Avoiding monocultures: uncertainty and the case for managed diversity within the European Union

A book "pre-nopsis"* by Richard Bronk[1] and Wade Jacoby[2]

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'Europe is, in my judgment, wholly indebted to this plurality of paths for its progressiveness and many-sided development. But it already begins to possess this benefit in considerably less degree', John Stuart Mill, On Liberty, 1859

Mill's argument in favor of following a 'plurality of paths' ascribes social progress as a whole to cultural and economic diversity and to the refusal to assimilate to the 'despotism of custom'. Yet, especially in the last three decades, the history of market and political integration reveals powerful pressures to erode such plurality. Moreover, as firms and regulators converge on apparently successful models, so too the way most of us think and analyse the world becomes increasingly constrained by the logic of these 'best practices'. By contrast, this is an argument for diversity—not because diversity is 'good' in all cases (it's not)—but primarily because it provides certain virtues that are hard to replace. Although diversity can exist at the level of firms, subnational regions, or even global regions, we focus on diversity in *national* regulatory policy.

This book thus makes a general argument about the dangers of such analytical and policy 'monocultures' in an uncertain world. It then shows the link between these monocultures and severe economic and political crises. We argue that homogeneity of thought and regulatory practice can lead both to high and destabilising correlations in behaviour and, crucially, to epistemic closure and a failure to spot emerging problems until it is too late. By contrast, policy diversity can lead to lower correlations in behaviour and, therefore, to less pronounced economic cycles; meanwhile, a plurality of conceptual and regulatory frameworks, and diverse 'experiments in living' (Mill, 1859), may ensure greater success in detecting emerging trends and producing successful innovations in thought and practice.

This conceptual argument is then used to recast the current debate about reform within the European Union (EU). In a nutshell, we argue that the EU often works best when it integrates by managing diversity rather than by effacing difference. This has particular implications for current debates about a fiscal and banking union in the euro area and for the calls in the UK and elsewhere for greater subsidiarity within the EU. Nevertheless, while the arguments presented here are critical of some recent trends in the EU – in particular the domination of policy and analysis by what we term the 'German Consensus' – they also provide a new rationale for the Union. Indeed, we argue that gains from diversity at a multi-national level are best achieved with the help of a set of deep institutions like those in the EU that can, when designed correctly, manage the inevitable frictions caused by diversity, while enabling member states to pool risks and learn from each other's diverse policies, practices and mental frames.

The book starts with two paradoxes from the recent financial crisis. The first paradox is that we live in an era of rapid change and radical uncertainty caused above all by the

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* A *synopsis* is a summary of a clear plan of action; we're not yet clear enough on where we're going or how we'll get there.

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high rate of technological and policy innovation; and yet, despite this, in certain social and economic spheres, we see the emergence of what Foucault called 'totalising discourses' or Lyotard cast as 'grand narratives' while, at a more mundane level, we see market- or regulation-led homogeneity of analysis and practice. An example is the 'world-level grand narrative of risk management' (Power, 2007) in the decade leading up to 2007, which 'fostered an illusion of control by confusing radical ontological uncertainty with measurable risk' and led nearly all players in financial markets (regulators included) to see Value at Risk models as best practice (Bronk, 2013a). In the pre-crash era of the 'great moderation,' most significant players were operating within *one* analytical mindset and with very similar practices. The result was a widely shared cognitive myopia, dangerously high market correlations, and – when the analytical monoculture faced innumerable previously ignored anomalies – a crisis shift in expectations, behaviour and outlook that affected almost everyone at once.

The second paradox is linked to the first: there is growing appreciation in academic, and in some policy and business, circles that analytical diversity is key to innovation and superior foresight. For example, Stark (2009) shows how the 'dissonance of diverse frameworks' produces a 'productive friction that disrupts organisational taken-for-granteds, generates new knowledge, and makes possible the redefinition, redeployment and recombination of resources'; Ostrom (2009) argues that a 'polycentric approach' has the advantage of encouraging 'experimental efforts at multiple levels'; while Page (2007) shows how diversity can trump ability in prediction markets. At the same time, there has long been an understanding in investment markets that diversification between different assets enjoying low correlations is key to stable returns. And yet despite this appreciation of the advantages of diversification, when it comes to economic policy, we hear time and again calls for global solutions to global problems, and for regulatory harmonisation and a level playing field across multinational markets. What is more, a homogenising discourse of best practice has become ubiquitous across business and government circles, despite the fact that it is often impossible to know *ex ante* what best practice will be. We continue to see widespread calls for global or EU-wide harmonisation of trade and accounting practices and of financial market regulation according to new definitions of best practice. In this book, by contrast, we will argue that such analytical and regulatory monocultures leave us exposed to unforeseen problems and may deprive of us the wherewithal to innovate our way out of trouble.

In arguing for the benefits of managed diversity in the EU and beyond, this book builds on seminal work from several disciplines. This includes Varieties of Capitalism arguments in favor of nations trading on (rather than effacing) their distinct comparative *institutional* advantages (Hall and Soskice, 2000), many of which support various firm-level advantages (Berger, 2005); we also draw inspiration from Nicolaidis' thesis (e.g., 2012) that the EU is politically and economically stronger if it is 'not constituted by separate demoi nor demoi-made-into one but by distinct demoi progressively opening to each other' – a 'third way' that involves 'sharing, pooling, enmeshing, but not unifying'. We owe much also to the argument in Hannan (1986) and Evans (2004) that 'institutional monocropping' shares the same flaws as its agricultural analogy, namely a reduction in (genetic) diversity that leaves us exposed to wipe out in the face of new unforeseen diseases, and with an impoverished potential for adaptation. Similarly, Rodrik (2011) warns that: 'In the light of the great uncertainty about the merits of different regulatory approaches, it may be better to let a variety of regulatory models flourish side by side' (see also Rodrik, 2007; Ban and Blyth, 2013). To this end, we examine the positive vision in Sabel and Zeitlin (2010) of the EU as having forged a novel form of governance – through mechanisms such as 'councils of regulators', the open method of coordination, and devolving much of the implementation of directives to national level – which they dub 'direct deliberative polyarchy,' which they see as 'a machine for learning from diversity' that transforms an 'obstacle to closer integration into an asset for achieving it'.

What, then, do we add? It is worth isolating four novel features of our theory of monocultures. First, we switch from the analogy of 'monocropping' to that of a 'monoculture' because the latter has epistemic and cultural connotations missing from the former. For us, the key feature of a monoculture is its tendency to constrain the way we frame problems and to structure how we collect and interpret evidence. In this, we stand in a post-Kantian philosophical tradition opposed to naïve empiricism: we cannot make sense of the world without the help of the conceptual grids and theoretical priors; but such grids and priors – particularly if used on their own – distort as well as focus our vision by being inevitably selective (Bronk, 2009; Kuhn, 1996; Hall, 1993).

Second, our notion of monoculture embraces not only ideas and conceptual grids or priors but also the institutions and practices structured by such thought or in which such thought is embedded. We see ideational and institutional frameworks as mutually constituted. This is crucial to our argument against regulatory monocultures: we argue that over time the enforcement of homogenous regulatory practice may lead, if accepted and internalised into operating and analytical routines, to homogenisation of thought and analysis. Our contention is that the tendency for any single or homogenous policy approach to constrain the way we *think* about issues, construct data, and analyse problems is every bit as important as its direct constraint on action, not least because of its implication for the possibility of policy learning or reform.

Third, our notion of monoculture includes notions of both market and political power. Discourses may be a conscious instrument of domination or merely become totalising as a function of asymmetries of power. So, for example, we will argue that a German Consensus has become established as the dominant discourse within the euro-area as a result of the huge asymmetry of economic and political power resulting from German economic superiority over its partners. While perhaps not a permanent thing, this worries us a great deal. The best antidote to monocultures is a balance of economic and political power and a vibrant peaceful political contest for power between parties or nations from competing ideational camps. Yet the travails of the French and Italian alternatives and the withdrawal of Britain make such a contest difficult to sustain.

Fourth, we build on a tradition of 'discursive institutionalism' (Schmidt, 2008) that sees institutions (and cultures) as both constraining individual actors and 'created and changed by those actors'. Institutional settings, that is, do not determine how we think and act: this is partly because there are normally degrees of freedom in these settings; but more importantly because imaginative and sceptical actors within them challenge and seek to reform them. Our thesis, however, is that this is true only when those actors have access to alternative scripts, narratives or discourses, and when these alternative ways of thinking are embedded in alternative experiments in living. When, by contrast, key actors live in a monoculture without access to minority scripts, the deterministic picture of early institutionalism or Kuhnian paradigms becomes more germane: actors are condemned to think and act alike until the monoculture suffers from a full-blown crisis of credibility. And our wager is that redundant and minority scripts will wither away to the point where they provide institutional entrepreneurs with few resources if they are not sustained by enactment in practice (Jacoby, 2006).

How can such abstract principles be translated into policy analysis? We claim that good governance in a multinational setting requires what we call *modus vivendi* institutions to enable diversity to thrive, manage the frictions implied by diversity, and exploit the gains that diversity allows. Since escaping epistemic closure, enabling innovation, and the pooling of risks among dissimilar economies, all require the long-term persistence of diverse modes of regulation, analysis and practice, a key feature of *modus vivendi* institutions is to ensure that any moves taken to harmonise and integrate economies do not jeopardise the vitality and diversity of the various successful models of capitalism involved. But diversity comes, of course, at a price in terms of friction for trade and the externalities of individual national policies. A successful *modus vivendi* regime, therefore, also limits these frictions (through, for example, the mutual recognition of different standards) and ameliorates negative externalities of any one country's actions.

But successful *modus vivendi* institutions do more than obviate mutual harm; they also seek to exploit the mutual gains to be had from the existence of diverse systems within one space, and to this end they must engineer the levels of trust required for coordination and cooperation (Puetter, 2014). One element of this may be the mutual insurance that comes from the pooling of risks among dissimilar economies. It is true that low correlations in economic performance imply some mutual insurance simply by virtue of the positive externalities of healthy growth in one country for its neighbour suffering a downturn. But this can be augmented by agreed mechanisms for temporary transfers to partially smooth fluctuations in relative performance. This way, the gains from diversification of economic specialisation and regulatory models can be more evenly shared. And, finally, *modus vivendi* regimes should seek to engineer deliberative mechanisms to enable member states to learn from the diverse outlooks at their joint disposal, and to innovate new ways of analysing and managing their economies by exploiting the recombination potential of a large pool of different approaches.

The second half of the book assesses how far the EU's practices measure up to the template we have set out for *modus vivendi* institutions. Do they allow diversity to survive and be successfully exploited? Separate chapters cover mutual recognition regimes and the Single Market, the uneasy balance between pressures for joint rules and accommodations of regulatory differences, the recent post-crisis 'German Consensus,' including current pressures for common fiscal rules, the extension of EU Commission conditionality to core nation-state prerogatives, and, finally, banking union, which sees conditionality emanate also from the European Council and the European Central Bank.

We start by reviewing the evolution and management of the Single Market, which in many ways is a triumph of managed diversity. While harmonisation of regulations has played a part, a whole host of mechanisms have evolved to allow for persistent difference and sensitivity to local particularities. So even harmonising measures usually take the form of directives that set framework goals but allow for some measure of diversity in the national transposition of legislation. In some cases, too, measures include the principle of 'comply or explain' that allows for some negotiated diversity to remain for good reasons. Furthermore, the Single Market eventually moved in many areas from the principle of harmonisation to that of *mutual recognition* of different standards. To be sure, Nicolaidis shows that mutual recognition has to be managed to ensure that there is sufficient equivalence in the diverse frameworks allowed, and other safeguards against destructive cross-border competition, to avoid a race to the bottom (itself a form of harmonisation) (2007). At a more general level, the EU has evolved a whole host of mechanisms – including formal opt-outs and informal agreements – to soften the impact of community mechanisms where damage to the political or economic stability of a member state would otherwise ensue (Kleine, 2013).

Another germane feature of the Single Market is the use of councils of regulators, and committees made up of member state representatives, as deliberative mechanisms to facilitate the management of externalities implied by residual difference, engage in mutual learning, and make joint judgments about the appropriate mix of harmonisation and mutual recognition. These committees and councils form part of the deliberative polyarchy (DDP) mechanisms discussed by Sabel and Zeitlin (2010). Others include the open method of coordination (OMC), which relies on working groups with experts from a wide range of countries and backgrounds tasked with establishing common guidelines that can then be tailored to suit local settings. The multipolar input to deliberations ensures the use of a plurality of perspectives, and the constant peer review and deliberative revision of shared goals and metrics. In truth, though, there are two aspects of OMC, and DDP more generally, that still concern us. First, OMC operates to some extent under the shadow of monoculture thinking, with its aim of fixing common guidelines and goals for the Union and establishing benchmarks of 'best practice'. More generally, Sabel and Zeitlin (2010) may argue that DDP does not have as its goal a 'reflective equilibrium'; but, wherever the multipolar input to deliberation is being used to fashion newly agreed harmonisation of regulations, then the very diversity that helps fuel DDP may become a wasting asset.

The fear that haunts our book is that the institutional, ideational and economic diversity that has proven the EU's greatest asset may waste away if this asset is exploited largely to fashion a new EU-wide set of best practices. Our related fear is that the EU may until recently have been enjoying a splendid phase transition when it possessed the undoubted benefits of harmonisation without having yet lost the benefits of the cognitive diversity originally embedded in divergent practice. But now we may be entering an age where the wellsprings of diversity in cognition and practice are drying up. For example, as we gradually lose separate central banks in the euro area with living expertise in monetary policy, the ECB will no longer be able to draw on a wide array of experience and outlook.

Beyond monetary policy, such homogenising developments are, in part, because of two insidious confusions at the heart of much policy discussion about diversity within the EU. The first is confusion between divergence in the *level* of performance and diversity in the *model* of development. It quite clearly *is* a problem if some countries within the EU persist in growing much more slowly than their peers for many years; but this does *not* imply that there is any problem with persistent difference between countries in their models of capitalism, so long as over a cycle each model has roughly equivalent performance. The second (and related) confusion is between coordination and synchronicity. Again it *is* a problem if member states are so poorly coordinated that, for example, they all engage in fiscal austerity at once. But it is emphatically of benefit to the Union as a whole if some countries are doing well while others are suffering the poor part of the cycle for their kind of specialisation. We would argue that the EU took a wrong turn with the Maastricht criteria's obsession with synchronicity rather than counter-cyclical coordination. And it is taking another wrong turn with the recent evolution within the eurozone of a common straitjacket for fiscal policy and a uniform approach to the need for supply side reforms.

This brings us to the two most potent mechanisms in recent years for effacing diversity and entrenching what is beginning to resemble an economic monoculture within the EU, namely, the German Consensus and the new technocratic straitjacket enforced by the Commission through the Fiscal Compact. As noted, monocultures often take hold as a result of an asymmetry of power, and this is exactly what is taking shape in the EU given the combined effect of German reunification, Germany's relative economic outperformance within the eurozone, France's relative economic decline, and the United Kingdom's progressive disengagement from many EU deliberations. Furthermore, Germany's financial and intellectual dominance within the EU has been reinforced by its successful imposition (as principle creditor) of strict conditionality for bailout funds in the eurozone crisis. We use the term 'German Consensus' to describe the resulting monoculture, making an analogy with the 'Washington Consensus' associated with the World Bank and IMF in the 1990s. Our intention here is not to suggest a complete consensus on fiscal and regulatory matters *within* Germany any more than there was such a consensus within the World Bank and the Washington establishment. Rather, the intention is to suggest an analogous imposition on weak recipient states of a hegemonic 'world view' backed by the use of strong conditionality. Germany has not, of course, got entirely its own way in the reform of the eurozone, but it has succeeded in entrenching via the Fiscal Compact a commitment to legally enforced debt brakes across the eurozone in return for only minimal mutualisation of resources under the ESM and the Single Resolution Fund. In refashioning so much of European policy in its own image, Germany also lays itself open to the potential financial costs of increased correlations in performance and synchronised downturns across the eurozone. The next downturn may be even bloodier in the eurozone if all countries perform increasingly alike.

The new roles assumed by the Commission in recent years – associated with the Two Pack, Six Pack, the Fiscal Compact and the European Semester – may, in the long run, have more impact than the position of Germany itself. Increasingly, the Commission is being transformed into a technocratic enforcement agency for the German Consensus. Nicolaidis (2014) argues that the Commission has increasingly sought to 'make permanent some elements of conditionality that are highly intrusive' by generalising approaches used in the bailout programmes. By signing up to the Fiscal Compact etc, member states have subjected themselves to a form of hands-tying that delivers market credibility benefits in the short run, but at the cost of long-term flexibility and discretion. And since Commission recommendations in the European Semester can only be overturned by a reverse QMV, the veto power of minority perspectives has been greatly reduced. Such hands-tying commitment devices are gambles in conditions of uncertainty when the payoffs from the commitment are unknown.

The book concludes with analysis of recent moves to a eurozone banking union. While we see merit in a Single Resolution Fund for cross-border banks, and in some mutualisation of banking risks so long as the banking sectors across the Union are weakly correlated, we are sceptical of moves to a Single Rule Book and a Single Supervisory Mechanism. When the de Larosiere report (2009) drew lessons from the financial crisis for the architecture of EU financial supervision, it argued for improved systemic shock absorbers and the prevention of systemic vulnerabilities. But then without irony it called for common approaches to regulation and 'consistent core rules.' We argue, by contrast, that common rules may increase systemic vulnerabilities by increasing correlations in behaviour across different national markets and putting all our regulatory eggs in one basket. Moreover, while acknowledging the importance of long-term private capital flows within the eurozone, we do not think all policy should be directed to harmonisation in the name of creating a single capital market. Indeed, by leaving some grit in the system in the form of national regulations, the EU might help rescue member states from destabilising short-term capital flows. For it is usually the case that compartmentalised and diversified systems are more robust than fully integrated and homogenous ones.

To sum up, the EU represents an appropriate case study for two reasons: first, because as a set of institutions it has unparalleled experience in developing a *modus vivendi* between the different regulatory models of capitalism; and, secondly, because in recent years old struggles to deal with the negative consequences of unmanaged diversity have become gradually subsumed into a mission to replace even managed diversity with a single set of policy and regulatory templates in the name of reducing transaction costs, improving coordination, and creating a level playing field in trade competition. The euro crisis and, most recently, the negotiations for TTIP have greatly accentuated these homogenizing trends. We document these trends empirically while building an analytical case for caution in the face of such pressures. 'Best practices', we argue, are in some ways the capitalist equivalent of the deluded 'five year plans' of the Comecon era, reflecting the same rationalist hubris and the same impulse to project current trends into an uncertain future.

This book makes an analytical and empirical case for diversity, and it does so in the apparently hostile terrain of market regulation in an increasingly integrated world. While we build on other path breaking and familiar works, our own contributions are clear and important: we add a Kuhnian dimension to existing worries about institutional monocropping, and show how cognitive lock-in has profoundly negative implications for the stability of markets and institutions and for our ability to learn and innovate. We show the particular dangers of the EU entrenching a single German-inspired model of regulatory practice and economic policy. As an alternative, we specify the conditions for enabling and managing the persistence of robust alternatives to whichever regulatory or policy construct appears in any one period to be the most successful. Our focus on applying these general lessons to the empirical case of the EU is justified by its status – despite all the difficulties of the last decade – as humanity's most advanced experiment in coordination between diverse regimes. Our conclusion is that the EU's current challenges will not be met by relentless homogenisation, nor by replacing what one might call the art of good governance with technocratic managerialism.

Legitimate questions

Q: Ok, I get that you guys 'like diversity,' but at what level? Are you calling for diversity of firm strategies or diversity of regulatory approach at the level of regions, sectors, or national states?
A: Right now, we're focused on national regulatory diversity.

Q: Doesn't the literature contain a fair amount of evidence of enduring and substantial regulatory divergence, despite pressures for convergence? Is there really a risk of putting all our regulatory eggs in one basket?
A: This is an empirical question. Our intent is to look at the combined effects of the 'diffusion of liberalism' literatures plus the pressures of the GFC since 2008.

Q: Is the EU case the right empirical strategy to test these ideas? How could this best be done, given that you are neither saying the EU has gotten it all right nor, exactly, gotten it all wrong?
A: We hope it's workable, but we acknowledge the difficulties. It's the most advanced set of *modus vivendi* institutions we know of. Unlike blunter forms of globalization, there is real mutual understanding—even intimacy—among the states. If *modus vivendi* institutions can't be sustained here, where could they be?

Q: On the 'German consensus,' is there enough consensus and enough staying power to build the book around? Or will German ideas gradually get displaced?
A: We do perceive some wobbling. We predict no full-scale retreat, however.

Q: Is it reasonable to expect policymakers not to be trapped by a single paradigm? How realistic is a kind of 'disciplined analytical eclecticism', in which policymakers consider insights from competing paradigms?
A: We're not sure. But the discussion about macroprudentialism makes us more optimistic that a larger community—including both academics and policymakers—can step outside the dominant paradigm.

Potential chapter headings

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<u>Contents</u>

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