

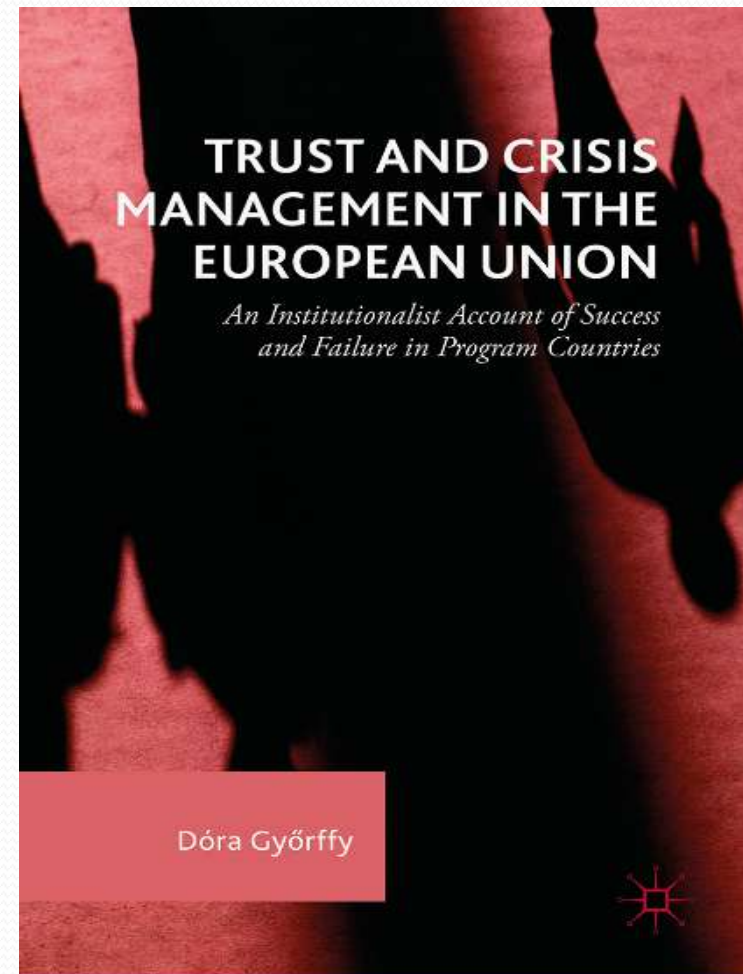
Bridging the Gap Between Moral Hazard and Solidarity in the EU: Domestic Institutions as the Missing Link

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Reforming the EU: Central European Perspectives
Budapest, 28 October, 2017

Structure of the presentation

- The dilemma of moral hazard vs solidarity
- The role of trust and institutions in the dilemma
- Domestic institutions in EU developmental policies
- Conclusions



The problem of moral hazard vs solidarity

Moral hazard

- The risks and the benefits of an action are not born by the same actors
- German economic thinking (Brunnermeier, Landau and James 2016)
- Issues for the North: Eurobonds, Single Resolution Fund for Banking Union, European Deposit Insurance Scheme, EU-wide unemployment insurance, etc.
- Issue for the East: migration

Solidarity

- We are all responsible for each other, and it is a common interest for all that all members of the community be able to live up to their full potential
- Catholic social teaching
- Issue for the South: development assistance, help in financial crisis
- Issue for the North: migration

Trust as a bridge between moral hazard and solidarity

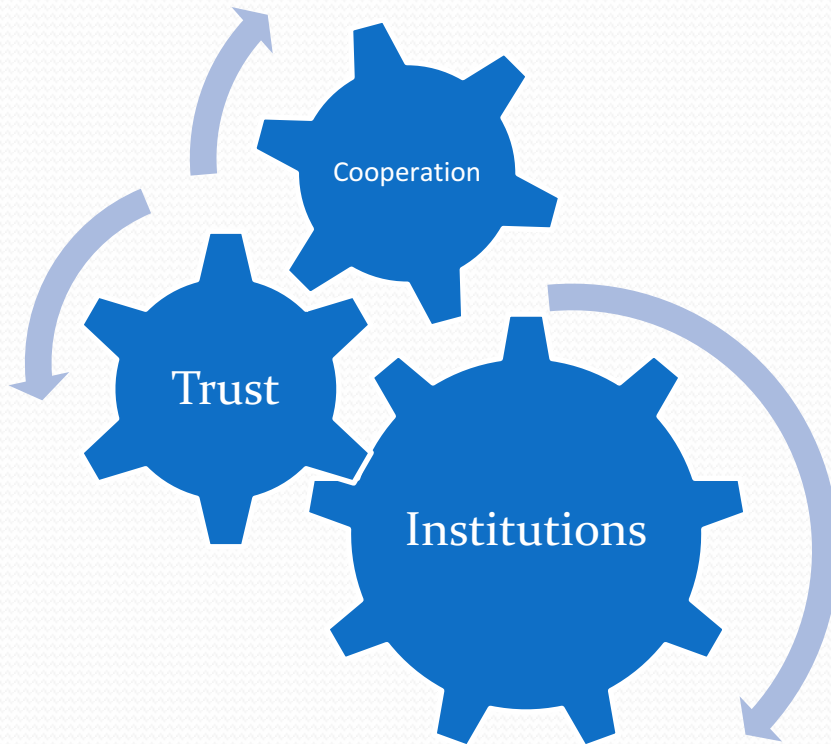
- Basic problem: fear and suspicion → need to build trust
- Trust: "a psychological state comprising the intention to accept vulnerability based upon the positive expectations of the intention or behavior of another" (Rousseau et al 1998).
- Building of trust: reputation and external commitment → limited government (incl. rule of law) as a source of trust
- Stronger institutions → reduce the need for solidarity + increase trust

Domestic institutions and economic development

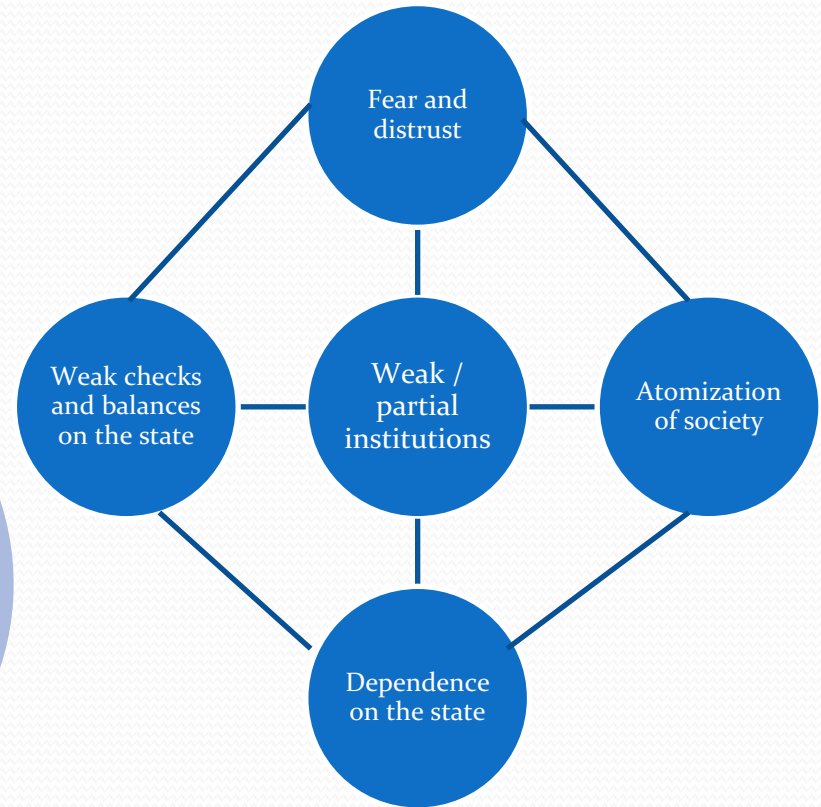
- Institutions as a fundamental source of long-run growth (f. ex. North 1991, Acemoglu and Robinson 2012)
- Mechanisms:
 1. Property rights
 2. Enforcement of contracts
 3. Trust → lower transaction costs
 4. Checks and balances on government → credibility of rule of law
- Consequences of weak institutions: corruption, policy volatility, political business cycles, shortening time horizon of actors – survival mode

Cycles of trust and distrust

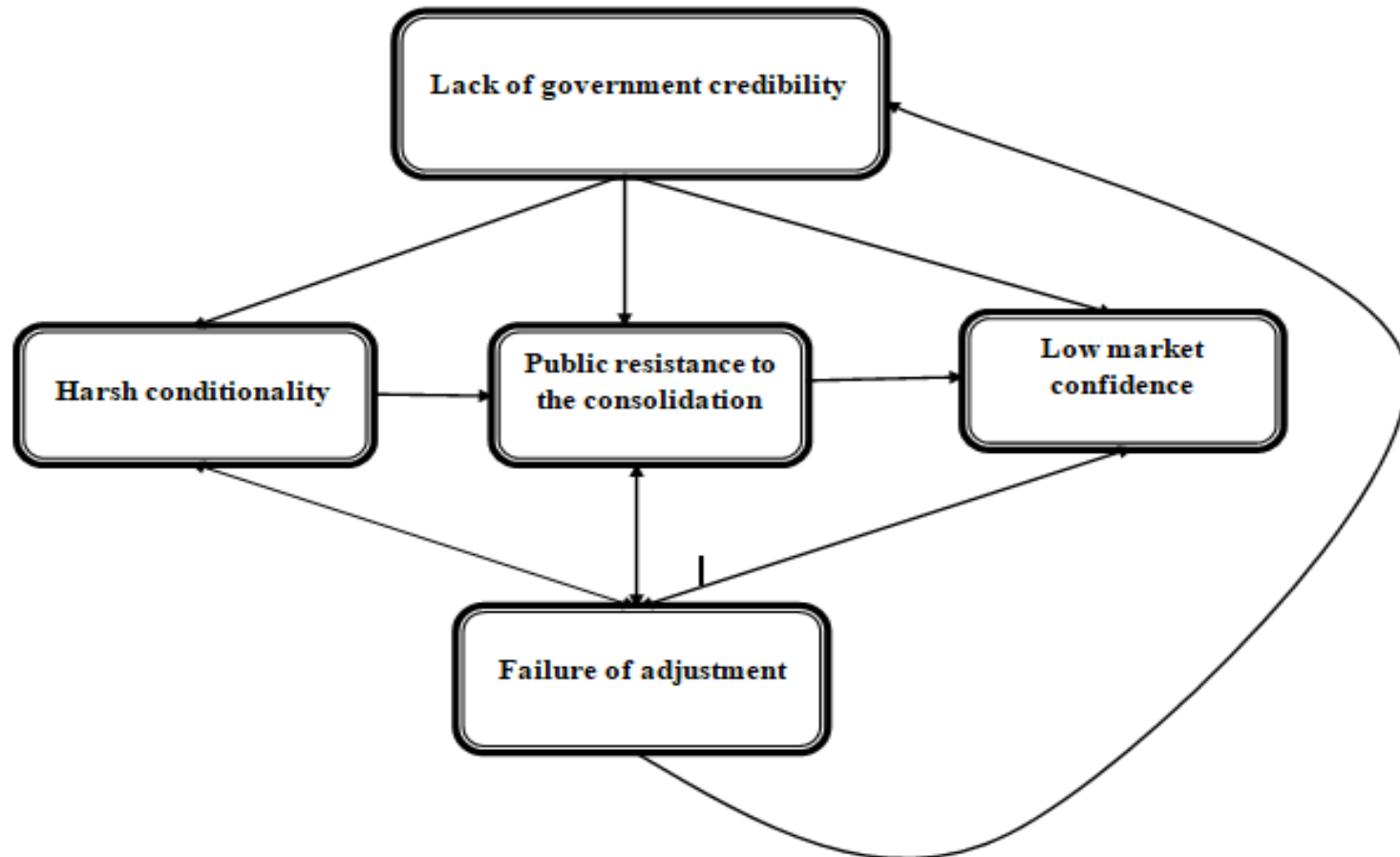
Cycle of trust



Cycle of distrust



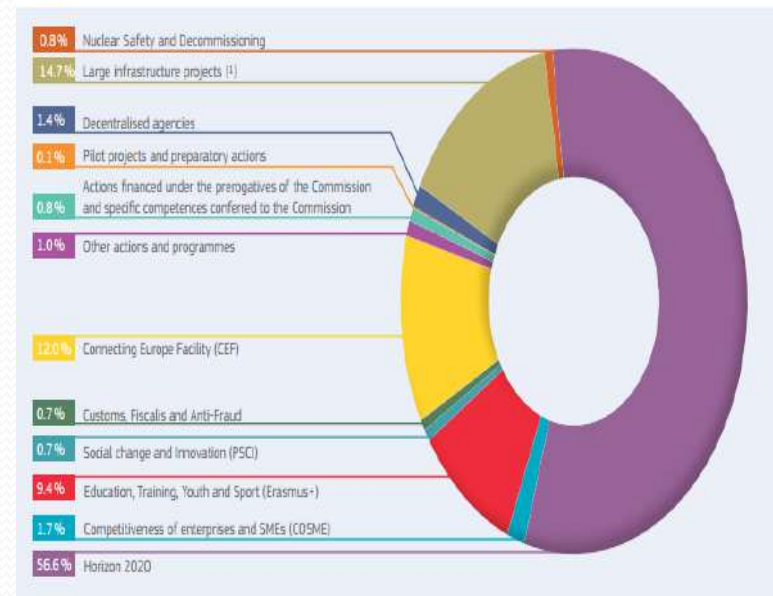
Distrust and austerity spirals during the financial crisis management



EU and institution-building

- Key aim during Eastern enlargement (Bruszt and Vukov 2017), single market, EMU, Schengen enlargement (Spendzharova and Vachudova 2014)
- Neglected in regional and competitiveness policies, financial crisis management (except Greece) and generally post-accession

Heading 1a: Competitiveness for growth and jobs



What explains the neglect of institutions?

- Concerns for clear and measurable outcomes
- Pressure for short-term results
- Concerns about sovereignty
- National-level resistance to external constraints from beneficiaries of the current arrangements
- Institutions: context- and geography-specific with significant complementarities → limited success with institutional transfer (Rodriguez-Pose 2013)

Why should the EU remain involved in institution-building?

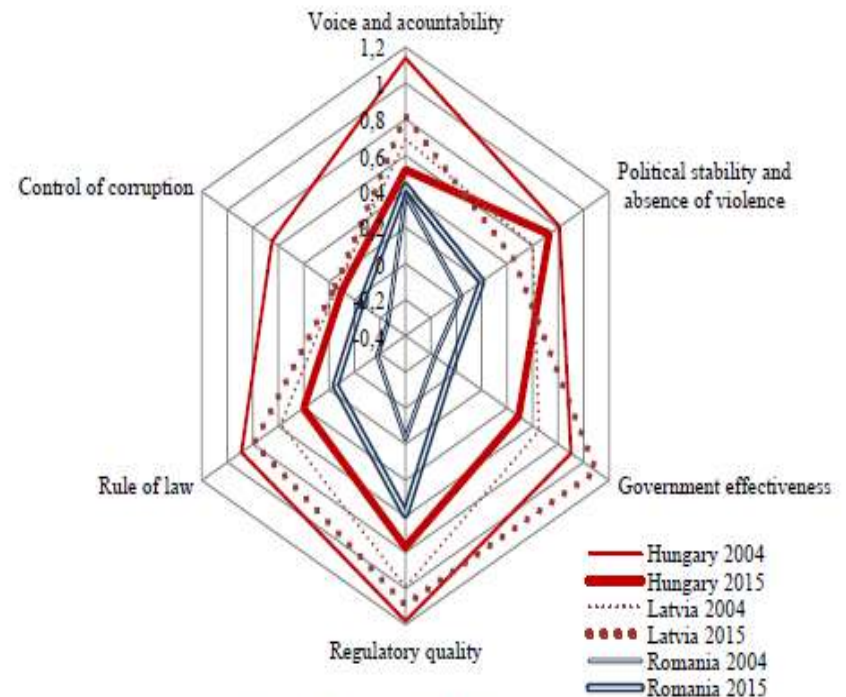
- Rule of law as a shared value across the EU
- Progress on competitiveness indicators as well as regional development is a function of institutions (Pasimeni and Pasimeni 2016, Charon, Dijkstra and Lapuente 2015) → public interest
- Abuse of solidarity is less likely in countries with better institutions → EU funding should not be used for weakening the institutional environment

Potential EU strategies to build resilient domestic institutions

	Top-down	Bottom-up
Ex ante	<i>Supranational strategies for institution-building</i> <ul style="list-style-type: none">• Institutional leg for competitiveness strategy• Conditionality for structural funds	<i>Improving incentives for good governance</i> <ul style="list-style-type: none">• Countering moral hazard on the financial markets• Promoting education• Containing foreign [Russian] influence
Ex post	<i>Sanctioning non-compliance</i> <ul style="list-style-type: none">• Strengthening enforcement of values• Institutional conditionality of financial support programs	<i>Fighting backsliding</i> <ul style="list-style-type: none">• Militant democracy• Supporting (defending) pro-democracy groups

Recent EU initiatives with institution-building

- SRSS: EU Structural Reform Support Service (for Greece and Cyprus)
- Cooperation and Verification Mechanism for Bulgaria and Romania
- Blueprints for inclusion of institutions exist



Data: World Governance Indicators at:
<http://www.govindicators.org>

Areas for SRSS

Governance & public administration

- Governance
- Central & local administration
- e-Government
- Management of human resources
- Better regulation
- Anti-corruption & anti-fraud strategies
- Anti-money-laundering strategies
- Judicial reform

Revenue administration & public financial management

- Revenue administration
- Budget preparation
- Spending reviews
- Fiscal strategies & tax policy
- Supreme audit institutions/ independent fiscal institutions

Growth & business environment

- Investment licensing
- Competition policy
- Trade issues
- Digital society
- Land registry
- Energy Union
- Better regulation
- Management of State-owned enterprises (SOEs)
- Sectoral expertise: transport, environment, water, agriculture, etc.

Labour market, health & social services

- Labour market policies & laws
- Welfare system
- Pension system
- Healthcare system
- Education & vocational training

Financial sector & access to finance

- Access to finance
- Capital Markets Union
- Bank supervision & resolution
- Non-performing loans
- Insolvency & financial literacy
- Insurance & pensions
- Competition issues

Top-down institution-building

- Prevention of deterioration is more likely to work than ex post interventions
- Recognition for its inherently political nature → no enthusiasm from trespassers
- Availability of programs is still important to raise public awareness
- Needs to be problem-driven rather than template-driven
- Competitiveness: include SRSS program into Europe2020 and its successor
- Regional policy: SRSS + some form of conditionality (f. ex. joining EU Prosecutor Office)

Conclusions – a CEE perspective

- Moral hazard vs solidarity debate as a phenomenon of distrust
- Institutions = pre-commitment devices, which build trust
- Recognition for their role is crucial for reducing the need for solidarity and building trust
- Existence of vicious cycles of distrust and weak institutions in the East and the South
- EU has a wealth of experience about building institutions, which should be utilized
- Without domestic institutional convergence the dilemma between moral hazard and solidarity is unlikely to disappear



Thank you for your attention!