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Second Edition

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## 16 The European Union's institutional design

*Elisabetta Croci Angelini*

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### **Introduction**

The Treaty establishing the European Economic Community (TEC) was signed in Rome by the six founding countries (Belgium, France, Germany, Italy, Luxembourg, and the Netherlands) on 25 March 1957. After the first enlargement to Denmark, Ireland and the UK in 1973, the second to Greece in 1981, and the third to Spain and Portugal in 1986, the cooperation among the 12 member states was fostered by a stronger agreement accomplished by the first revision to the Treaty of Rome, the Single European Act (SEA) in force since 1987, and later by the European Union Treaty (TEU) signed in Maastricht in 1991. The European Union (EU) came into existence in 1993 and consists of three pillars: the European Community (EC), the Common Foreign and Security Policy (CFSP) and Justice and Home Affairs (JHA). Austria, Finland and Sweden joined the EU in 1995. Two more revision treaties were agreed: in Amsterdam in 1997 and in Nice in 2000. The most recent enlargement involved the entry of eight Eastern European countries (the Czech Republic, Slovakia, Slovenia, Hungary, Estonia, Latvia, Lithuania and Poland) plus Cyprus and Malta, in May 2004. The process of European integration may be described as a sequence of successful widening and deepening operations, yet this representation overlooks the considerable modifications undertaken over the years.

The integration process was initiated with the application of the incremental tactic envisaged by Jean Monnet, pointing to the development of a European interest above the national interests. The strategy was to pursue common policies in the areas where cooperation could be exploited to mutual advantage. The self-enhancing character of the succession of agreements consisted in each common policy creating spillovers, from which a new common project entailing positive net benefits for all members could be devised.

This strategy is behind the functionalist view of the EU integration process whereby the EU is a continuous process of accumulation of cooperative agreements, based on two commitments: (i) the aim of further integration, stated in the preamble of the treaties of Rome (TEC) and Maastricht (TEU); and (ii) the acceptance of the *acquis communautaire* (the set of EU treaties, laws, rules and practices), whereby the accession countries are required to accept the EU obligations as such. However, the accession of new members is usually preceded by many years of negotiation, followed by a transitory

period. The six founding countries had a 12-year transitory period, divided into three phases and ending in 1969, while Spain and Portugal were given a six-year period. The UK, having changed government just after acceding, then succeeded in renegotiating its terms of accession. Negotiations for the 2004 enlargement were begun in 1998 and the transitory period is planned to end in 2006. On rare occasions some exceptions, exemptions or delayed applications to the *acquis communautaire* have also been sanctioned.

In the absence of a supranational state or federal government, the EU has developed a system of laws, rules and decisions made by the four main institutions: the Commission, the Council, the Parliament and the Court of Justice.

The European Commission, composed of executive commissioners and headed by their president, is appointed by the national governments and approved by the Parliament. It has the important task of proposing common policies, ensuring the correct implementation of the treaties, and representing the EU in international trade negotiations (formerly within the General Agreement and Tariffs and Trade: GATT; and now in the World Trade Organization: WTO). In the EU Council, each national government is represented by the relevant minister (foreign affairs, finance, agriculture and so on). The Council's decision-making activity is endorsed by the European Council, the quarterly summit of the heads of state and governments of the member states, and includes the participation of both presidents of the Commission and the European Parliament. The European Parliament (EP) currently comprises 730 members elected by the national constituencies and organized in transnational political groups. The EP's powers, whose prerogatives have been continuously strengthened since the SEA and through to the Nice Treaty, are threefold: (i) supervisory: mainly trying to influence the Commission's proposals and Council decisions; (ii) legislative: it has a co-decision power along with the Council; and (iii) budgetary: its vote is decisive for the approval of the EU budget both *ex ante* and *ex post*. The Court of Justice (ECJ), which is composed of one judge for each member state, has the task of clarifying the interpretation of the treaties and EU law, and adjudicates over disputes which may arise among the member states, the EU institutions, as well as with any other concerned parties.

The EU institutional architecture is not characterized by a complete separation of powers among the four main institutional bodies. On the contrary, they exercise mutual monitoring through a complex system of checks and balances, finally reaching consensual decisions. According to principal-agent theory, this interdependence creates a conflict of interests – between the Commission and the Council (for example, the conflict over the possible revision of the Stability and Growth Pact: SGP) or between the Council and the Parliament (for example, the EU budget) – from which the appropriate

incentives for each institution and the officials' accountability should follow. The Commission has the agenda-setting power that enables it to control the integration process by putting forward proposals to be approved by the Council and the Parliament. Most of the EU legislation proposed by the Commission is approved under the co-decision procedure, whereby the Council and the Parliament can amend each other's changes to the proposal. If there is disagreement, the matter is passed to the Conciliation Committee, which makes the final decision regarding adoption or rejection. The power of the Council as a whole has been endorsed by the European Councils, which have acted as an important, though informal, decision-making forum and have strengthened the power in the hands of national governments. The Court of Justice is acknowledged to have acted as a main engine of integration by passing judgments that in many cases have fostered the integration mechanism. The doctrine of direct effect and supremacy of European over national law, which is needed to guarantee the coherence of the system, has been applied since its inception, and national courts accept its authority.

### **Methods of integration**

An integration process among a number of national economies is characterized by the evaluation of benefits and costs. Benefits consist mainly of economies of scale and the internalization of reciprocal externalities. Costs are related to the heterogeneity of national preferences with regard to public goods provision.

EU integration has consisted of a collective action for delivering common policies with the characteristics of public or club goods to the member countries. So far, the most important achievements have been: (i) the Single Market, which is an area of free circulation of goods, services, capitals and individuals, separated by tariff as well as non-tariff barriers from the rest of the world; and (ii) The European Monetary Union (EMU), which has delivered the euro as a club good after the fixed (but adjustable) exchange rate agreement established in 1979 by the European Monetary System (EMS) delivered the public good of monetary stability to its members.

Both these achievements have certainly provided the firms and economic sectors of the member states with the advantage of benefiting from economies of scale. The Single Market for internal free trade has spread over larger markets, and the single currency for external trade has signalled the end of expectations of exchange rate variations as well as the likely upgrading of the euro to the rank of second international reserve currency, competing with the US dollar. In addition, the EMU has given the participating countries the advantage of the internalizing the externality of frequent devaluations which caused considerable macroeconomic instability in Europe during the last decades. The cost of the EU integration process is more difficult to assess. In

the past decades, an increasing heterogeneity across the EU member states has resulted from diverging fiscal policies due to public primary deficits and public debt accumulation. The coordination device of the SGP was created to foster convergence to sound national fiscal stances, after the enforcement of the Maastricht criteria came to an end with the monetary union.

However, two issues emerged connected to the lack of EU centralization of fiscal policies. First, the deflationary bias caused in the macroeconomic governance by the tight European Central Bank (ECB) monetary policy and by the restrictive orientation imposed on national fiscal policies by the SGP. Second, the absence of any internalization of the externalities provoked by the very different levels and composition of both income taxes and social expenditures.

In addition, the most recent EU enlargement is likely to result in further costs in the EU integration process. First, the EMU as a club good could be burdened by congestion costs. The higher average inflation of the accession countries might undermine the EMU monetary–fiscal policy mix as an ECB interest rate vote could result in a level that is too high for the incumbent economies' macroeconomic equilibrium (de Grauwe, 2003). Second, the extension to the accession countries of the EU common policies devoted to foster real convergence in the backward areas, could magnify the redistributive problems stemming from externalities. In particular, the welfare state reforms undertaken in the EMU countries are bound to take into account the structural change in the labour markets which will be created by the migration of workers coming from the Eastern countries.

The interpretation of the EU integration points to two approaches to integration: supranationalism and intergovernmentalism. The supranational approach to integration tends to pursue the idea of a European entity, defined in terms of social and cultural identity, which should be translated into a political and economic being. The intergovernmental approach instead conceives integration mainly as the coordination among national interests. In Table 16.1, various features of the EU institutions are classified under these approaches.

*Table 16.1 Features of EU institutional bodies*

	Appointment	Composition	Task	Decision rule
Commission	Intergovernmental	Intergovernmental	Supranational	Supranational
Council	Intergovernmental	Intergovernmental	Intergovernmental	Mixed
Parliament	Supranational	Supranational	Supranational	Supranational
Court of Justice	Intergovernmental	Intergovernmental	Supranational	Supranational

The balance of power in the integration process has been proceeding as a 'pendulum' (Wallace, 1996). Sometimes, intergovernmentalism, mainly aimed at finding a mere compromise among the conflicting national interests, has prevailed and so the Council has gained power *vis-à-vis* the Commission. On other occasions, supranationalism has been promoted by allowing a somewhat undefined common interest to prevail over the arrangement of national interests. Despite its composition on a national basis, like the Council, the ECJ has aptly endorsed the supranational attitude towards the EU integration process, in line with the scope of its responsibility. This was especially evident during a long stagnation of the integration process, in the 1970s, when political will was lacking and decision making impaired. In fact, after the Luxembourg compromise *de facto* impeded the regular application of the majority rule, decisions were made only after long-drawn-out negotiations whereby consensus was finally obtained by eliminating national vetoes in the Council. The impasse ended when the SEA required qualified majority voting over matters related to the completion of the internal market. The different voting weights assigned to the ministers sitting in the Council reflect their countries' size in terms of population. This criterion underlines the intergovernmental character of the institution, whereby the voters are the member states – on an equal basis when voting under the unanimity rule, or with weighted votes under qualified majority rule – and it is assumed that each government adequately represents the preferences of the citizens of its country. The voting rules within the Council were reformed by the Nice Treaty, which required a triple majority for any proposal to be accepted: (i) the usual majority of at least 71 per cent of the Council's weighted votes; (ii) the majority of two-thirds of member states; which may also be asked to correspond to (iii) at least 62 per cent of the EU population.

In 2002 the constitutional design of the EU integration process was addressed by the Convention on the Future Europe, which produced a Draft Treaty establishing a constitution to be submitted to the Intergovernmental Conference on the Future of the Union.<sup>1</sup> On the one hand, the convention can be regarded as an expression of the intergovernmental method. First, through its procedure: a constitution is not usually provided by an international treaty, although the existing treaties are regarded as having a constitutional status. Second, the EU's identity, formerly seen as a 'process creating an ever closer union' and based on the European Community and its common policies, as stated in Article 1 of the TEU, has become an agreement on policy coordination and on a limited number of 'competences' attributed to the EU by the member states. Third, if a state is defined by the relationship between representation and taxation, then the failure to reach unanimous agreement on the transition to majority voting on fiscal matters is a clue to the intergovernmental grip over political integration. On the other hand, the convention maintains

a supranational attitude in some ways: by incorporating the Charter of Fundamental Rights; by declaring the legal status of the EU, thus adding the legitimacy of the EU institutional entity and that of EU citizenship to the national constitutions; and by trying to find ways of avoiding the limits to integration if a sufficient number of countries so desire. The convention also recognizes the right to secession from the integration process. This proposal, which can be explained by the increased recourse to the majority rule, is meant to alleviate the institutional shock following a possible separation of a member state from the EU.

*Modes of integration: enhanced cooperation*

Special attention has recently been given to the idea of enhanced cooperation, in that a proposed common policy could be endorsed and pursued by a group of member states, as a second-best solution, rather than waiting for the first best from participation by all member states. The veto power on the launch of an enhanced cooperation, conferred by the Amsterdam Treaty on non-participating countries, has been removed by the Nice Treaty, as decisions and commitments taken in an enhanced cooperation are not part of the *acquis communautaire*, and so are not binding for the opting-out member states. When a common policy is decided by a subset of countries, the opting-out member states lose in terms of vote-trading power as well as in their power to block future initiatives.

The question is whether this should be acknowledged as a damage requiring compensation. In addition, should the opting-out countries be given the right to be consulted on the enhanced cooperation dealings, since they retain the option of a late access and might experience spillovers following its implementation? Moreover, a late participation could be conceived as free-riding wait-and-see behaviour, opting for participation if there are net benefits. A possible solution to the compensation dilemma is to compare enhanced cooperation with the two extremes of no common policy (decentralization) and cooperation among all member states (centralization). When the indicator of the preferences' dispersion is lower for enhanced cooperation than for centralization, and it does not damage the opting-out countries, this mode is the efficient solution. In fact, even if negative spillovers arise for the opting-out countries and compensation should be paid by the enhanced cooperation member states, then the amount is likely to be lower than compensation under centralization.

This reasoning suggests that the more profound question about this method of integration deals with the tradeoff between the subsidiarity principle and the commitment of the treaties to a closer union. Were this principle to be applied, a stop to further integration would become an advantageous policy for member states favouring the status quo. If instead the viability of the



process of integration prevails over the subsidiarity principle, then the correct procedure would be to allow enhanced cooperation and then negotiate to solve the compensation issue at the moment of the delayed accession. There was no compensation for those member states which declined to take part in the two major cooperative enterprises put forward outside the EU framework: the monetary integration process from the EMS to the EMU and the Schengen *acquis* from the Agreement to the Convention and its inclusion in the Amsterdam Treaty. Monetary union was initiated by a subset of countries which were subsequently joined by other member states, when it became evident that the exchange rate agreement was conveying the benefit of a slow but clear deflationary trend. This enhanced cooperation was successful in aggregating an increasing number of member states in the cooperative effort of establishing the public good of monetary stability. However, in the 1990s the prolonged tightness of both monetary and fiscal policies imposed by the need to comply with the Maastricht Treaty and participate in the EMU was probably responsible for the hysteresis effect in the EMU labour markets that yielded structural unemployment. The Schengen Agreement was signed by the founding EC member countries (with the exception of Italy), to eliminate controls at their common borders and allow free circulation. Many other countries joined later, including two outsiders: Iceland and Norway. The UK and Ireland never joined, but have taken part in some activities after the Schengen *acquis* was included in the Amsterdam Treaty. The latter status applies to the accession countries on a temporary basis. In addition to the enhanced cooperation initiatives within the EC, this mode will also apply to the second and third pillars. The CFSP includes the organization of a common military force, either under the Western European Union (WEU) or linked to the North Atlantic Treaty Organization (NATO). Despite the pure public good feature of defence, the paradox might be that a subset of member states launches an initiative for an army with positive spillovers over the remaining non-contributing countries which are opting out for political reasons.

The decision to abolish the veto power by the opting-out member states makes enhanced cooperation a sort of substitute for the extension of majority voting to the most controversial EC areas (tax system, social policies and environment).

#### *Modes of integration: open coordination*

Open coordination differs from enhanced cooperation in that all member states are required to participate from the beginning. This mode consists in the formulation of objectives and procedures aimed at boosting convergence to a common standard in a particular domain.

The preamble of the Treaty of Rome places a common standard for labour and welfare conditions among the goals of the EC. The social policy started

in the early 1960s was funded by the common budget with limited, ad hoc funds according to a 'key' included in the treaty, and was especially concerned with immigrants' right to non-discrimination. Yet the European legislation of the Single Act and the Maastricht Treaty was concerned solely with competition policy, by stimulating deregulation, liberalization and privatization processes. Social policies<sup>2</sup> aimed at the catching up of disadvantaged or stagnating areas (cohesion funds and structural funds) have been incorporated into the social cohesion policies. The convergence process was hampered by the depressed growth environment surrounding these policies. In 1999 the launch of the EMU definitively abolished the autonomy of national monetary and exchange rate policies, a process started by the need to comply with the EMS fixed exchange rates. Alternatively, the limited room for manoeuvre left to national fiscal authorities by the constraints of the SGP has undermined macroeconomic stabilization after negative demand and supply shocks, with negative implications for the EU growth rate. The Lisbon European Council (2000) then encouraged growth by the implementation of a series of microeconomic policies coordinated by Brussels and pursued at the national level. Education, training, research and development, social protection and social inclusion were declared appropriate domains for the implementation of open coordination. The aim is to commit national governments to 'modernize the European social model' by voluntary cooperation through the exchange of plans for active policies with such objectives as promoting equality of opportunity in the labour market, employability (to improve skills and labour incentives), entrepreneur spirit (to foster propensity to risk and investment by deregulation), adaptability (lower job protection), and common standards as for social inclusion.

In the future, these active policies put forward by a subset of the EU member states to improve the employment rate might be complemented by the revision of the rigid SGP rules. Since these rules are part of the European legislation and thus overrule national legislation, any attempt by countries who promote open coordination are induced to rely more on further deregulation than on re-regulation processes aimed at increasing employability by training programmes which might conflict with the 3 per cent deficit/GDP ceiling.

#### *Mutual recognition versus harmonization*

The principle of mutual recognition was introduced by the ECJ with the Cassis de Dijon judgment in 1979, which allows every good legally produced in one member state to circulate freely in all others. This principle has mainly been used for fostering trade in domains where information is available and consumer sovereignty may prevail, whereas harmonization is pursued when, due to health and safety reasons or severe asymmetric information, the matter

cannot be left to the market. Mutual recognition is unlikely to evolve in complete harmonization because in many domains where sunk costs are considerable, the national interests of the member states mutually conflict and each country refrains from complying with the adoption of another country's national standard as the EU common standard.

In the area of labour market institutions, partial harmonization has been endorsed by the EP encouraging a threshold as for the minimum wage, working day length, vacation periods and so on. The Commission is trying to harmonize the regulation of private pension funds in terms of transparency, portfolio management and precautionary requirements. The Social Charter of 1989 states a commitment by member states on health and safety issues. However, to enable the smooth development of the 'negative' integration consisting of the abatement of any obstacle to the free circulation of goods, services, capital and workers, there has been a virtual stasis in the harmonization on social protection. Mutual recognition in the labour market would mean allowing on the same market the existence of different wages and regulations linked to the rules existing in the worker's country of birth or residence rather than according to the worker's country of employment. In a country with a high wage and high job protection, mutual recognition would be likely to foster a downward pressure on wages and regulations. The ECJ has repeatedly stated that diversity of retributive and regulatory treatment of employees in the same working condition is illegitimate within a country, being at odds with the principles of equal treatment and competition. The convention recognizes European citizenship (art. 8), forbids discrimination and promotes social justice and social cohesion (art. 3).

Mutual recognition has been applied partially to welfare benefits. The welfare system broadly consists of social protection (health care, unemployment benefits, poverty subsidies), and social security (the pension system and invalidity). In the actuarially fair domains, where contributions correspond to benefits, each country is responsible for its own share of social insurance benefits in proportion to the contributions received although only one country actually pays (and is reimbursed by the others via a clearing system). Being actuarially unfair, health care and unemployment benefits are excluded, while retirement benefits can be cumulated across countries (although in the individual balance between contributions and benefits of the pension system there may be a certain degree of redistribution). The present EU welfare policy on the one hand has a limited harmonization – the introduction of a common standard in the area of absolute deprivation, such as a safety net against social exclusion and poverty – and on the other hand expects each member state to provide social protection according to its own tradition and coverage. Another goal is the progressive move towards actuarially fair national welfare systems. The presumption is that the welfare reforms aimed at reducing social expenditures

will improve the balance between contributions (and the share of fiscal revenues devoted to social protection) and monetary and in-kind benefits. The application of mutual recognition to social protection would represent an incentive to lower taxes and welfare benefits, as a country with high taxes and benefits is particularly exposed to system competition.

The fiscal system is a domain where spillovers are more widespread. While economic theory underlines the advantages of centralization in order to internalize the reciprocal externalities, the negotiations over coordination are complex and even steps towards improving harmonization have been only partially successful, since under unanimity voting any harmonization proposal may be opposed by veto. As for personal income, taxation follows the system in the country of birth, even if taxes are paid in the country where the person actually works. This regime may become an incentive to workers' mobility towards countries with high-tax and high-welfare benefits, since workers from low-tax countries would gain by being taxed in their own country and enjoying the high level of welfare services and in-kind benefits of their country of immigration (if citizenship is maintained, this would apply only to wages and salaries). The orientation in the member states has been towards the application of taxation in the country in which income (wages, profits) is received rather than in the country of residence.

Although the creation of the single market should have fostered coordination in the taxation of goods, real harmonization of indirect taxation is still to come. In fact, the member states have resisted the Commission's attempt to switch from the destination to the origin principle in both the excise and the value-added tax rates. The origin principle would amount to extending the logic of the single market to the fiscal domain, as it would imply that goods from all countries should be considered on an equal basis in each market. The main reason for the member states preferring goods to be taxed at the rate of the consumption country is to avoid fiscal competition, with an obvious cost in terms of a decrease in inflows.

As for financial assets, a centralized fiscal regime would respond to the need to internalize spillovers stemming from the high mobility of financial capital. Financial interests and dividends are taxed in the country but non-residents enjoy complete exemption. To progressively introduce the principle of residence, member states are required to exchange information on financial assets in the portfolios of individual residents of another member state. Although the phenomenon of country bias (despite capital liberalization, the so called 'home bias share' that is, the continuing high share of domestic financial assets in the saver's portfolio) mitigates the problem of capital flight, fiscal competition represents too dangerous a threat on public budgets. Under unanimity voting, the veto threat to any proposal of harmonization has brought about a provisional agreement consisting in the progressive conver-

gence across tax bases and the option between two alternative regimes of capital taxation (to limit tax evasion by exchange of information or adopt a system of tax withholding, that is, taxation at the source). Yet, member states whose financial markets attract many capital inflows shopping around for the best fiscal treatment, are resisting the implementation of the agreement.

### **The democratic legitimacy of EU institutions**

In the future developments of the European integration process the question of the EU's so-called 'democratic deficit' is likely to surface. It is important to observe that the term 'democracy' is compatible with a wide range of possible definitions. This indeterminacy enables us to look at this issue from several vantage points.

The most popular appraisal of the democratic deficit undermining the EU integration process argues against EU institutional organization by observing that only the EP has direct accountability to the voters in the national constituencies. The procedural weakness of the decision process originates in the fact that hitherto, two non-elected bodies (the Commission and the Council) have been responsible for a great part of the legislation process. The lack of democratic legitimacy of the market-building process and realization of the four liberties upheld by the ECJ, and the lack of accountability of the ECB, have also been criticized. According to the view of perfect substitutability between the market and the voting mechanisms, a Commission concentrating its efforts towards the completion of the single market, and an ECB committed solely to monetary stability, aim at 'levelling the playing field' for the deployment of competitive forces, and are considered to confer democratic legitimacy on the marketplace. This view can be questioned by arguing that democracy should not be narrowly identified with voting. Many members of democratic institutions, who are appointed rather than elected, derive their democratic legitimacy indirectly through another elected institution that is responsible for appointing them. Just as the Commission's president and members are nominated by the intergovernmental method and approved by the EP, in many European countries there is no constitutional obligation for the government to be composed of elected representatives only. Although from the EU perspective the Council's decisions can be considered barely accountable, nevertheless the Council indirectly derives its democratic legitimacy from the accountability of its representatives at the national level.

However, another problem arises with the increased use of majority voting in the Council, whereby an entire country may be outvoted and bound to comply with the very same legislation it opposed. In such cases, the democratic deficit is strictly interwoven with the intergovernmental method and makes accountability impossible within the Council, while the same problem does not affect the democratic substance of the EP decision making which

abides by the supranational method. The democratic control about how the representatives in the EP interpret their mandate is validated by voting in the national constituencies. On more general grounds, the democratic accountability of an institution-building process with no federal state yet in place is quite different from the democratic accountability within a nation-state. A related question is the accountability of the quasi-jurisdictional bodies. The practice of empowering independent institutions to represent groups of interest is increasingly popular in the EU decisional process. The recognition of political accountability to agency-type regulation has been defended on the questionable grounds that the EU is just a regulatory state (Majone, 1996).

Another, less discussed, aspect of the democratic deficit is economic democracy. A higher level of social cohesion in the EU should be pursued through the improvement of the well-being of 'disadvantaged individuals' (the unskilled, the poor, immigrants, the disabled and so on). Public policy oriented to equality of opportunity could play an important role in fostering economic democracy with positive fall-out on the quality of the public discourse. The record of EU integration on social policy is not outstanding.

The market-building process of negative integration through the abatement of tariff and non-tariff barriers to trade has scarcely been complemented by the market-correcting process of positive integration (Scharpf, 1999). This view stems from two structural changes which are soon to be implemented: (i) after the liberalization of the national markets promoted competition inside the integrated market, the stringency of anti-inflationary monetary policies, the loss of the devaluation instrument after the passage to the EMU, and the anti-state-aid legislation have reduced the financial capacity of the national states to set up fiscal stabilization policies, to provide financial support to the national strategic companies, and to devise education programmes dedicated to improving human capital; and (ii) fiscal competition might also put pressure on the national systems of social security and health care. In contrast to market competition, where the exit of non-competitive firms strengthens the functioning of the market, a competitive tendency across fiscal systems may weaken social cohesion by provoking a welfare system squeeze. In order to avoid capital flight, governments may be compelled by fiscal competition to reduce taxes and transfers in order to keep the rich, reject low-income and needy people and attract capital from abroad. The complementarity of market institutions and social protection institutions in fostering both efficiency and well-being might be undermined. The competition among the welfare systems may have differential effects on investors and the less-mobile unskilled workers and may undermine the long-term efficiency of the EU countries. While the EU has accomplished the objective of liberating the market-building competitive forces, the competition system may ultimately cripple the implementation of the market-correcting legislation. A possible strategy aimed

at fostering positive integration could consist in a coordinated effort by those member states with similar systems of social protection to launch their own harmonization process.

On the political side, the opposition to a federal Europe relies on the argument that no European *demos* exists. This position is controversial. Equating *demos* with *ethnos* fails to distinguish between the pre-political cultural and historical ties and the common political objectives that a group of communities such as the European peoples may consciously set up as a result of public discourse taking place in the domestic and supranational democratic environments. A European constitution could be conceived as the self-recognition of choice of belonging to consensual norms and values (Habermas, 2001). An indicator of the democratic accountability of the EU governance system could be found in European citizens' satisfaction with the consequences on their well-being of the implemented policies. Many domains so far excluded from the competence of EU institutions include several of the most important and controversial issues: the fiscal system, the welfare state, home security and immigration (Scharpf, 2002, 2003). From the consequentialist perspective, a poor EU performance in terms of positive integration indicates that EU citizens consider issues in the realms of domestic security and the welfare state so important for their well-being that policy makers do not dare to remove power from the national legislative bodies lest it provoke an uncertain harmonization outcome at the supranational level.

### **A theoretical appraisal of EU integration**

Institutional design has probably been the most important device for the EU member states to agree on common policies. The design, as a provider of appropriate incentives to the participating countries, can be presented in game-theoretic form as the achievement of the optimal common policy in coordination games among member states where a conflict of interest hinders the Pareto-optimal solution. Many common policies have been transformed from prisoner's dilemma (PD) games to coordination games of mutual advantage just because an institution made the cooperation strategy more profitable than the defection strategy. However, the widening number of both member states and common policies has intensified the integration process to the extent that the increasing complexity of the bargaining has made any agreement a difficult compromise in terms of the distribution of benefits and costs across member states. In general, institutions have been successful in achieving cooperative agreement on the proposed common policies when the member states were under a 'veil of ignorance' concerning the future division across the states of benefits and costs deriving from their implementation.

An example of institution design is the regulation of competition in the manufacturing, public utilities and services markets. Competition policy has

played a relevant role in sustaining the implementation of the Single Market by a variety of community laws, deliberations and judgments regarding the monitoring and enforcement of rules not only for competitive market structures, but also for corporate governance, mergers and acquisitions. The problem is that public ownership in strategic sectors (energy, financial institutions and so on), oligopolistic market structures, and national regulations operating as non-tariff barriers are very common in the EU countries, but unevenly distributed across sectors and member states. In game-theoretic terms, the desire to gain the highest free-riding pay-off – to get the best advantages of competitive European markets, while scarcely cooperating due to a slow domestic process of privatization and liberalization – has led many governments to a ruthless defence of their ‘national champions’. The EU institutions have been struggling in order to protect the integration process and avoid a situation whereby an efficient solution to the coordination game of constructing an environment of competitive markets could be jeopardized by the cooperation–failure pay-off matrix of the prisoner’s dilemma. The Commission has endeavoured to influence the privatization and liberalization processes inside the EU economies by endogenously influencing these processes through the provision of the necessary institutional infrastructure. The Commission’s strategy can be likened to fostering the pay-off structure of a ‘chicken game’ where the conflict of interests dominating the coordination nature of the players’ interaction is offset by the alteration of the PD game with a penalty greater than the pay-off of mutual defection. In Figure 16.1, for the sake of simplicity the pay-off matrix of the chicken game refers to two players only. We can think of the Commission as aiming at reducing the pay-off for defection from further liberalization. When the pay-off matrix of the EU competition game is modified from a PD to a chicken game, the possibility of mutual efforts is strengthened.

Deliberations opposing state aid to strategic sectors, as well as pecuniary sanctions to punish monopolistic practices (collusion in price formation, mergers to control competition, low transparency and low compliance with regulations by companies operating in the service sector and so on) can be

	Cooperate	Defect
Cooperate	4,4	-2,6
Defect	6,-2	-5,-5

*Figure 16.1 Pay-off matrix of the EU*



formally devised in terms of a penalty for being suckered ( $-2$ ) greater than the pay-off associated with mutual defection ( $-5$ ). Since free-riding behaviour is discouraged, in contrast to the PD game, mutual defection ceases to be the rational strategy. However, the Commission's efforts to enhance competition were undermined by the incentives to free-riding continuously created by the externalities across the various privatization and liberalization processes going on in the member states where a conflict of interest is aggravated by the variable degree of public ownership in the service sectors across the states. The generalization of an  $n$ -player chicken game, with the number of players who pre-commit to defection not exceeding the maximum number of individuals who may free ride on the cooperation of others without causing the non-provision of the public good (Taylor, 1987), may represent the formal explanation of the still lacking rationale for cooperative behaviour.

Three further institutional designs – group asymmetry, procedural technologies regulating cooperative games with conflict of interest among member states and the commitment device of 'tying-one's-hands' – can also help explain the EU integration process.

#### *Group asymmetry*

A first aspect of institutional design, which has been studied by both Olson (1965) and Keohane (1984), is group asymmetry as a facilitator of successful cooperation. Collective actions may be asymmetric in the sense that they may be laid out in a form that allows the common policy to deliver both public advantages for all countries and private advantages for single member states. An asymmetric strategic interaction was exploited by the countries launching a fixed but adjustable exchange rate system in Europe (the EMS) to put a stop to the accelerating inflation. The strategic interaction among the European countries – which consisted in the beggar-thy-neighbour situation of competitive devaluations and resulted in the PD suboptimal outcome of stagflation – was transformed in order to establish low inflation as a public good in Europe. Soon after its inception in 1979, the EMS cooperative agreement took the semblance of a hegemonic agreement, due to the asymmetric solution given to the  $n - 1$  problem (since among  $n$  participants  $n - 1$  bilateral parities are formed, just one central bank is left free to conduct its own monetary policy, while the monetary policy autonomy of the remaining  $n - 1$  central banks is constrained by the commitment to defend the exchange rate). An assurance game was set up in a leader–follower structure where a cooperation pledge from Germany – the leader country whose central bank was soon singled out as having the best performance in curbing inflation – created the positive net benefits from which the remaining countries, the followers, derived their incentives for participating in the collective action. During the EMS period, with tight bilateral bands, the Bundesbank virtually dictated the

money supply for the whole area, while the remaining central banks were compelled to peg their exchange rate to the German mark in order to take advantage of Germany's reputation as the best performer for low inflation. This privileged position gave the German manufacturing sectors a private advantage to benefit from real depreciation *vis-à-vis* the remaining EMS countries.

#### *Linkage across games*

The EU institutions may also make recourse to an institutional design exploiting the interaction between games representing different areas in which cooperation could be pursued to advantage. A first case of linkage deals with the need by the largest member states to dodge the free-riding problem by organizing the implementation of common policies as a nested game with alternative asymmetric positive net benefits. The largest member states were able to overcome the conflict of interests by having one (or a subset) of them contributing or providing the most in a certain game, and another one (or a subset) doing so in another game. A condition for establishing the linkage between the two games is that the common policy proves to be mutually advantageous by the summation of the pay-off matrices. It can be shown that the case of connection between two games is linked to the kind of admitted institutional technology.

In Figure 16.2, the pay-off matrices of two games (I and II) are considered, with the pay-off values stemming from the status quo (SQ), enhanced cooperation (EC) by a subset of two out of three member states (A,B,C) and a common policy (CP). The pay-off values of the game sum show that complete integration (that is, CP) – which compels member states to participate jointly in both policies – is inferior in terms of total welfare to enhanced cooperation. Therefore, the game sum shows that the outcome is different depending on whether or not enhanced cooperation is admitted as a possible

	Game I			Game II			Game sum				
	A	B	C	A	B	C	A	B	C		
SQ	20	10	5	SQ	10	5	10	SQ	30	15	10
EC	25	30	15	EC	10	35	35	EC	35	65	50
CP	20	25	20	CP	25	30	25	CP	45	55	45

*Key:*

SQ = status quo, EC = enhanced cooperation, CP = common policy.

*Figure 16.2 Games: pay-off matrices*

option. In the example, EC can be a superior alternative to CP in both games (that is, in the sum game). In fact, game I shows a possible enhanced cooperation between A and B, and game II shows a possible enhanced cooperation between B and C. In case of non-admission of enhanced cooperation, the maximizing option is definitely the common policy (the sum of the pay-off values for CP is higher than for SQ). However, CP no longer enjoys a preferential status *vis-à-vis* EC.

In fact, the Nice Treaty has amended the Amsterdam Treaty, whereby an enhanced cooperation could have been stopped by a veto from some other country. A subset of at least one-third of the total number of member countries can now submit a project to the Council which will be decided by qualified majority voting. The EU integration process might be weakened by this procedural change. It is easy to show that once enhanced cooperations are admitted, the CP outcome is undermined. In being compelled to enter the CP in both games, countries B and C lose with respect to entering an EC (in game I, between A and B; in game II between B and C). Even if negotiation costs were nil, the gain of 15 accruing to country A in passing from SQ to CP is insufficient to compensate the other two countries for renouncing EC. A fails to negotiate compliance with a CP because it is unable to cover the compensation of 10 due to B (5 in each game) plus 10 due to C in game II. Country B might then convince C to join in an EC in game II, so that A will have to renounce the CP and join B in an EC in game I. This example demonstrates that the view according to which the EU integration process has gained flexibility, by the availability of the option by a subset of countries of autonomously choosing to start an EC, is flawed. As a matter of fact, the larger set of options magnifies the incentive to exert the threat of power and bargain on compensation.

*A commitment to 'tie one's hands'*

This commitment consists in the exploitation by a country of the strategic interaction which can often be established between the outcome of a domestic game (the political elections in a society split between reformers and anti-reformers) and the EU game opposed by some member states (see Figure 16.3).

Assume that a common policy among three countries (A, B and C) is expected to enjoy substantial economies of scale only if game I is changed in game I'. In the initial situation of Game I an EC may be preferred by countries B and C, thus leaving country A in SQ. Suppose that country C – the only country in Game I of Figure 16.3 to show a lower pay-off for CP than for EC – could improve its pay-offs by getting rid of some inefficiency which negatively affects its capacity to exploit the economies of scale expected from a fully-fledged CP (for example, poor educational institutions

	Game I			Game I'			
	A	B	C	A	B	C'	
SQ	5	5	10	SQ	5	5	20
CP	40	25	20	CP	40	25	40
EC	10	25	30	EC	10	25	35

*Key:*

SQ = status quo, EC = enhanced cooperation, CP = common policy.

*Figure 16.3 Games: tied hands matrices*

hindering the level of human capital), as column C' of game I' shows. The pay-off values of game I' indicate that A could gain its much higher CP pay-off and C would prefer CP, to EC with B. Yet, some social groups in country C oppose the needed efficiency-enhancing reform (a structural change in education) because they would be negatively affected by the progressive taxation which is required to fund it. The institutional mechanism capable of rendering the common policy feasible is a change in the 'contract' between the agent (the coalition of parties in charge of the government in country C) and the principal (the constituency). Suppose that the coalition makes the political choice to take a bet in the polls by tying its hands by making the commitment to implement the reform despite the domestic distributive conflict. On the basis of the expectation of being able to convince the opposition voters of the long-term 'mutual advantage' of a higher social welfare, the coalition centres its electoral programme on the structural change in education as the first reform due to the 'national interest' to abide by an external constraint imposed by the supranational EU institutions and take advantage of the strengthening of the integration process.

Had the elections been won and the reform passed, the strategic interaction among the three countries would be modified. While B remains indifferent between CP and EC, the pay-off of both countries A and C is now higher in the case of a CP as C no longer prefers to set up an EC with B. The supranational solution of a CP is finally taken. Because B is aware that the institutional mechanism implemented in the domestic political arena of country C has changed the strategic environment, B is forced to enter the agreement for the CP in order to avoid the worst outcome (the SQ pay-off). However, in contrast to the example given, this top-down approach to the approval of common policies by the national constituencies may be undermined by asymmetric information. A government may have a vested interest in the proposed policy and public officials may be tempted to manipulate the voters' opinion

by distorting statistics and reports produced by governmental research agencies to their advantage.

### Notes

1. The Constitution was approved by the European Council on 28 October, 2004 in Rome and at the time of going to press is being ratified by the national parliaments of the 25 member states.
2. The Treaty of Amsterdam included the Social Policy Agreement in Title XI of the TEC, despite the UK opting out of the 1989 Community Charter of the Fundamental Social Rights of Workers (the Social Charter). Its objectives cover employment promotion, proper social protection, dialogue between management and labour, the development of human resources, and combating exclusion (Article 136).

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