled the Greek crisis before and during the financial crisis. The uncertainty about whether states would be bailed out or not generated market instability. Before the crisis, markets treated southern European debt, including Greek debt, basically as German debt, with no risk premium. That was an incentive for some countries to borrow since it was so cheap. When the Greek crisis exploded, the market was unsure for a while about what policymakers would do, and the crisis spread.

In an ideal world, countries could be trusted to implement well-designed fiscal adjustment polices without exporting contagion to the Euro Area. Was it reasonable for northern Europe not to trust the sincere desire of southern Europe in general (not only Greece) to adopt responsible fiscal policies? We will never know for sure, but my guess is that the collapse of trust beyond Greece surpassed what might have been reasonable. Was it reasonable for (some) southern European politicians to blame the northerners for the delays in their policy reforms and their inability to establish credibility with the markets? In most cases, the answer is no.

The result of these events is that the Euro Area is now moving even more in the direction of rules to tighten budget controls. Currently, European institutions get involved in discussions about the first decimal of deficit projections of this or that country. As expected, tightening the rules of the failed compact seems to be the answer to the collapse in trust.

Unemployment insurance in a monetary union

In the United States, the federal government finances the unemployment subsidy program. This means than when a state in the union suffers disproportionally from a recession, other states indirectly redistribute to the badly hit states through the federal unemployment insurance program. In some cases, these redistributions are quite large when recessions hit different states in very different ways, as the Great Recession did.

In Europe, unemployment subsidies are national programs. There has been some discussion about making them supranational. Recently, the French authorities proposed a plan to introduce unemployment subsidies financed at the European level with funds provided in some proportion by national governments.

WITH SUPRANATIONAL UNEMPLOYMENT INSURANCE, THE INCENTIVES ARE LESS FOR A NATIONAL GOVERNMENT TO ENGAGE IN POLICIES THAT RESCUE THE UNEMPLOYED

This is a good idea in theory. Monetary policy cannot target the need of states in deeper recessions than others, since this is common for the Euro Area, and the European Central Bank can only target "average" European macroeconomic trends, for instance, inflation and, indirectly, income growth. As we have discussed above, even fiscal policy is constrained by the fiscal compact. In addition, labor migration within Europe is much lower than in the US, and different levels of unemployment in different European countries generated much lower response in terms of labor mobility than in the US.

I predict that this proposal will not be implemented anytime soon. The reason is, once again, the lack of mutual trust. With supranationalunemployment insurance, the incentives are less for a national government to engage in policies that rescue the unemployed. In Europe, with its highly regulated labor market, these policies would involve some sort of liberalization, with the details differing from country to country. As is well known, this issue is politically quite challenging because of the stance of local unions. If unemployment subsidies were financed by a European fund, then the political incentives to engage in the necessary struggle to implement labor market reforms would decline, and the costs of this would be transferred to the supranational level.

On the other hand, one may argue, labor market reforms that could imply some temporary unemployment in the short run, compensated by long-run gains, would be made easier by European level unemployment subsidies. This force, however, would be at work if European partners would trust each other about the long-term commitment to labor reforms. That is, European institutions should view unemployment in this or that country as a temporary cost to pay in a period of reforms (if those cost existed), rather than a permanent attempt of that country to receive funding from Europe. Lacking this trust, I am afraid the first type of incentive and political argument would prevail.

LABOR MARKET REFORMS THAT COULD IMPLY SOME TEMPORARY UNEMPLOYMENT IN THE SHORT RUN, WOULD BE COMPENSATED BY LONG RUN GAINS

If, in the future, such a system of unemployment subsidies financed at the Euro level became acceptable, it most likely would be accompanied by a set of complicated rules to avoid the behavior described above of simply accepting national unemployment subsidized by Europe (or at least not do enough to reduce it). I envision a Euro Area agreement accompanied by a complete set of prescriptions about the level of unemployment, cyclical versus structural (and who decides?); what to do about black economy employment; and under what circumstances funds would be available and potentially subsidized supranationally, etc. Whether such a set of rules would make the system work or actually be counterproductive and confusing would remain to be seen.

Conclusions

Citizens of a common monetary area need a minimum level of trust to make their union work. The European Monetary Union joins several countries with different attitudes, cultures, and histories. Critics of the euro project (for instance Martin Feldstein) suggested that the monetary union would instead add to the potential animosity amongst members, and he was proven right. The level of animosity amongst European partners is at a high point.

At this stage, I see two possibilities. The pessimistic view is that Europeans are correct in not trusting each other. Southern Europeans are indeed unable to keep their budgets in order and/or to be more efficient in managing their economies. Northern Europeans are indeed unwilling to do any more in terms of redistribution to help southerners and continue to demand unreasonable conditions. As a result, the Euro Area might survive only with a set of stringent and inefficient rules.

The optimistic view is that the Greek crisis has taught a positive lesson to all concerned. Can trust increase in a group lacking it? This is indeed a tough question that relates more generally to the issue of how quickly certain cultural traits evolve.[4] Certain cultural attitudes are quite persistent; however, recent evidence by Giavazzi, Petkov, and Schiantarelli (2014) suggests that perhaps people can learn to trust each other relatively quickly. Their evidence is based on immigrants to the US and thus refers to individuals in contact with each other. This suggests that education and a closer interaction between Europeans may work in the right direction. For instance, Erasmus programs and other educational exchanges may help.

Geographical mobility within Euro Area countries is, in fact, notoriously low compared to the US, probably lower than what it is normally believed to be a condition for labor market adjustments in a monetary union. There is, however, a more subtle reason why more geographical mobility may help. In addition to clearing labor markets, it may also help develop more trusting Europeans.

What is certain is that without a minimum level of trust, a monetary union does not function well.

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4 For an overview of this and related issues about persistence of cultural traits, see Alesina and Giuliano (2015)

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