The single market and European organisational sclerosis

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Thank you Mr Chairman.

I'd like to present a view that we cannot understand what determined the move towards a single market[1], what are the possible evolutions of the single market right now, and what are the reasons for the obstinate attempts of national political classes at building a centralized political European Union, without a theory of centralization, that is, of the changing optimal size of hierarchical organizations. The facts and consequences of the "centralization of Western Europe" have been exposed, many years ago, with remarkable clarity and perspicacity by Professor Roland Vaubel in an IEA publication[2].

What I present here is a view of the economic calculus of optimizing organizational structures, a calculus which was massively in favour of larger hierarchical organizations during the first three quarters of the XXth century, leading to the concentration of giant firms [3] and to the centralization of the political structure of the world under the dominance of two giants empires – The USA and the Soviet Union – that confronted each other in the Cold War. The attempt to construct a third superpower by combining the former imperial nations of France, Germany, Italy and possibly even Great Britain was intended to reinforce and consolidate the Western Alliance. But the last quarter of the century saw a sea change in organization, coming, as I shall explain shortly, from the information and communication technological (ICT) revolution. The organizational trend underwent a complete reversal from the mid-1970s onward, changing the structure of most hierarchical organisations, and boosting the development of markets everywhere. I claim that the optimal organisation of the public sector and also of private businesses has been revolutionized by an informational tsunami during the past three decades in favour of smaller hierarchies and larger markets. And that is the reason why the old project of centralizing Western Europe by building an additional level of political organization above that of the nation states is now not only obsolete (a remain of a former era) but also moving more and more afar from the modern (information era) optimal political organization. For that reason it is deeply detrimental to growth and economic dynamism.

The singe market itself is another step in that wrong direction, alongside with other centralising policies, whether effective, such as monetary policy (the creation of the euro) or projected, such as a single tax policy intended to suppress tax competition among governments. They all belong to the general category of anti-competition policies.

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[1] The « Single Act » of 1986 substituted the aim of a « single market » to the previous policy objective of a « common market ».

[2] Roland Vaubel, The Centralization of Western Europe, IEA, 1995.

[3] As described in the U.S. by Alfred Chandler and in the UK by Leslie Hannah.

I'd like to present this plain economic analysis in terms of the public choice theory and of the theory of industrial organisation. And for that I'm asking three basic questions.

First question: in what respect is a single market different from the previous notion of a common market? What are its effects on competition and consumer welfare (the second depending on the first)? And the answer is: the single market really means European-wide centralisation of national regulations, a regulatory centralisation that decreases competition and consumer welfare.

Second question: what are the reasons for the dogged pursuit of such a centralising strategy? And the answer is: huge new rents for centralized European regulators and for business interest groups and oligopolies.

and finally,

Third question: how far can it go and could it be reversed? And the answer will be suggested as a result of my analysis.

I. Common market versus single market.

At the time when Jacques Delors coined the term "single market", the "common market" had not even been completed yet (especially lagging were the agricultural sector and the service sector, particularly banking). The aim of creating a truly single market thus appeared in reassuring continuity with previous policies. But the appearance was deceptive. There is in fact a huge difference between the common market and the single market. The common market was basically a free trade area with a low common external tariff. It helped transforming and opening the formerly protectionist and fragmented national economies of Western Europe after the war, and it was hugely successful.

But then the utility of this common market policy decreased with time, first because of its very success, and second because of the worldwide trend towards freer trade (GATT, WTO). The interest of a regional market was still important, but decreasingly so.

It followed that European politicians needed another program to keep their own business growing. A new program of action had also to contribute to the overall centralization of the continent that was their ultimate aim and their main strategy. Their motto was the "bicycle theory": if "Europe" (read political centralization of Europe) does not progress, then it fails.
The new instrument that was chosen in 1986 was the single market, or in other terms "deep integration". Just ordinary free trade (no tariffs, no quotas) wouldn't do. What was needed was a "level playing field" meaning that the political framework of economic activity should be the same in all countries: unification, centralisation of all regulations in all fields, was required for "fair" competition to exist. Social regulations, taxes, industrial standards, competition policy and cultural policy, subsidisation of industrial sectors, and of course a single currency (which means that a single monetary policy rules the whole of Europe) were all to be unified as elements of the single market.

The creation of a regulatory union would, allegedly, foster product competition by decreasing political competition between national governments. Indeed, under national regulations there is a competition of different policy models and that's good for the consumer because competition should prune out the inferior regulations and promote the good ones through movements of firms and people from one country to another.

What are, in the facts, the effects of such a suppression of political competition on consumer welfare?

First it cannot improve much, if at all, the protection of consumers: it would be hard to explain how a single European regulatory body could be more efficient than several national regulatory authorities, which are more attuned to the local preferences of national consumers (and here the often cited example of the fabled French cheese variety obviously comes to mind!)[4]. There is no rationale for that. So it's most likely that the motive for centralising regulations is not one of a defence of consumers.

What could it be?

Well, in practice it stifles competition, competition of products and competition of policies. Product competition is weakened because a single regulatory framework homogenises the products. This means that "non-price" competition, the competition through quality and variety, decreases. And non-price competition is very important for all products that are not "commodities" (products that are perfect substitutes to each other such as a barrel of oil of a same quality). All that is left to firms is price competition for products that tend to become similar. And this decreases the range of products and variety available to consumers, thus their welfare.

The centralisation of regulation ignores the difference of tastes in various countries. It also ignores the difference in economy conditions, such as the local (national) elasticity of demand, the elasticity of supply, the density of population in various countries, and so on. These factors explain the differences in the demand for environmental regulations from one country to another. Fixing the same standards for the whole of Europe ignores these differences in demands: one size does not fit all and the consumers are less well served.

I thus conclude that centralising regulation distorts competition instead of increasing competition[5]. It's just the reverse of what the common market was intended to do.

So it appears that the substitution of the single market objective to the common market objective is an instance of what George Orwell forecast for the year 1984 in his well known novel: the reign of "newspeak", the official language the terms of which mean the contrary of their ordinary meaning. In the "single act" of the EU, the request for a more competitive environment means in reality just the contrary of what it seems to be meaning. Instead of a further progress towards competitive markets, the centralisation of regulatory authorities is a regress and a distortion of competition.

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[4] The well known « Cassis de Dijon » decision shows how regulatory competition between member states could be enforced while maintaining a common market at the same time.

[5] See Roland Vaubel, op. cit. on that point.

"Newspeak" thus became a reality in Europe in 1986, when the project of a single market was adopted. It was only two years late on Orwell's forecast schedule: that's not too much of an error by the current standards of economic forecasting!

This brings me to the second question: why are European politicians doing that?

II. Interest groups versus consumers.

My answer is rather straightforward in public choice and industrial organisation terms. There are large benefits for interest groups, including the interest groups of the politicians and bureaucrats themselves, to be gained from these distortions of competition. It must be understood, to start with, that a regulation in fact is a tax plus a subsidy.

Take the example of seatbelts. When you regulate carmakers to compel them to put seatbelts in their new cars, this is going to increase the price paid by the consumer for the car, so it's a tax on consumers since at least a part of the additional cost is born by the consumer, not the carmaker.

And by the same regulation you develop the sales of the business firms that produce seatbelts, so you increase the profits of the seatbelt providers. It follows that the seatbelt regulation is a transfer: it is both a tax on consumers, and a subsidy for the belt producers.

This gives us the key of what happens with the centralisation of regulations. Transferring income is the basic business of politics. Politics is about the distribution and redistribution of income. It consists in taking money (or resources) from some groups and giving money (resources) to other groups. Increased regulations thus develop the business of politics, and politicians of course are glad of that. They are glad to see their business increased, so they usually are in favour of extensive regulations.

The question is: is the centralisation of regulation increasing the overall volume of regulation? I say yes of course.

Why? Well take the European Union. The total population of the 27 countries is about 500 million people. The "theoretical" average size of the national economy is thus about 18.5 million people. So when you shift regulation from a national authority to a central EU regulator you multiply by 27 the value of the national regulation for the regulated firms because when your product gets market access (because of the conformity to the norms) it is for a market of 500 million potential customers instead of a market of 18,5 million people. The costs of regulation for the firms are divided by 27 because one of the main costs, the cost of lobbying the regulatory authorities is now incurred only once, instead of 27 times in 27 different national markets.

Increasing the benefits of regulation and decreasing its cost for the firms will result in a large increase in the demand for (favourable) regulation because the cost/benefit ratio (the "price" of regulation) is much decreased.

Is that good for consumers because of the economies of scale in regulation and cost savings for the firms? I don't think so. A large enough firm will now have its former lobbying budget available to lobby not 27 regulatory bodies but just one central authority. Since all firms are in the same situation they will spend at least the same amount on lobbying the central authority that they used to spend in 27 lobbying campaigns in 27 different countries. But the price of regulation having been decreased they should even "buy" more of it.

Consider also that lobbying is usually a collective activity. A lobby is a group of firms, usually large enough to find an incentive in spending time and money for promoting a collective interest. Smaller firms that could not create a lobby and cover its fixed costs in a small economy with a narrow market now can do so to influence regulations in a large market of 500 million people. New lobbies will form. That's why the lobbying industry has been growing so rapidly in Brussels, imitating what happened long ago in Washington D.C.
Overall the total amount of lobbying will increase with centralisation.

So there is an overall increase of the money spent lobbying and of course the regulatory authorities are influenced by the spending of lobbies and that's what the late Professor and Nobel Prize winner George Stigler showed and called the "capture" of regulators by the regulated firms and their lobbies. The regulatory authorities are not completely independent of the actions and spending of the lobbies. Bureaucrats controlling access to a 500 million people are obviously more actively lobbied than bureaucrats controlling a market of 18,5 million people.

It follows that not only will the overall amount of lobbying increases but the distortion of regulatory decisions will be more important in large centralized markets than in smaller ones. Rent seeking will increase and that's bad news for consumers. That's good for some businesses, that is good for the bureaucrats, but it is bad news for consumers.

A last effect is detrimental to consumers. When there is an increase in spending for lobbying, and new lobbies are formed, individual firms get used to work more intensively and more efficiently together, to get "better" regulations passed by the authority. And so the incentives for forming cartels, the collusion between firms, are much increased. As we know, cartels are good for business and bad for consumers: they result in higher prices and lower quantities.

So all of these effects are bad for competition and detrimental to the consumers' interests. But that's not all.

There is a second important real effect of the centralisation of regulation and I'll just explain why it matters so much. It comes from the dilution of democratic control. You could consider that regulations are ultimately the result of elected politicians' decisions, and politicians in Brussels or Strasbourg are elected, one way or another. Presumably they thus have to defend the interest of voters. But which voters?

They are less and less efficient representatives of the voters who elected them. Why? Because the number and the influence in the EU of politicians of a given nation, is proportional to the importance of nation's population in the overall EU population, according to the institutional rules of the EU. Be it in the council of ministers or in the parliament.

For instance, before the existence of the EU, whatever the French voters collectively wanted the French politicians could supply and control at 100%. Now in a 500 million polity the politicians of the average "theoretical" country of 18,5 million people amount to only 1/27 of the total number of EU politicians. That represents about 4% of the elected members of the Parliament. It follows that if 100% of the voters of that country want a law or a regulation to pass, their influence on the final result is minimal instead of total. The preferences of the average German or Italian voter are not influential anymore. Actually, laws and regulations are decided by German, French and Spanish voters for Portuguese, or Belgian citizens. The power of national electorates is diluted.

Their formerly hard won national democratic control is reduced through the extension of the voting area and voting population, and that's exactly what happens in business firms when you dilute the capital by the creation of new shares. You increase the capital and you dilute the power of the former owners (voters or shareholders). The control that these "owners" can exert on managers, that is, in this example, the politicians and bureaucrats, is lowered in the same proportion. Accordingly, the politicians all over the EU are not going to resist the trend towards more centralisation. On the contrary they retire some personal benefits and increased independence vis-à-vis the electorate by that very diluting process.

My conclusion is that the centralisation of regulation brings about an extension of the size of central bureaucracies and this is the case even more when you consider that existing bureaucracies usually do not disappear when new ones are created.

Look at the European Central Bank. The ECB has been created and is now working in a huge expensive building in Frankfurt. But the French Central Bank still exists, it didn't decrease its employment or budget and I suppose it's the same for other national central banks in the Eurozone. So there is a net addition of monetary bureaucracies with the centralisation of monetary regulation and the creation of one more level in the political hierarchy, which results in an increase of the overall size of bureaucratic Europe.

On the business side of that process, the development of lobbies mainly benefits existing established firms because they are the only firms that can create a lobby. "Potential" firms obviously cannot, nor do the new entrants. The extension of lobbying thus favours existing firms. Existing firms are large firms, and the older they are the larger they are. It follows that centralisation of regulation and increased lobbying promote the concentration of business firms and business interests and that's not really an advantage for consumers either.

This is not good for the creation of new firms and for the general dynamism of the economy. Indeed, it is the source of what I call the sclerotic organisation in the EU. It enforces and enhances the rents of large, older business firms and bureaucracies and freezes the hierarchical structure of both industry and political production at a moment when innovation, new small firms, and lighter government are required. It is a recipe for accelerated decline.

III. Organisational sclerosis

How far can this process go? Well I think that we now have to understand what happened in organisational terms in the 1970s. It was a revolution. I explain in my book on the 'Second 20th Century: How the Information Revolution Shapes Business, States, and Nations' (Grasset, Paris, 2000, and Hoover Press, Stanford, 2006) that during the first three quarters of the 20th century there was a trend towards centralisation, concentration, increase of the size of hierarchies both public and private (big firms, big states). Industrial organisation economists call it the "fordist" era after the name of the American carmaker that invented the continuous production line, but it was also the era of socialism and centralisation of the state and of the increase of the size of state bureaucracies everywhere, including in the democratic "market economies".

But from the mid-70s on, a reverse track upset organisational structures everywhere. Big conglomerates disappeared in the following decade, very large and inhomogeneous countries dissolved: the USSR first and then Yugoslavia, Czechoslovakia, while regionalist and secessionist movements multiplied in Spain, Italy, and elsewhere in the world.

So something big happened in the 1970s: that was the dawn of the information era. Suddenly information costs fell vertically because the drastic fall in the cost of storing, processing and communicating information due to the microchip, the computer, and radio transmission of the internet. An economist would say that when the cost of information is going down more information should be used. But a more intensive use of information is going to impact profoundly the structure of organisation of all productions.

We know basically of two modes of production: decentralised production operated through market exchanges between makers of parts of a product, and centralised production in which parts makers are integrated as specialised employees in a single hierarchical firm (whether a privately owned firm, as in thee U.S., or a state owned firm as in the USSR or many continental European economies of the 1950s). This is the Coase-Williamson theory of markets versus hierarchies. In it, the choice of the type of organisation is more fundamental than the choice of the type of property, public or private, because both public and private hierarchies have many similarities while they fundamentally differ from market organisation. In this view of production we should add that the respective roles of markets and of hierarchies in an economy are distributed along a continuum. Some economies include more markets and thus less hierarchies, while other rely more on hierarchies and less on markets. And I'd like to emphasize that the position of a given country on that continuum could very well change through time. It is not given forever: it evolves.

The question is: what are the drivers of such an evolution in productive structures. My suggested answer is that the cost of information is the main determinant of the adoption of centralised or decentralised structures, and thus of the economic "regime" or "system".

Why? Because of the big difference in information use between a market exchange and exchanges within a single firm. The market is an information-intensive mechanism: each buying agent in the market needs a lot of information to discover who are the producers, what is precisely the product they offer (their "qualities"), what are the prices and what are the transactions cost for the purchase of a given intermediate product. The hierarchy, on the contrary, is an information-saving device because (in an extreme case) only the top of the hierarchy needs to be informed. It thus uses information sparingly. Once you produce the information for the top management you can use it again through the directives by which the manager transmits it to all the people under him, instead of having each of them look for information separately. The hierarchy uses economies of scale in information. So you can save information and information seeking by adopting an integrative hierarchical structure in place of a decentralised market economy.

The conclusion I draw from this analysis is that when information is very costly it should be used sparingly and thus the “best”, more efficient organisation of production (including “political production”, that is, the activity of politicians), should be integrated in large hierarchies and few markets.

On the contrary, when the cost of information goes down dramatically as it did in the 1970s, then the market becomes more efficient than the hierarchies. So hierarchical Europe is to shrink its hierarchies: they should be divided and reduced, and at the same time markets should expand, and that’s what happened in the 1980s, worldwide. It was even more the case in highly centralised economies such as the USSR. They simply went broke because their organisational structure had become uncompetitive and obsolete. They did not take advantage of the sudden fall in the cost of information. They did not realize that a new and abundant resource (information) was available for maximizing growth. Or if they did they weren’t able to change their out dated organisational structure to benefit from the new cheap resource and they lost to information intensive competition from the U.S.

Adam Smith called attention to the invisible hand of the market and the American economist Alfred Chandler explained in a symmetric fashion that the “visible hand” of the big corporation, the existence of large hierarchies, was characteristic of the XXth century businesses. What one could observe today is that since the last quarter of the past century large hierarchies are shrinking: the information era is the era of the “shrinking hand”[6].

Against this general background what are we doing in Europe? We are still extending the public (or political) hierarchies and contracting markets, a directly dysfunctional and unproductive strategy. The relative prices of factors and information tell us that we should be doing the opposite.

Such a policy that ignores the new relative prices in an information economy is detrimental to efficiency in production and to wealth creation because, as Alfred Marshall, the English economist, showed, organisation is a factor of production besides capital and labour. Capital and labour can be used in various mixes with more or less centralised or decentralised modes of organisation, which use information more or less sparingly. The right mix depends on the relative prices of factors, capital, labour, and organisation (i.e. information). Using too much centralisation when information is cheap is inefficient. The economy could be much more productive with the same amount of capital and labour but with more use of information, through a decentralised (market) structure of production.

It is not always so: in an information scarce economy, centralisation would be more productive, be it private (big firms and corporatism) or public (state capitalism also called “socialism”).

But in the present, and for a foreseeable future, we live in an extraordinary abundance of information, and the deluge is increasing.

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[6] See my recent article in “The International Journal of the Economics of Business”, July 2012.

Given the current relative prices of labour, capital and information, if you use large organisations, large hierarchies, when these prices tell you that you that you should use few hierarchies and more markets, then you are not efficient in the absolute and you lose ground relative to your competitors, you produce and sell less, and consequently the consumers can get less goods and services.

I conclude that in the present circumstances the centralisation of regulation is detrimental to growth and wealth production. This inability of organisational structures to adapt to the new relative scarcities and relative prices of factors is what I call the European organisational sclerosis[7].

What then is going to happen? I'd like to give you my best forecast, hopefully as good as that of George Orwell. I think that something has got to give. The current European orientation towards increased centralisation is itself increasingly questioned and will be reversed just as in the last part of the 19th century, the previous British trend towards free trade and small hierarchies was replaced by a new trend towards centralisation, including both big firms and big state. I think that current European policies are a legacy of this period (the 20th century) but that they are counter productive in the new era of the information age. What we need to avoid a growing organisational sclerosis is a radical about face of policy, a great reversal if you like.

A uniform union-wide regulation (and the underlying model of centralisation of everything) is just like the Ford Model T: the choice of the car paint is up to every buyer, provided it's black. This could be a productive, wealth enhancing, policy in the price context of the past century. But it won't do today. With the falling costs of information, centralisation is out, variety is in and centralisation becomes directly unproductive and will lead to failure in a very short term as the information revolution proceeds at an accelerating pace.

Variety and specialisation are now cheaper to obtain through market exchange and as Adam Smith wrote, specialisation, not uniformity, is the key to wealth creation.

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[7] A sclerosis already diagnosed by Herbert Giersch in the 1980s, but linked in his analysis to an insufficient flexibility of market prices (especially in the labor market) and not to the evolving structure of organizations.