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Liberalization, Re-Regulation, and Mutual Recognition: Lessons from Three Decades of EU Experience

Scottish Jean Monnet Centre Working Paper Series
Vol. 1, No. 1, January 2009

Scottish Jean Monnet Centre of European Excellence

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How to cite this paper

Giandomenico Majone, "Liberalization, Re-Regulation, and Mutual Recognition: Lessons from Three Decades of EU Experience", *Scottish Jean Monnet Centre Working Paper Series,* Vol.1, No. 1, January 2009.

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Liberalization, Re-Regulation, and Mutual Recognition: Lessons from Three Decades of EU Experience

GIANDOMENICO MAJONE*

Abstract

Three propositions form the core of this paper. First, the term "neoliberalism" is inherently ambiguous, but part of the ambiguity can be removed by distinguishing between neoliberal policies and a neoliberal ideology. The EU offers many examples of a strictly utilitarian use of allegedly neoliberal policies and policy instruments. The second proposition deals with the distributive consequences of "neoliberal" policies. Such policies, like all public policies, have distributive consequences; but it is not obvious why debate should focus on the consequences of one particular group of policies. About forty per cent of the EU budget still goes to the CAP – hardly a neoliberal policy – largely to the benefit of wealthy landowners and large agribusinesses. Nor are these perverse effects of the CAP restricted to the members of the EU, for it is well known that agricultural protectionism hits hard the farmers of other continents, including the poorest of the poor – the farmers of sub-Saharan Africa. The third main topic is the implication of socioeconomic heterogeneity for regional or international regulation. I argue that beyond a certain threshold, regulatory instruments such as harmonization and mutual recognition become ineffective, or unacceptable to public opinion, and may even reduce aggregate welfare. The economic theory of clubs suggests a promising way of dealing with high levels of heterogeneity. Recognizing that good regulation must be responsive to the preferences and resources of the community of users, rather than to some centrally defined vision of the 'common interest', the theory suggests that in today's world economy sufficiently homogeneous communities of standards users may form various regulatory networks. The implication for the EU is likely to be a shift from positive to negative integration – a return to the spirit of the Treaty of Rome.

1. Introduction: How Neo-Liberal is the EU?

Arguments about the alleged neo-liberal character of the EU have been voiced with increasing frequency since the constitutional debacle of 2005. They are best understood as attempts to redefine the *finalité* of the integration process along lines which should make it easier to attract popular support. Thus a small but influential body of elite opinion claims that only a strong social dimension can legitimate the process of European integration. This is position, for example, of the Belgian political leader and convinced federalist, Guy Verhofstadt, but also of members of the intelligentsia, including such luminaries as Juergen Habermas. The German philosopher chose to interpret the rejection of the Constitutional Treaty as a rejection of the neo-liberal stance of the EU, and as the expression of popular demand of a more welfare-oriented Union. In an article in the *Sueddeutsche Zeitung* of 9 June 2005, Habermas argued that with the achievement of the basic economic freedoms, the common market, monetary union, and the Stability and Growth Pact for the eurozone, the neo-liberals have achieved all their objectives. Now, he warned, it is time to deepen the social dimension, and in particular to soften the impact of monetary integration by means of the progressive harmonization of fiscal, social, and economic policies. According to the German philosopher, the entire integration process is distorted by the neo-liberal philosophy which pervades the European Treaties. This is the original sin which Social Europe is supposed to redeem.

Even a casual acquaintance with the history of post-war Europe, however, is sufficient to cast serious doubts on the plausibility of this interpretation. In the 1950s liberalism, as a political and economic ideology, was at its nadir in West Europe, with the partial exception of Germany. Central planning, industrial policy, public ownership as the main mode of economic regulation, were advocated practically by all political parties, including most liberal groupings. The nationalization of key industries, in particular, was seen as the most effective solution to all sorts of problems: not only to eliminate the political power and economic inefficiency of private monopolies, but also to stimulate regional development, redistribute resources in favor of particular social groups, protect consumers, foster industrial democracy, and, not least, ensure national security. These, or very similar, views were held by political leaders of the right and of the left; they were important ingredients of the contemporary Zeitgeist. Those same years also witnessed the rise of the European welfare state, hence the puzzle: how could the authors of the Treaty of Rome – who at home accepted, indeed practiced, interventionism in all sectors of the economy and society – espouse economic liberalism at the European level? A sudden ideological conversion has to be excluded since the same political leaders, and those who followed them, continued to support interventionist policies domestically, at least until the 1980s – and many still do.

The thesis of a general neo-liberal bias of the process of European integration is contradicted also by more recent developments. In particular, it is wrong to consider monetary union a "neo-liberal objective", as Habermas does in the passage quoted above. Indeed, no other European project has been as politically motivated, and as persistently pursued by integrationist leaders over many years, as the introduction of a single currency in an economic area characterized by deep structural differences, and in the absence of a serious coordination of the economic and fiscal policies of the member states. The political motivation of EMU has been clear to competent observers from the very beginning. As two well-known political economists wrote shortly after the project was formally launched: "Uncertainty about the empirical magnitude [of the various benefits and costs of monetary union] suggests the absence of a clear economic case in favor of EMU. Given the risks and uncertainties that pervade the process, there would have to be a clear margin of benefits over costs for economic considerations, narrowly defined, to provide a justification for such a radical departure in policy. The absence of such a margin implies that the momentum for monetary union must therefore derive from other, primarily political, factors" (Eichengreen and Frieden 1995: 274). Many other experts pointed out that the EU is far from being an optimal currency area, in the sense of being able to make easy domestic adjustments to external shocks. Areas within which factors of production can move readily, or are distributed uniformly, can establish a common currency with a reasonable chance of success because balance of payments deficits can be corrected by shifting resources between industries according to conditions of international demand. In the EU, however, there are no adequate adjustment mechanisms, such as labor flexibility and large budget transfers, to act as effective substitutes for the exchange rate. The EU budget remains very small, with no provisions for a stabilization function, and no indication that the member states are willing to expand it. Such arguments suggest that EMU, far from being a neo-liberal project, is the most important element of a political strategy aimed at making the integration process irreversible.

This political rationale explains why a number of distinguished economic liberals, both economists and policymakers, both in Europe and in the US, have seriously questioned the wisdom of EMU. A Nobel-prize winning monetarist, Milton Friedman, went as far as predicting that EMU would not last more than fifteen years. The possibility of a deflationary bias in the monetary union, and a resulting drag on growth in the United States and the rest of the world, was a fairly constant concern of US policymakers throughout the 1990s. Lawrence H. Summers, as deputy secretary of the Treasury, in early 1996 explicitly pointed to the danger of deflation, while White House, Treasury, and State Department officials reiterated these concerns at the G-7 summit meeting in Lyon in July 1996 (Henning 2000). Even earlier, the president of the Bundesbank had reminded European leaders that '[m]ore than a single currency, the emerging single European market needs converging policies, which are still not in place in all participating countries. The repeated references to alleged huge savings in transaction costs for the countries of a single currency area are not in the least convincing' (Poehl 1990: 36). Given the economic realities, Poehl concluded, the willingness of the German government to transfer responsibility for monetary policy to the European level 'can be accounted for only in a broader political perspective, with the long-term objective of creating a political union' (ibid.: 37). It is also noteworthy that the UK, the most "neo-liberal" member of the EU, has not joined the eurozone, and gives no indication of wanting to do so in the foreseeable future. In fact, Gordon Brown, when he was Chancellor of the Exchequer, warned that monetary union deprives the governments of the eurozone of the flexibility necessary to adapt to globalization. The required flexibility can be achieved, according to Brown as reported by the *Financial Times* of 13 October 2005, only by doing away with all fixed parameters, not only in monetary but also in fiscal policy. In sum, far from having been planned as a neo-liberal ploy to impose discipline on spendthrift welfare states, monetary union must be considered a risky political strategy to make the integration process irreversible, as well as a political deal between some of the larger member states, notably France and Germany.

The other supposedly neo-liberal objectives mentioned by Habermas are hardly more credible, as such, than monetary union. The Stability Pact, which was supposed to impose some fiscal discipline on the members of the eurozone, never worked as intended. The reform of the Pact in June 2005 eliminated the elements of automatism in the original agreement, and introduced considerable room for intergovernmental margins of maneuver. The increased uncertainty that surrounds the determination of acceptable medium-term budget balances makes it even more difficult for the Council of Ministers of the EU to trigger sanctions against errant member states. The political motivations behind the reform are revealed by the fact that the fiscally virtuous member states defended the original Pact, while most of those states exceeding, or at risk of exceeding, the deficit threshold sought reform. It is also difficult to agree with Habermas that with the Treaty of Nice the other major neo-liberal goals – the implementation of basic economic freedoms and the common market – have been achieved, see section 6.

But what about the more general point made by Habermas and by a number of other writers, namely the alleged neo-liberal bias of the European treaties themselves? The truth is that different economic and social philosophies coexist in the founding treaties and in all subsequent amendments. What the critics fail to see, or prefer to ignore, is that those elements of a liberal economic constitution that can be found in the treaties have only instrumental value – they do not express an ideological commitment; rather, they serve integrationist objectives. As mentioned above, the founders of communitarian Europe came from countries where public ownership of key industries, national planning, aggregate-demand management, and large-scale income redistribution were considered perfectly legitimate forms of state intervention in the economy. This ideological background is evident in the 1951 Treaty of Paris, which established the European Coal and Steel Community (ECSC). Although the declared objective of the Treaty was the elimination of trade barriers and the encouragement of “normal” competition (rather than competition per se) in the sectors of coal and steel, many specific provisions were hardly compatible with economic liberalism. Thus the High Authority, the supranational executive of the ECSC, was given extensive powers of intervention, including the right to levy taxes, to influence investment decisions, and even in some cases to impose minimum prices and production quotas. Given the limited scope of the Coal and Steel Community, and of Euratom, the corresponding treaties could largely avoid questions of general economic philosophy. Such questions played a much larger role in the preparatory work for the establishment of the European Economic Community (EEC), when it was realized that the integration of highly regulated national markets would have been impossible without a serious effort to deregulate and liberalize the economies of the member states.

Thus, the well-known fact that monopolies and cartels have an inherent tendency to carve up markets was the main motivation for introducing fairly strict competition rules. It would indeed be useless to bring down trade barriers between the member states if the national governments or private industry remained free to use subsidies or cartel-like arrangements to divide markets, or to reserve them for home producers. Even a customs union, let alone a common market, must worry about the effects of cartels and concentrations: as tariff barriers go down, firms and governments might resort to various non-competitive practices, or non-tariff barriers, in order to offset the effects of the removal of protection. On the other hand, a customs union – which is what the EEC was initially – represents a preferential trade agreement among a subset of countries, and as such it was always considered with suspicion by economic liberals, who much preferred multilateralism (free trade for all countries) and the most-favored-nation principle of the GATT and WTO charters. For this reason the distinguished German economist Wilhelm Roepke was opposed to the establishment of the EEC. According to the first Commissioner responsible for the competition policy of the European Community, "Roepke was not prepared to acknowledge that the EEC (Rome) Treaty was based upon the market economy philosophy and that the rules of competition in particular were in accordance with neo-liberal ideas and were now being extended to international trade within the Community" (von der Groeben 1987: 48). Also the father of the German "economic miracle", the Minister of Economic Affairs Ludwig Erhard was quite skeptical about preferential trade agreements, favoring instead a multilateral, rather than a regional, approach to free trade. A significant number of German academics of the *Ordo*-liberal school, took the same position, and also opposed early projects of monetary union, supporting instead the idea, popularized by F.A. Hayek, of competing national currencies.

We may conclude that the influence of neo-liberalism on the European treaties and on European policies is much more limited than the critics claim. To the extent that such an influence may be detected, as in the case of the competition rules, the reason is not ideological, but strictly utilitarian: the impossibility of integrating of a group of heavily regulated economies without some limits on the interventionist tendencies of national governments and the cartelization tendencies of private and public enterprises. Scholars like Fritz Scharpf (1999), who argue that competition policy should not be given a higher, quasi-constitutional, status than all other legitimate purposes of public policy do not seem to be aware of the *constitutive* role of competition regulation in European integration. The unique role of the rules on competition and state aid is also demonstrated by the fact that, within the EU, competition rules take the place of WTO-authorized countervailing duties to offset the damage caused by export subsidies to the industries of importing nations. It is the combination of rigid market access rules with flexible safeguards that has permitted multilateral trade integration to proceed so far without any domestic policy harmonization. Members of WTO not only enjoy domestic policy autonomy but must also respect the exercise of that autonomy by other WTO members (Roessler 1996: 50-51). The member states of the Union, on the other hand, have surrendered their policy autonomy in matters relating to intra-EU trade, but only because of the existence of a European competition policy.

At any rate, even the Treaty of Rome, although more "neo-liberal" than the ECSC and Euratom Treaties, contains a number of interventionist features, most strikingly in the articles dealing with the Common Agricultural Policy. The objectives of the CAP, as defined by the Treaty, are complex and partly contradictory, but the ECJ has realistically interpreted them so as to give priority to maintaining farmers' incomes over increasing agricultural productivity or ensuring reasonable prices for consumers. Thus the Court has recognized the essentially redistributive character of a policy which still absorbs about 40 per cent of all budget expenditures of the EU (down from about 75 per cent in 1980). These redistributive objectives – aiming at establishing what has been called a "welfare state for farmers" – are pursued by a variety of interventionist and protectionist means. The operational core of the CAP is the common organization of the markets for specific products, based on the instruments of common, politically determined, prices, Community preferences, and financial transfers. To appreciate the importance attached to the CAP by the Treaty of Rome one should keep in mind that in postwar Europe "agriculture became the equivalent of a large nationalized industry, managed by interventionist policies which sought to impose macroeconomic objectives in return for exemptions from the forces of open economic competition" (Milward 1992:229). Short of leaving agriculture outside the scope of the European common market – an option favored by some countries but categorically rejected by France – the only solution was to move state intervention to the European level.

The CAP is the most obvious, but certainly not the only, sign of the influence of interventionist philosophies in the Rome Treaty. One can find evident traces of such philosophies even in the "neo-liberal" core of the Treaty. Thus, Article 85 deemed inconsistent with the common market "all agreements between firms…and all concerted practices likely to affected practices between Member States". As Harvard economist F.M.Scherer observed, the reference to "all agreements" has the ring of the per se prohibition embodied in judicial interpretations of America's Sherman [Anti-Trust] Act. However, Scherer continues, article 85 went on to permit exceptions for agreements and concerted practices that contributed "towards improving the production or distribution of goods or promoting technical or economic progress while reserving the users a fair share in the [resulting] profit…Thus a complex balancing process – what US jurists call a "rule of reason" approach—was instituted" (Scherer 1994:35). This is a more realistic view of the way competition rules are used in the EU than is conveyed by phrases such as "singleminded maximization of free market competition", or "zealots of undistorted competition" (Scharpf 1999: 167).

2. Regional Liberalism and the Perils of Eurocentricity

The instrumental character of the alleged liberal bias of the EU, and the distributive consequences of its deeper protectionist bias, are best seen in the field of international trade. Reference was already made in the preceding section to the opposition of liberal economists like Roepke and liberal statesmen like Ludwig Erhard to the EEC's regional (rather than multilateral) approach to free trade. Customs unions cut tariffs for their members but not for other members of the General Agreement on Tariffs and Trade (GATT, renamed WTO since 1995), which are thus denied the benefit of the most-favored-nation rights. In fact, the compatibility of the Treaty of Rome with GATT rules was hotly contested by a number of countries. In particular, strong objections were raised regarding the association between the Community and the "Overseas Territories" – mainly former colonies and territories of France and the Benelux countries. This association was seen by third countries as effectively dismantling the ceiling placed on preferences in force at the time the GATT was established (1947), thereby creating a new and wider preferential system. Because of this and other complaints, no agreement was ever reached on the compatibility of the Rome Treaty with Article XXIV of the GATT, which deals with the formation of customs unions and free trade areas. The issue was resolved pragmatically, i.e., by shelving it, but only because the United States threw its weight behind a relaxed interpretation of Article XXIV in favor of the EEC.

Not surprisingly, relations between the Community/Union and its trading partners have been problematic from the very beginning. It suffices to recall the international problems created by the protectionism of the

Common Agriculture Policy – including the failures of the Seattle and Cancun Rounds, and the possible failure of the Doha Round. Nor are these the only problems. The EU has been accused of using not only the CAP, but also food safety regulations – in particular those based on the Precautionary Principle (PP) – as protectionist devices (Majone 2005). An important cause of the international isolation of the EU in trade-related matters is the insistence of the World Trade Organization that departures from international standards must be justified by scientific studies and formal risk analysis. A well-known example is the Beef Hormones case. In 1997 the United States and Canada fined complaints with the WTO against the European ban of meat products containing growth hormones. According to these two important trade partners, the EU ban violated the WTO's Sanitary and Phytosanitary (SPS) Agreement. The Agreement allows WTO members to adopt health standards that are stricter than international standards, but the stricter standards must be supported by risk assessment. Unfortunately, the risk assessment conducted by the Community's scientific experts had not established any significant health risks connected with the use of growth hormones. Hence the Commission was forced to meet the WTO challenge with more political arguments, saying that a ban of beef containing growth hormones was necessary to restore consumer confidence. In the end, WTO decided against the EC – one more proof that Eurocentric regulations, such as those based on the precautionary principle, can lead to international isolation. The trading partners of the EU tend to view the PP as a protectionist device. From their perspective it must appear rather odd that the Union is accused by some European intellectuals and integrationist leaders of being "neo-liberal".

The Commission's Communication on the PP reveals, not only a worrying ignorance of the logic of decision-making under uncertainty (Majone 2005: 138-142), but also a serious disregard of the distributive implications of the principle, in particular the impact of precautionary standards on the welfare of developing countries. The Commission maintains that in considering the positive and negative consequences of alternative risk strategies, one should take into consideration '*the overall cost to the Community*, both in the long- and short-term' (Commission 2000: 19; emphasis added). Such Eurocentrism could perhaps be justified if the cost of precautionary measures was felt only by exporters in rich countries, but what if the cost is borne by very poor countries? The EU claims to be deeply committed to assist, financially and otherwise, developing countries, especially African ones. However, estimates by World Bank economists of the economic impact of precautionary standards for aflatoxins, proposed by the Commission in 1997, tell a different story. Aflatoxins are a group of related toxic compounds that contaminate certain foods and have been associated with acute liver cancer in humans. Aflatoxin B_1 – the most common and toxic of these compounds – is generally present in corn and corn products, and various types of nuts. The proposed Community standards were significantly more stringent than those adopted by the US, Canada, and Australia, and also stricter than the international standards established by the FAO/WHO Codex Alimentarius Commission. Brazil, Bolivia, India, Mexico, Uruguay, Australia, Argentina, Pakistan, and other countries, in opposing the proposed measures, demanded to know in detail which risk assessments the EU had used in setting the new standards. As a consequence of consultations with the trading partners about these concerns, the Commission relaxed the standard for cereals, dried foods, and nuts. But even the modified aflatoxin standards for products intended for direct human consumption remained quite stringent: 4 parts per billion (ppb), and 2 ppb for B_1 aflatoxin, against an overall Codex standard of approximately 9 ppb.

Using trade and regulatory survey data for the member states of the EU and nine African countries between 1989 and 1998, the World Bank economists estimated that the new standards would decrease African exports of cereals, dried fruits, and nuts to the EU by 64 percent, relative to regulation set at the international standards (Otsuki, Wilson, and Sewadeh 2000). The total loss of export revenue for the nine African countries amounted to US$ 400 million under EU standards, compared to a gain of US$ 670 million if standards were adopted according to Codex guidelines. Were these costs, imposed on some of the poorest countries in the world, justified by health benefits to Europeans? According to studies conducted by the Joint Expert Committee on Food Additives of the Food and Agriculture Organization and World Health Organization, the Community standard of 2 ppb for B_1 aflatoxin would reduce deaths from liver cancer by 1.4 deaths per billion, i.e. by less than one death per year in the EU. For the purpose of this calculation the Community standard was again compared to a standard that follows the international (Codex) guideline of 9 ppb. Since about 33,000 people die from liver cancer every year in the EU, one can see that the health gain promised by the precautionary standard was indeed minuscule, certainly out of proportion to the cost imposed to the countries of Sub-Saharan Africa (Majone 2005: 136-138).

3. Re-Regulation and Harmonization

"Deregulation" is a notoriously misleading term. Neither in the United States nor in Europe, or anywhere else, has deregulation meant an end to all regulation. In the US, for example, airlines have not been deregulated with respect to safety, and deregulated industries lost their pre-existing statutory immunity from anti-trust law. In Europe, privatization of natural monopolies has been followed by price regulation, and also by national and European competition regulation. In sum, what is observed in practice is never total deregulation, but a combination of deregulation and re-regulation. In the EU, in particular, deregulation at national level is often followed by re-regulation at European level, meaning some type of harmonization of national rules and regulations. The harmonization of national laws and regulations is one of the three techniques which the Rome Treaty made available to the Commission for establishing and maintaining a common European market – the other two techniques being liberalization and the control of anti-competitive behavior.

From the early 1960s to about 1973 – the date of the first enlargement of the Community – the Commission's approach to harmonization was characterized by a distinct preference for detailed measures designed to regulate exhaustively the problems in question, to the exclusion of previously existing national regulations – the approach known as 'total harmonization'. Under total harmonization, once European rules have been put in place, a member state's capacity to apply stricter rules by appealing to the values referred to in Article 36 of the Treaty of Rome – such as the protection of the health and life of humans, animals, and plants – is excluded. Clearly, total harmonization reflects a federalist vision of the integration process; it corresponds to what in the language of American public law is referred to as "federal preemption". For a long time, the ECJ supported total harmonization as a foundation stone in the building of the common market. By the mid-1970s, however, the limits of the approach had become clear: total harmonization confers on the Community an exclusive competence which it is ill-equipped to discharge (Weatherill 1995): the EU simply lacks the material, cognitive and, not least, the normative resources to operate without the cooperation of the national governments. At the same time, mounting opposition to what a growing number of member states considered excessive centralization convinced the Commission that harmonization had to be used so as not to interfere too much with the regulatory autonomy of the member states. The emphasis shifted from total to optional and minimum harmonization – and to mutual recognition.

Optional harmonization aims to guarantee the free movement of goods, while permitting the member states to retain their traditional forms of regulation for goods produced for the domestic market. Under minimum harmonization, the national governments must secure the level of regulation set out in a directive but are permitted to set higher standards – provided that the stricter national rules do not violate Community law. Mutual recognition (discussed in sections 5 and 6) does not involve the transfer of regulatory powers to the supranational institutions, but nevertheless restricts the freedom of action of national governments, since they cannot prevent the marketing within their borders of a product lawfully manufactured and marketed in another member state.

The idea that economic integration requires extensive harmonization of national laws and regulations had been criticized by a number of distinguished economists already in the early years of the European Community. Thus, Harry Johnson wrote : "The need for harmonization additional to what is already required of countries extensively engaged in world trade is relatively slight…The problems of harmonization are such as can be handled by negotiation and consultation according to well-established procedures among the governments concerned, rather than such as to require elaborate international agreements" (Johnson 1972, cited in Kahler 1995: 12). In opposing the harmonization bias in the literature on economic integration of the post-war years, Johnson pointed out that the eventual gains from harmonization should be weighed against the welfare losses produced by harmonized rules that are not tailored to national preferences except in a rough, average sense. The welfare loss entailed by centralized harmonization has become a major theme in the more recent literature on free trade and harmonization (Bhagwati and Hudec 1996), and is one of the major issues facing the enlarged EU today, as discussed below.

The most important reason for the decline of harmonization in the EU – not only total harmonization, which is seldom used nowadays, but also minimum harmonization – is the heterogeneity of the Union since the latest enlargements. Today income inequality, as measured by the Gini coefficient, is greater in the socially-minded EU than in the arch-capitalist USA. Now, such cross-country differences in socio-economic conditions, entail a corresponding diversity in national preferences and policy priorities, and as a consequence, exponentially rising costs of harmonized regulations – the problem raised by Harry Johnson. It follows that regulations which maximize aggregate welfare must be different rather than harmonized. Since the famous *Cassis de Dijon* judgment of the European Court of Justice it has been thought than harmonization problems could be overcome by means of mutual recognition. After the "big bang" enlargement of 2004-2007, however, implementation of this regulatory technique – which, via regulatory competition, should lead to ex post, market-driven harmonization, instead of the bureaucratic, top down, mode – is becoming increasingly difficult because of intense political opposition, see section 6.

4. Social Dumping, Race to the Bottom, and Social Harmonization

One of the standard arguments in favor of the top-down harmonization of social regulations is the need to prevent the possibility that the members of the EU take advantage of the single European market to engage in "social dumping", or in a competitive lowering of social standards, in order to attract foreign investments. Indeed, many measures of positive integration in the areas of health, safety, and environmental regulation, have been justified by the argument that without EU-level harmonization member states would engage in a socially undesirable 'race to the bottom'. A vivid demonstration that this fear was well-founded seemed to be provided in 1993, when the US-owned domestic appliance group Hoover Europe, faced with the need to close either its factory in Scotland or one in the Dijon region of France, decided to transfer the production of the French plant to Scotland. One of the reasons for the company's decision was a new collective agreement at the Scottish plant, where unions agreed to a wage freeze, greater flexibility, and a ban on strikes. The French workers and their government reacted angrily, arguing that what was involved was a British attempt to compete on low labor costs and lax social standards – "social dumping", as the French prime minister denounced the day after Hoover's decision became known. Intervention by the European Commission, headed at the time by the formidable Jacques Delors, was demanded. However, Delors could do little more than express sympathy when, at the peak of the crisis, he received a delegation of workers from Hoover France. The truth, he pointed out, is that differences in labor costs between member states could not be eliminated, or even reduced, by existing EU social legislation. Only EU-wide minimum wages could have helped to reduce differences in labor costs across member states, but no such harmonized rules were available then – and are even more unlikely to be agreed upon in the present EU-27. Ironically, at the same time as the Hoover decision to transfer production from France to Scotland, the Swiss multinational Nestlé announced that it planned to transfer part of its operations from Scotland to France!

That harmonization is needed in order to prevent member states from competing for industry by offering social standards that are too lax relative to the preferences of their citizens, is an argument often used to justify the centralization of rule-making, not only in the EU but also in federal systems. It is not difficult to show, however, that the argument is theoretically unsound. Following Revesz (1992) we may take the simplest case of two states that are identical in all relevant aspects, including (say) the level of environmental quality desired by their citizens. State 1 initially sets its standard of pollution control at the level that would be optimal if it were a completely independent country rather than the member of a federation. State 2 then decides to set a less stringent standard, and we assume that industrial migration from State 1 to State 2 will ensue. To recover some of its loss of jobs and tax revenues, the first state then considers relaxing its own standard, and so on. The process of adjustment continues until an equilibrium is reached. At the conclusion of the race, both states will have adopted sub-optimally lax standards, but will have roughly the same level of industrial activity as before engaging in the race: in equilibrium the two states will not experience any net inflow or outflow of industry. The race to the bottom may be considered an example of the prisoners' dilemma. If the two states could enter into a cooperative agreement to adopt the optimally stringent standard they could maximize aggregate welfare without engaging in 'unfair' competition for industry. This presupposes, of course, that the agreement is enforceable and that preferences for environmental quality are about the same in the two jurisdictions. As long as the jurisdictions are independent states, any cooperative agreement would lack credibility, but the situation is different if they are part of a federal or quasi-federal system. In such a case the sub-optimal outcome could be avoided if national environmental standards were harmonized, *provided* that the harmonized standards were equal to the standards the two states would find optimal if they were still independent. The proviso about the equality between the harmonized and the optimal national standards is crucial; it implies what has already been noted above, namely that in a highly heterogeneous EU rules that maximize welfare would be different rather than harmonized. It is thus quite possible that even if there were a "race to the bottom" a European standard might still reduce aggregate social welfare.

Moreover, as Revesz pointed out, the race-to-the-bottom argument is incomplete because it fails to consider that there are more direct means of attracting foreign direct investments than lowering social standards. The advocates of social harmonization implicitly assume that states compete over only one variable, such as environmental quality or labor costs. Given the assumption of a 'race', however, it is more reasonable to suppose that if harmonization prevents competition on the social dimension, states would try to compete over other variables, such as taxation of corporate profits. To avoid such alternative "races", the central regulators would have to harmonize national rules, so as to eliminate the possibility of any form of inter-state competition altogether. This would amount to eliminating any trace of national autonomy, so that the race-to-the-bottom argument is, in the end, an argument for centralization and against subsidiarity.

Naturally, the fear of social dumping or of a race to the bottom is not the only rationale for harmonization of social standards. A more plausible argument for EU-wide harmonization of such standards is the need to dismantle non-tariff barriers to trade within the Single Market. Even in this respect, however, ex ante*,* top-down harmonization probably has been pushed too far. A number of case studies have shown that the costs imposed by social standards are only a minor consideration in the location decisions of large, multinational firms: quality of infrastructure, education of the labor force, or political stability are much more important factors influencing such decisions (Majone 2005: 153-5). Today it is also recognized that an initial difference in health, safety, or environmental standards need not distort international trade; rather, it is trade itself that leads to their eventual convergence. The reason is that social standards are positively correlated with the standard of living. Hence, as wealth grows as a result of more inter-state trade, the endogeneous demand for higher social standards grows as well. By the way, the 1957 Treaty of Rome rejected the view that differences in social conditions between the member states could represent a form of 'unfair' competition, so that to prevent social dumping social regulations should be harmonized prior to, or even concurrently with, trade liberalization within the common market. Rather, the founding fathers believed that harmonization should in general be regarded as a corollary of, rather than a requirement for, market integration (Majone 2005).

5. The Theory and Practice of Mutual Recognition

In the famous *Cassis de Dijon* judgment of 1979, the European Court of Justice stated that a member state may not in principle prohibit the sale in its territory of a product lawfully produced and marketed in another member state, even if this product is produced according to technical and quality requirements which differ from those imposed on its domestic products – except when the prohibition is justified by the need to ensure fiscal supervision, to protect public health or the environment, or to ensure the fairness of financial transactions. The European Commission's White Paper on *Completing the Internal Market* extended this judicial doctrine to the free movement of people and services, and attempted to clarify the distinction between matters where harmonization is essential and those where it is sufficient that there may be mutual recognition of the equivalence of the various requirements set by national law. The key word here is "equivalence". According to the White Paper, "the objectives of national legislation, such as the protection of human health and life and of the environment, are more often than not identical" (Commission 1985: 17). Thus, the principle of mutual recognition rests on an empirical assumption of equivalence of certain basic rules enacted at the national level. Only if this assumption is factually correct does it follow that "the rules and controls developed to achieve those objectives, although they may take different forms, essentially come down to the same thing, and so should normally be accorded recognition in all Member States" (ib.).

But the essential equivalence of the health, safety, or other social standards enacted by the member states cannot be taken for granted, even when the policy objectives may be assumed to be the same. This was shown, for example, by the judgment of the ECJ in the "wood-working machines" case decided in 1986. In this case the court was confronted with two different national approaches to occupational safety: German regulation was less strict and relied more on an adequate training of the users of this type of machinery, while French regulation required additional protective devices on the machines. The Court ruled against the Commission which had argued that both regulations were essentially equivalent, and found that in the absence of harmonization at Community level, a member state could insist on the full respect of its national safety rules, and thus restrict the importation of certain goods.

In addition to the hypothesis of essential equivalence, the Commission's 1985 White Paper attached great importance also to mutual trust among the member states. For example, it mentioned mutual trust as the first element of the new approach to the mutual recognition of university diplomas. Trust among the member states was to replace the impossible task of harmonizing vastly different national systems of professional training and licensing. Each state is to trust other member states' courses of study as being generally equivalent to its own, and a competent national authority must accept the evidence provided by another member state. Thus, the principle of mutual recognition is very demanding also in terms of loyal cooperation among the member states. An American scholar has observed that the principle presupposes a higher degree of comity among the members of the Union than the Commerce Clause of the US Constitution requires among individual states. The Commerce Clause has been interpreted by the US Supreme Court to allow each state to insist on its own quality standards for goods and services, unless the subject matter has been preempted by federal legislation, or unless the state standards would unduly burdened interstate commerce (Hufbauer 1990: 11).

It is hence remarkable that in the past it has proved possible to pass important pieces of legislation based on mutual recognition, such as Directive 89/48 on "a general system for the recognition of higher education diplomas awarded on completion of vocational courses of at least three years' duration". The system introduced by this directive is general in the sense that it applies to all regulated professions and to employed professionals as well as to the self-employed; and that it deals with both entry into and exercise of a profession. Unlike the older, sectoral directives dealing with individual professions, the new directive does not attempt to harmonize the length and subject matters of professional education, or even the range of activities in which professionals can engage. Instead, it introduces a system by which the states can compensate for eventual differences in the length of the training or the contents of the professional curriculum, without restricting the freedom of movement. In the latter case, for example, the host country can demand that the applicant take a test or else acquire practical experience for a period not exceeding three years. The applicant is free to choose between these two "compensation methods", while the competent authority of the host country has the burden of showing in detail the deficiencies in the diploma of the applicant. The procedure must be concluded within four months, ending with a reasoned decision that may be appealed in the courts of the host member state. In sum, Directive 89/48 created, for the first time in Europe, a single market for the regulated professions. A member state no longer can deny access to, or the exercise of, a regulated profession on its territory to EU citizens who already exercise, or could legitimately exercise, the same profession in another member state.

Another impressive application of the philosophy of mutual recognition is Directive 89/646 on credit institutions, often referred to as "Second Banking Directive". The basic regulatory framework which applies to European banks is provided by this directive and by three more narrow directives concerned with the definition of a bank's capital, with the solvency ratios banks should adopt, and with procedures for winding up credit institutions. These three technical directives aim to harmonize basic prudential standards, thus establishing a basis on which mutual recognition can take place; all other conditions are defined and controlled by the authorities of the country where the credit institution is licensed (principle of home-country control), and must be accepted by the other member states. The essential elements of the 1989 banking directive are the concept of a single banking license and the list of permissible banking activities. The list is very broad, and can be updated by the Commission to reflect the emergence of new banking services. Within this basic regulatory framework, a European bank needs a single license from its home country to be allowed to establish branches or directly market financial services in any other member state without further authorizations or controls. With very few exceptions, the host country in which the bank provides its services has no power to seek further authorization or exercise supervision. The question which concerns us in the immediately following pages is why an approach that had been used without serious problems in the 1980s and 1990s became so controversial in the first years of the new century.

6. Mutual Recognition After the Recent Enlargements of the EU

Like the Second Banking Directive and other liberalizing measures based on mutual recognition, also the draft Services Directive presented early in 2004 by Commissioner Bolkestein – who at the time was responsible for the internal market program – was based on the home-country-control principle. It aimed to go beyond past sector-specific attempts at building the single market for services by adopting a horizontal approach which covered services of a general interest, including health and social services not directly provided by the state, while non-profit services (e.g., in education and cultural activities) were left out. Moreover, the draft did not apply to sectors already covered by European regulations, such as the directives dealing with the professions or with "posted workers" working for no more than 12 months in another EU country – it only aimed to complement existing regulations. Bolkestein was convinced that there was only one way to dismantle the many regulatory and bureaucratic obstacles still remaining at the national level: to make access to the market for services as automatic as possible by applying mutual recognition, i.e. the home-country-control (or "country-of-origin") principle. The most controversial aspects of the draft directive had to do with the conditions under which workers providing cross-border services (say, construction workers) would be treated. In principle such movement falls under the 1996 Directive on the Posting of Workers, under which *host-country* conditions are always imposed on posted workers, except for social security contributions when the period of posting abroad does not exceed 12 months. Thus, a French firm hiring a Polish construction worker must apply French standards and regulations, and offer a French wage and French working hours. Under these conditions the firm has no incentive to hire Polish or other East European workers; as a result, labor mobility across Europe is severely restricted.

Nevertheless, Germany experienced a large influx of temporary workers from the East after the 2004 enlargement, despite restrictive arrangements limiting freedom of movement for labor coming from the new member states (excluding Cyprus and Malta). The explanation of this apparent anomaly is the fact that Germany (like Sweden and Denmark) has no general minimum wage. Hence, despite the host-country provisions of the Posted Workers Directive, workers from the East could be paid the wages of their home country – in many cases two to three euros an hour, a miserable wage by German standards, but presumably better than being unemployed at home. In some sectors the consequence has been a significant lay off of German workers as firms brought in personnel from the East. For example, the trade union of slaughterhouse workers spoke of 26,000 job losses, or one-third of all employees in the sector, being replaced by East Europeans (Nikolaidis and Schmidt 2007). Germany (and the Scandinavian countries) could have solved this problem by legislating a national minimum wage, but this apparently obvious solution was rejected for domestic political reasons.

It should be kept in mind that the 2004 Bolkestein draft explicitly stated that the directive on posted workers would not only remain in force, but in case of conflicting rules, the older directive would prevail. The proposed regulation focused instead on the free movement of services provided by self-employed individuals temporarily offering their services in another EU country. Article 16 of the Bolkestein draft stated: "Member States shall ensure that [service] providers are subject only to the national provisions of their Member State of origin". According to economist Kostoris Padoa Schioppa (2007: 741), "[t]his sentence by itself, if adopted, would have implied a true revolution. That was so well understood by trade unions, by protected employees and by their parties in continental Western Europe that they aimed only at its cancellation, after massive demonstrations where they pretended to represent social Europe". In spite of the opposition of East European member states – which as low-wage countries had most to gain from the "neo-liberal" Bolkestein proposal – the Services Directive finally approved in December 2006 made no reference to the principle of home-country-control, so that the host-country rule now applies to self-employed and to employed workers. As a matter of fact, the new directive does little more than restating the principles that have evolved in the case law concerning the freedom to provide services, and the freedom of self-employed professionals and companies to set up the base of their operations anywhere in the EU ("freedom of establishment"). The elements of novelty are few and relatively unimportant: the obligation for all authorities involved to communicate with applicants through a single point of contact, and to offer the possibility to complete all procedures electronically; the duty of the member states to provide information about their regulatory systems, such as the regulation of the professions and the means of redress available against their service providers, should things go wrong; and the ban on the prohibition of advertising.

At the Lisbon Summit of March 2000 all member states had agreed on the necessity of a deeper and wider internal market for services as a crucial element of the general strategy to make the EU the most advanced economy in the world by 2010. In 2002 the Council urged the Commission to come up with a horizontal proposal to tackle all the many, costly, and sometimes prohibitive obstacles to a truly integrated market for services. With its horizontal approach based on home-country-control, the Bolkestein proposal moved precisely in the direction indicated by the Council. Its rejection will have serious consequences not only for the Lisbon Strategy, but for the entire European economy. Given the importance of the services sector—70 per cent of Union GDP and more than 50 per cent of employment – even a satisfactory development of agriculture and industry would have only a limited effect on growth and employment in the EU, simply because of the decreasing share of these two sectors in overall activity.

A recent reconstruction of the history of the services directive from the initial draft to the approval by the EP and the Council of the final, watered down, text in December 2006 concludes that "[t]here is little doubt that the EU's biggest enlargement since its inception conditioned the reactions to the services proposals…the level of differences in national regulatory and legal settings was becoming too great to sustain the permissive consensus on liberalization that had (more or less) prevailed until then" (Nicolaidis and Schmidt 2007: 724). Also other students of this significant episode in the history of EU policymaking agree that the campaign against the "Frankenstein Directive" – as the Bolkestein draft had been renamed by its opponents – could elicit popular support because diffuse fears of "social dumping" and wage competition, previously associated with globalization, now had a specific (East) European focus. Whereas in the old EU such fears had not prevented fairly extensive use of mutual recognition, after Eastern enlargement public opinion could be fed concrete images such as that of the "Polish plumber" taking away jobs from French workers—an intentionally deceptive symbol since France has a minimum-wage law, but one which played a role in the rejection of the Constitutional Treaty, as well as in the rejection of the initial Commission proposal.

After passage of the watered down directive, some economists predicted that it would take a decade, or more, to have an internal market for services. Also the OECD *Economic Survey of the European Union 2007* was moderately optimistic on this score. However, such forecasts are based on the assumption of rapid economic convergence between the new member states and the old EU-15 – a rather doubtful assumption, not only because of the example of persistent regional disparities even in some prosperous members of EU-15, or because growth figures can be misleading in case of poorer countries, whose backwardness provides greater scope for faster economic growth; but especially because the process of eastern enlargement of the EU is far from being concluded. Thus Nicolaidis and Schmidt (2007) report that in Poland Solidarnosc justified its opposition to the Bolkestein draft by pointing to the risk that Polish workers would soon suffer from wage differentials with Ukrainian workers. In West Europe, on the other hand, opposition to the draft directive was also supported with the argument that a host-country regime would benefit workers from the new member states, for example by preventing that posted workers coming from those states and delivering services on a temporary basis in the West, would have to live on their miserable home-country wages. This disingenuous argument attempts to conceal the fact that while the host-country regime offers better conditions to the few eastern workers who are lucky enough to be accepted in the West, it effectively denies access to western labor markets to most of their compatriots. However, the argument is politically convenient, it has been accepted also by some labor leaders from the new member states – partly out of deference to their western colleagues – and could evidently be repeated with each new enlargement bringing in countries whose GNP is below the EU average, say the Balkan countries or Turkey. The sensitivity of mutual recognition to differences in socioeconomic conditions is an issue which concerns not only the EU. This particular mode of regulation is playing a growing role also at international level, especially in the context of the World Trade Organization. Also here mutual recognition requires the harmonization of essential requirements, but this could leave poor countries at a disadvantage in international trade. Hence Joel Trachtman's suggestion that for essential harmonization to be established in a way that protects poorer countries, will require technical assistance, transfer of resources, and accommodation of differences (Trachtman 2007).

Coming back to Europe, it seems rather paradoxical that many of the same people who opposed the neo-liberal, mutual-recognition philosophy of the Bolkestein draft also maintain that the EU should be much more than a free-trade area: it should also have a strong social and political dimension. With the services sector still largely regulated at the national level, however, it can no longer be excluded that the enlarged EU may regress, if not to the stage of a free-trade area, then to that of a customs union, with elements of a common market, mostly for goods: according to Commission data, in 2001 intra-EU export of services represented only 20 per cent of trade in the Single Market, compared to the 70 per cent share of the services sector in Union GDP. It is indeed ironic that after the introduction of the common currency, the near doubling of EU membership in the space of a few years, and the setting of overly ambitious goals at the Lisbon summit, one has to face the prospect of a full-fledged Single European Market receding into the indefinite future.

7. Back to Negative Integration?

Somewhat belatedly, EU leaders have acknowledged that "the pace of enlargement must take the Union's absorption capacity into account", and started to worry about "the perception of enlargement by citizens…and the need to explain the enlargement process to the public". It is however difficult to see how, having already admitted ten countries from Central and Eastern Europe, the Union could refuse to admit, sooner or later, Croatia, Montenegro, Bosnia-Herzegovina, Serbia, Kosovo, Macedonia, and Albania, as well as Moldova, Ukraine and, possibly, Turkey and Georgia. It seems rather unlikely that there will be another "big bang" enlargement as in 2004, but in some years the EU will comprise more than thirty countries at vastly different levels of development, and with correspondingly different policy preferences and national priorities. It is hard to imagine how integration methods designed for a small group of fairly homogeneous West European countries, could survive intact in a completely different environment. It seems much more probable that the EU of the future will be characterized by flexible institutional arrangements such as those variously described in the literature as "variable geometry", "Europe a la carte", "multi-speed Europe", or by even more radical institutional designs, see the next section. In this scenario the scope of traditional methods, such as the so-called Community Method, would have to be restricted, and some of its key principles, including the European Commission's monopoly of the policy agenda, either abandoned or extensively reformed (Majone, forthcoming).

This does not mean the end of the integration process, or the disappearance of institutions like the European Commission and Court of Justice. Rather, the Commission's loss of competence in some domains would have to be compensated by strengthening its power to veto national decisions contrary to the rules voluntarily accepted by all the members of the Union. In practice, such a development would signify a return to the primacy of negative integration, in the original spirit of the Treaty of Rome. The proliferation of Community programs of doubtful effectiveness has been abetted by the mistaken idea of the superiority of 'positive' over 'negative' integration. The distinction between these two approaches goes back to the earliest studies of regional economic integration, but the Treaty of Rome itself did not attach any normative connotation to it. More recently, however, positive integration has often been identified with positive values like deeper integration and social cohesion, while negative integration has been linked to deregulation, a neo-liberal ideology, and the prevalence of narrow economic interests. In fact, multinational firms generally support measures of positive integration, such as harmonization, which promise to reduce transaction costs; while fundamental rights and the diffuse interests of consumers are often more effectively protected by measures of negative integration. For example, the rights of EU citizens to receive cross-border health care have been enforced through litigation at the European Court of Justice, on the basis of internal-market (negative) law. Consider, instead, the perverse redistributive effects of what, in terms of funding, is still the largest program of positive integration: the quasi-federal Common Agriculture Policy. Already in 1992 the European Commission reported that the richest 20 per cent of European landowners and agribusiness companies received 80 per cent of EU farm aid, and it seems that the situation has not changed significantly since then. Until recently, moreover, the recipients of EU agricultural subsidies remained mostly undisclosed. In 2005, for example, the Dutch minister of agriculture was called before the country's parliament to answer questions about payouts to his own farms. Knowing that his subsidies would soon be made public, the minister disclosed that his farms in the Netherlands and France received at least euro 185,000 in 2004. What is even more shocking, among the largest receivers of CAP subsidies are some of the most prestigious aristocratic families of Britain, as well as the present owners of the large collective farms privatized after the fall of East Germany's communist regime. According to a study by professor Richard Baldwin of the Graduate Institute of International Studies in Geneva (reported by the *International Herald Tribune* of November 8, 2007) in the 2003-2004 farming year, the Queen of England and Prince Charles received euro 360,000 in EU farm subsidies, the Duke of Westminster euro 260,000, and the Duke of Marlborough euro 300,000. Incidentally, the capture of what was supposed to be the core of a "welfare state for farmers" by powerful national interests exemplifies the kind of problems that a European welfare state – advocated by some to correct the alleged neo-liberal bias of the EU – would have to face.

In comparing the two modes of integration, another important factor should be noted. While the actual outcomes of positive integration are uncertain, in part because of their dependence on implementation by national bureaucracies with their different methods and levels of efficiency, the results of negative integration are clear-cut, and generally implemented, albeit reluctantly, by the affected member states. The strength of negative integration was demonstrated once more by the ECJ's decision of October 2007 against the German law protecting Volkswagen from hostile takeovers, and making possible higher wages and shorter working hours for workers lucky enough to be employed by VW rather than by other car companies. The Court's decision was an impressive demonstration of the power of negative integration, and a significant legal victory for the Commission which, in an effort to get rid of the law, had taken the German government to court in October 2004. This victory followed the Microsoft decision to surrender in its nine-year battle with the Commission over its dominance of the software market. Microsoft agreed to apply the decision globally, thus acknowledging that the Commission's reach as a competition regulator extends beyond Europe. Comparing these victories with the failure, or limited success, of so many measures of positive integration (for instance, in the area of environmental policy, see Majone 2005), we can see that negative integration still works – not always but at least in a number of important cases.

Under a negative-integration regime, most regulatory responsibilities would be left with the people who are most directly affected by a given problem, and who have to bear the cost of regulation. The tasks of the European institutions would primarily consist in monitoring the behavior of national regulators to make sure that they do not abuse their autonomy for protectionist purposes, or to violate rights guaranteed by European law. Where the functional requirements of the common market, or of international trade, require some type of ex ante harmonization, this can be achieved by a variety of methods: mutual adjustments; information exchange; greater reliance on international standards or on self-regulation. Centralized, top-down harmonization would become a measure of last resort, while under the Community Method too many harmonization claims were driven by a political agenda rather than by genuine concerns about the integrity of the Single Market.

8. Regulations as "Club Goods"

Each enlargement of the EU necessarily changes the calculus of the benefits and the costs of integration—the reduction in transaction costs made possible by harmonized regulations, on the one hand, and the welfare losses entailed by rules that are less precisely tailored to the resources and preferences of each member state, on the other. As long as resources and preferences are fairly similar across countries, the advantages of harmonization are likely to exceed the welfare losses, but when heterogeneity exceeds a certain threshold, the reverse will be true. There are several indications that in the present Union this threshold has already been exceeded. Harmonization, even of the minimum type, and other legally binding measures are increasingly resented – hence the current popularity of the so-called open methods of coordination, and of other "soft" modes of governance. After the "big bang" enlargement to the East, on the other hand, trade unions and politically important sections of public opinion in the older (and richer) member states, became particularly sensitive to the distributional consequences of the principle of mutual recognition. Fears of regulatory competition and "social dumping" – which in the 1980s and 1990s had not prevented the application of this principle to important sectors of the economy – now led to a political veto of the original draft of the services directive.

As already mentioned, issues concerning the benefits and costs of harmonized rules, and the distributive implications of mutual recognition arise not only in the EU, but with increasing frequency also in the global economy; and because of their practical importance and intrinsic interest, they are attracting the attention of international economists and lawyers (Bhagwati and Hudec 1996; Trachtman 2007). In particular, the economic theory of clubs, originally developed by James Buchanan (1965), has been applied by Alessandra Casella (1996) to study the role of market size in the formation of "clubs", and in particular to model the interaction between free trade and the provision of standards. She argues, *inter alia*, that if we think of standards as developed by private coalitions (clubs), then "opening trade will modify not only the standards but also the coalitions that express them. As markets…expand and become more heterogeneous, different coalitions will form across national borders, and their number will rise." (Casella 1996: 149). The relevance of these arguments extends well beyond the area of standard setting. In fact, Casella's emphasis on heterogeneity among traders as the main force against harmonization and for the multiplication of "clubs", suggests an attractive theoretical basis for the study of differentiated integration in the EU. Before following up this hunch, however, we need to recall a few definitions and key concepts of the theory.

Pure public goods, such as national defense or environmental quality, are characterized by two key properties: first, it does not cost anything for an additional individual to enjoy the benefits of the public goods, once they are produced (*joint supply property*); and, second, it is difficult or impossible to exclude individuals from the enjoyment of such goods (*non-excludability*). A *club good* is a public good from whose benefits particular individuals may be excluded – only the joint supply property holds. An association established to provide excludable public goods is a *club*. Two elements determine the optimal size of a club. One is the cost of producing the club good – in a large club this cost is shared over more members. The second element is the cost to each club member of a good which does not meet precisely his or her individual needs or preferences. The latter cost is likely to increase with the size of the club. Hence the optimal size is determined by the point at which the marginal benefit from the addition of one new member, i.e., the reduction in the per capita cost of producing the good, equals the marginal cost caused by a mismatch between the characteristics of the good (say, a standard or other regulatory measure) and the preferences of the individual club members. If the preferences and the technologies for the provision of club goods are such that the number of clubs that can be formed in a society of given size is large, then an efficient allocation of such excludable public goods through the voluntary association of individuals into clubs is possible. With many alternative clubs available each individual can guarantee herself a satisfactory balance of benefits and costs, since any attempt to discriminate against her will induce her exit into a competing club – or the creation of a new one. The important question is: what happens as the complexity of the society increases, perhaps as the result of the integration of previously separate polities? It can be shown that under plausible hypotheses the number of clubs tends to increase as well, since the greater diversity of needs and preferences makes it efficient to produce a broader range of club goods. The two main forces driving the results of Casella's model are heterogeneity among the economic agents and transaction costs – the costs of trading under different standards. Harmonization is the optimal strategy when transaction costs are high enough, relative to gross returns, to prevent a partition of the transactors into two clubs that correctly reflect their needs, but not so high as to compensate the users of the more expensive standard for the difference in cost. Hence harmonization occurs in response to market integration, but possibly only for an intermediate range of productivity in the production of standards, and when heterogeneity is not too great.

Think now of a society composed not of individuals, but of independent states. Associations of independent states (alliances, leagues, confederations) are typically voluntary, and their members are exclusively entitled to enjoy certain benefits produced by the association, so that the economic theory of clubs is applicable also to this context. In fact, since excludability is more easily enforced in such a context, many goods which are purely public at the national level become club goods at the international level (Majone, forthcoming). The club goods in question could be collective security, policy coordination, technical standards, environmental quality, or tax harmonization. In these and many other cases, countries which are not willing to share the costs are usually excluded from the benefits of interstate cooperation. Now, as an association of states expands, becoming more diverse in its preferences, the cost of uniformity in the provision of such goods – harmonization – can increase dramatically. Hence the theory predicts an increase in the number of voluntary associations to meet the increased demand of club goods more precisely tailored to the different requirements of various subsets of more homogeneous states.

It will be noted that the model sketched here is inspired by a pluralist philosophy quite different from the sort of state-centric philosophy of enhanced cooperation adopted by the European treaties. It is not a question of groups of member states working closely together in order to further the objectives of the Union, protect and serve its interests, and reinforce the integration process, as demanded by Article 43(a) of the Treaty on European Union. Rather, the underlying idea is that aggregate welfare is maximized when the variety in preferences is matched by a corresponding variety in institutional arrangements. Still, all member states are supposed to respect a core of freely accepted, binding rules – at least those necessary to constitute something more than a free-trade area, say, a customs union or a common market. Monetary union (with the British, Danish, and Swedish opt-outs) and the Schengen Agreement (with the British and Irish opt outs, and Denmark's partial opt-out) may be cited as concrete examples of "clubs". But of course clubs, in the sense of the theory sketched here, need not be formed by governments.

In fact, the theory explains why a number of important tasks which used to be assigned to central governments are today performed by private, increasingly transnational, organizations. Although there is a strong historical link between standardization and the emergence of the sovereign territorial state (Spruyt 1994), current views of standardization have changed radically as a result of the advance of globalization, the development of technology, and the growing variety and sophistication of technical standards. Standards are indeed public goods – in the sense that they fulfill specific functions deemed desirable by the community that shares them – but this does not mean that they must be established by government fiat. A good standard must reflect the needs, preferences, and resources of the community of users, rather than some centrally defined vision of the 'common interest'. As Alessandra Casella (1996) has argued, the fact that in today's integrating world economy the relevant community of standards users need not be territorially defined, distinguishes the traditional view from the contemporary understanding of standards as a special class of club goods. It will be recalled that the general implication of Casella's model is that top-down harmonization is desirable only when the market is small and relatively homogeneous. In a large market harmonization tends to be brought about, not by a policy imposed from the top, but through the recognition of similar needs or preferences. This conclusion is supported by empirical evidence. Already some years ago, the OECD noticed that all industrialized countries tend to converge towards a greater emphasis on self-regulation and non-mandatory standards – hence towards a greater variety of standards and standard-setting organizations. A large market like the United States, Casella notes, is remarkable for the high decentralization of its standardization system. There are literally hundreds of organizations involved in the development of standards. The American National Standards Institute (ANSI), a private organization, coordinates private standards, approves standards as American National Standards, and represents the United States in international standards organizations. In practice, however, only about one-half of all standard-setting organizations participate in the ANSI system, and several organizations which do not participate, such as the American Society of Testing, are as well-known internationally as ANSI.

Also Europe is slowly moving in the same direction, although the temptation to think of standard-setting and regulation in Euro-centric terms is still strong in Brussels. Already the Commission's 1990 Green Paper on *The Development of European Standardization: Action for Faster Technological Integration in Europe* was strongly criticized by some national standardization bodies because of its sole focus on EC-mandated standards, neglect of international standardization, and, in the words of the Dutch Interdepartmental Committee for Standardization, "an almost cavalier disregard of all interests other than the Community's" (citation in Joerges *et al.* 1999: 19). Also recent telecommunications directives have been criticized for being insufficiently aware of the global dimensions of the industry, and for representing "just attempts of the Commission to push Europeanization forward" (Engel 2002: 15). What the Brussels authorities tend to forget is that regulation is by now an international activity, subject to peer review and scholarly criticism, and open to comparisons with the best international practice. National regulators increasingly tend to oppose Euro-centricity precisely for this reason. They are aware that their reputation depends on finding efficient solutions to concrete problems, rather than on their commitment to political objectives related to European integration. Membership in international networks helps national regulators avoid the narrow regional focus which can lead to the international isolation of the EU—as in the case of the precautionary standards. A regulatory authority that sees itself as member of an international network of agencies pursuing similar objectives and facing analogous problems, is strongly motivated to defend its professional standards and policy commitments against external influences, and to cooperate with the other members of the network. This is because the agency executives have an incentive to maintain their reputation in the eyes of their international colleagues. Unprofessional, self-seeking or politically motivated behavior would compromise their international reputation and make cooperation more difficult to achieve in the future. The importance of the social mechanisms of reputation and trust is one reason why national regulators increasingly organize their transnational (European and extra-European) networks outside the formal EU framework (Majone, forthcoming).

9. Final Thoughts

Three propositions form the core of this paper. First, the term "neoliberalism" is inherently ambiguous, but part of the ambiguity can be removed by distinguishing between neoliberal policies and a neoliberal ideology—however the latter term is defined. Just as in the past the nationalization of key industries was not always inspired by a socialist ideology – Bismarck, Mussolini, Franco and De Gaulle have been among the most energetic nationalizers of European history (Majone 1996: 11) – so privatization, liberalization, deregulation, even monetarist or supply-side policies, need not be inspired by a neoliberal ideology. The EU offers an excellent example of a strictly utilitarian use of allegedly neoliberal policies and policy instruments, see sections 1 and 2. The history of European integration shows that integrationist leaders have been willing to use any approach – from free trade (within the EU) to protectionism, from competition policy to neocorporatism – as long as it promised to advance the integration process, and to expand the competence of the European institutions. The distinction between a policy and the ideology which may (or may not) have inspired it, is particularly important if one wishes to understand the real causes and consequences of EU policies. As a good illustration let me mention again monetary union. We already saw that neither the historical record nor economic theory support Habermas' view of European monetary union as a "neoliberal goal". Beyond its economic aspects, however, the centralization of monetary policy is obviously important also for the legitimacy of the EU, and this is the aspect I intend to discuss briefly here (a more detailed analysis can be found in Majone, forthcoming).

The framers of the Maastricht Treaty decided to give quasi-constitutional status (i.e., a treaty basis) to the independence of the European Central Bank – a decision of great normative significance. Before EMU the independence of national central banks had only a statutory basis. This meant that in principle national legislators could always change the rules if they thought that the central bank was using its independence in a manner with which they disagreed. This was true of the Bundesbank, and is still true of the Bank of England and of the US Federal Reserve. In contrast, to change the rules under which the ECB operates requires a treaty revision acceptable to all the member states – a complex and politically quite difficult process. The net result is that the national parliaments of the members of the eurozone have lost any control over monetary policy, while the European Parliament has no authority in this area. The ECB is free to operate in a political vacuum since there is no true European government to balance its powers, and even the institutions of economic governance are still poorly defined. The Bank itself strongly resists any external interference in its own decisions. For this reason, it does not wish to be considered a "European institution", as had been suggested during the debate on the now defunct Constitutional Treaty. The fear is that having the same legal status as the Council, the EP, the Commission, and the Court of Justice could entail some commitments – such as expectations of inter-institutional cooperation, and consultations before taking certain decisions – which could threaten its total independence. Legally, the ECB is simply a "body"; hence, it is not stuck in the same "constitutional glue" that is supposed to hold together the European institutions listed as such in the Treaty.

It is also important to recall that the political insulation of the ECB was imposed by Germany on the other member states as a non-negotiable condition for giving up the Deutschmark in favor of the euro. The lesson one can draw from this case – but a similar lesson can be drawn from other aspects of the integration process, such as the Commission's monopoly of legislative initiative—is that it is pointless to complain about the "democratic deficit" of the ECB without first questioning the wisdom of a monetary union introduced less for economic reasons than in order to advance the integration process, and to favor particular national interests. Scholars who deplore the EU's "democratic deficit", in its different facets, tend to complain about epiphenomena, instead of going back to first principles to identify underlying causes and possible remedies. Without going back to first principles there is no hope of understanding, let alone resolving, the legitimacy problems of the EU. In case of the central bank, going back to first principles means recognizing that certain crucially important mechanisms of economic governance should have been agreed upon long before the creation of the eurozone. Until these holes in the policymaking machinery are filled, authority over the entire domain of monetary policy will continue to flow by default to the ECB; in which case responsibility for the deficit of political accountability should be attributed less to the Bank than to those who hoped to make monetary union the capstone of a European federal structure. Neoliberalism, at any rate, has little to do with all of this.

The second proposition refers specifically to the main theme of this Conference: the distributive consequences of "neoliberal" policies. Obviously, such policies, like all public policies at national or supranational level, have distributive consequences; but it is not obvious why political discourse and scholarly debate should focus on the consequences of one particular group of policies. In case of the EU, the perverse distributive consequences of the CAP – hardly a neoliberal policy – have been mentioned above. About forty per cent of the EU budget still goes to agriculture, largely to the benefit of wealthy landowners and large agribusinesses in western Europe, rather than to poor hill farmers of southern Europe or small farmers of eastern Europe. Nor are these perverse effects of the CAP restricted to the members of the EU, for it is well known that agricultural protectionism, sometimes practiced under the guise of food safety regulations, hits quite hard the farmers of other continents, including the poorest of the poor – the farmers of sub-Saharan Africa, whose losses under the EU's precautionary standards were estimated, not by EU specialists but by World Bank economists. The obvious lesson here concerns the assessment of the distributive consequences of policy decisions in a globalizing world. The temptation to use a national frame of reference is understandable in light of our historical experience, but should be resisted. Thus, in case of Hoover's decision to transfer its production from France to Scotland, the French workers' loss was, presumably, the gain of the Scotch workers.

Quite recently the Finnish multinational Nokia decided to close its plant in Bochum and to move the production of mobile phones to Rumania.

One can understand the furious reaction of the more than 2300 German workers who lost their job, and of the German tax payers who only a few years ago had subsidized the construction of the Nokia plant at Bochum to the tune of 41 million euros. Yet, an old-fashioned economist, unaware of Pareto's objections to the addition and subtraction of personal utilities, would likely conclude that since the income of Rumanian workers is so much lower than that of their German counterparts, the algebraic sum of the utilities of the two groups is positive. He might add that state aid to industry, however camouflaged, is bound to invite other countries to engage in a competitive race, see section 4. In sum, the Nokia decision is not only in line with the logic of a single European market, according to which the process of enterprise relocation is a normal, even desirable, phenomenon but, *pace* Pareto, may actually increase aggregate welfare. Of course, German voters are entitled to reject this logic, but then they should blame, not Nokia but their own leaders who accepted, indeed strongly supported, the single market project. Finally, the discussion on the perils of Eurocentricity in section 2 suggests that not only a national, but even a regional framework may be too narrow to adequately assess the distributive consequences of certain regulatory decisions.

The third main topic of the paper is the implication of socioeconomic heterogeneity for regional or international regulation. I have argued that beyond a certain threshold, regulatory instruments such as harmonization and mutual recognition become ineffective, or unacceptable to public opinion, and may even reduce aggregate welfare. The economic theory of clubs suggests one promising way of dealing with high levels of heterogeneity. Recognizing that good regulation must be responsive to the needs, preferences, and resources of the community of users, rather than to some centrally defined vision of the 'common interest', the theory suggests that in today's integrating world economy sufficiently homogeneous communities of standards users may form a variety of partly competing, partly cooperating regulatory networks. International bodies such as the International Standards Organization (ISO) and the Codex Alimentarius Commission already operate in network-like fashion. For example, the ISO is a worldwide federation of national standards bodies from more than 130 countries, between full members (almost 90), correspondent members, and a score of subscriber members.

Standards set by these and other international bodies are generally produced by consensus of the participants. Rather than insisting on a consensus which may lead to least-common-denominator solutions, however, it seems preferable to acknowledge that different standards represent different ways of meeting the needs and preferences of various potential users. Since international standards are typically voluntary, they are used only to the extent that people find them useful; in this sense, they are market-driven. Once it is recognized that, *substantive harmonization* of rules is either impossible or undesirable because of heterogeneity, the aim of international regulatory cooperation should be to reach agreement on procedures which would facilitate mutual recognition, and ensure the fairness of regulatory competition: *procedural harmonization*. An important example of procedural harmonization is provided by the WTO Agreement on Sanitary and Phytosanitary Measures (SPMs). Article 3 of the Agreement states, in part, that in order to harmonize SPMs on as wide a basis as possible, member states shall base their measures on international standards, guidelines or recommendations, where they exist. Member states may, however, introduce or maintain SPMs which result in a higher level of protection than would be achieved by measures based on the relevant international standards, provided there is "scientific justification" for the stricter measures. Article 5 specifies the procedural constraints on the freedom of each member state to choose its own levels of safety: risk assessments based on the available scientific evidence and on relevant inspection, sampling, and testing methods; consideration of relevant economic factors and of the relative cost-effectiveness of alternative approaches to limiting risks; consistency in the application of the concept of the appropriate level of protection, and so on. It seems clear that in an area as politically sensitive as the protection of health and life, and where at the same time regulators face great scientific uncertainty, procedural harmonization is the only way to promote international regulatory cooperation.

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[*] Keynote Speech given at the Second Biennial Conference on "(Re)Regulation in the Wake of Neoliberalism", organized by the Standing Group on Regulatory Governance of the ECPR, Utrecht, June 5-7, 2008.