# 3 INSTITUTIONS FOR EUROPEAN COOPERATION

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## The renegotiation

In this chapter, I shall contrast the real, existing EU with the ideal institutions for European cooperation. The British renegotiation will not bring about this ideal, but it may bring the EU nearer to it. The basic choice facing the UK is between opt-outs and reform of the EU institutions. Clearly, general institutional reform is more valuable for Europe and more attractive for Britain than special treatment of an outlier.

Which reforms should the British government aim at? Obviously, they ought to be important for Britain. At the same time, however, they ought to be unimportant or even attractive for the other governments.

Restraining immigration and access to welfare benefits is an example of what cannot be achieved by amending the treaties or adding a protocol. The East Europeans would object. Another example is the demand to abolish the Strasbourg sessions of the European Parliament. The French government would never agree to that.

However, all EU governments share a common interest in curbing the centralising powers of the EU institutions: the Commission, the Parliament and the Court. The British wish-list has to be targeted on the EU institutions, not on other member states.

The EU institution most in need of reform is the Court of Justice. Very few people realise this. The Court is the lynchpin of the system. Without its protection, the Commission and the EU Parliament could not (mis)interpret the treaties in the centralising way they do. As I have shown elsewhere (Vaubel 2014), the rule of law has effectively broken down at the EU level with the open or tacit approval of the Court. Most of these breaches concern the euro zone. However, the UK is also severely affected by the Court's misjudgements on financial and labour market regulation. The Court has upheld the use of Article 114 of the Treaty on the Functioning of the European Union (TFEU) as a basis for financial regulation, even though international differences in process regulations – as Fahey (2011) and others have pointed out – are perfectly consistent with the free movement of capital.[1] Article 114 of the TFEU is about protectionist product regulations, not about process regulations. Process regulations cannot serve as instruments of protection. Margaret Thatcher, in agreeing to the predecessor of Article 114 of the TFEU (Article 100a of the Treaty Establishing the European Community, TEC) in the Single European Act, did not sign up to European regulation of the City. As for labour market regulation, the Court rejected the British complaint against the Working Time Directive, for example. This set the stage for the dozens of EU labour market regulations that followed (Vaubel 2009a).

The Court supports the Commission in 69 per cent of cases against the member states (Sweet and Brunell 2010: 28). It has a vested interest in centralisation. The more powers it transfers to the EU level, the more important and interesting are the cases that the judges will be entitled to decide. The problem can be solved by establishing an additional court – call it the 'Court of Review' – which decides all cases affecting the distribution of powers between the EU and the member states. It would be charged to apply the principles of subsidiarity and proportionality. All other cases would remain with the Court as it stands. The

1 I shall explain this in more detail in Section 4.

judges of this subsidiarity court would not be chosen by national governments but delegated by the highest courts of the member states, and they would be required to have judicial experience, which, at present, most of them lack. This reform would be in the common interest of all EU governments.

The reform of the Commission has to deal with its monopoly of legislative initiative. The Commission will not propose legislation if it expects that the resulting legal act will reduce its power. Therefore, EU legislation is a one-way street in the direction of EU centralisation. The Commission's right of legislative initiative is also incompatible with the principle of the separation of powers. The right of legislative initiative belongs to the EU Parliament and the Council. Moreover, the legislative majority requirement in the Council should not depend on the opinion of the Commission as it does at present (Article 294, Section 9 TFEU). Finally, the Commission ought to be stripped of all its non-executive functions (infringement procedures, competition policy, the so-called anti-dumping policy, etc.) as Wolfgang Schäuble, the German Minister of Finance, has suggested.

The EU Parliament has a vested interest in EU centralisation for the same reasons. By transferring powers to the EU level, it increases its own influence. Moreover, there is a problem of self-selection: a euromantic is more likely to run for the EU Parliament than a eurosceptic. Comparative opinion polls by several survey institutions have demonstrated that the members of the EU parliament are far more centralisation-minded than the public at large (see Vaubel 2009a). The required reform is analogous to the reform of the court: the creation of an additional chamber. The second chamber of the EU Parliament would be in charge when – and only when – the legislation concerns the distribution of power between the EU and the member states. The members of the second chamber would be delegated from the national parliaments, as before 1979. To avoid self-selection, the members would be selected by lot from the party groups of the national parliaments. The second chamber could not only veto new centralising legislation, but also – together with a majority of the Council – annul previous centralising legislation. The size of the first chamber could be halved.

The alternative is to strengthen the role of the national parliaments, possibly giving them veto power ('red card') if a certain quorum is reached. Several EU governments support this reform. But it would be less effective than the second chamber because it is more difficult to mobilise a majority of parliaments in a large number of member states.

Apart from these institutional reforms, the governments share a common interest in repatriating EU powers that have failed the test of history. The repatriation must not make any member state worse off. For example, the member states may spend the structural funds and the agricultural subsidies to which they are currently entitled as they think fit.

Where interests and opinions diverge among EU governments, the UK should demand opt-outs. There are various ways of institutionalising them. Most likely, they would cover whole policy fields – say, labour and financial market regulation. Would the right of opt-out be confined to new legislation, or would it also cover the whole body of existing legislation in the policy field? Would the UK be free to opt in for specific pieces of legislation on a case by case basis, or would such opt-ins have to be agreed among the UK and the remaining EU? This might require a permanent liaison committee. If the UK opts in for a specific piece of legislation, would it subject itself to the jurisdiction of the EU Court of Justice with regard to those policies? Would it be free to withdraw again, and under what conditions? All these issues have to be clarified in the negotiations.

The British Prime Minister is trying to exploit the fact that some members of the euro zone (Germany, Italy, Spain, etc.) advocate treaty amendments to introduce additional institutions and powers for the euro zone. The UK would have to assent to those changes. But it is most unfortunate that Cameron and Osborne also actively advocate the political centralisation of the euro zone. This is not necessary to obtain a better deal for Britain.

If the outcome of the negotiations is rejected by British voters in the referendum, the British government may either notify the Council of its intention to withdraw, according to Article 50 of the Treaty on European Union (TEU), or it may try to negotiate the withdrawal by amending the treaties. By directly amending the treaties, it could circumvent the European Parliament and the Commission. This is also in the interest of the other governments.

However, if, for some reason, one of the other governments refused to negotiate a British withdrawal by direct treaty amendment, Article 50 of the TEU would be the only legal avenue for withdrawal. According to this article, the notification of withdrawal would have to be followed by negotiations. The negotiations would not be about whether but how the UK would withdraw. There would be a period of notice of two years, but this could be extended indefinitely by mutual consent.

I assume that the other member states prefer to keep the UK in the EU on present terms as long as possible for at least two reasons. First, the UK is a net contributor. Second, the other member states can outvote the UK on most issues, i.e. they can impose their level of regulation on the UK so as to improve their competitiveness. Thus, they may not negotiate in earnest unless the UK, in its notification, rules out any extension of the negotiations. An extension beyond the two years could also be precluded by the referendum question.

## Which institutions does European cooperation require? A summary

In the following analysis I shall try to show that four types of institutions may be needed for international cooperation:

1. international courts or arbitration tribunals (enforcing freedom of trade and capital movements, the rules of competition, commitments regarding ocean fishing, defence, development aid and international networks);
2. international public prosecutors, who monitor compliance in these fields;
3. international fora, in which these commitments can be negotiated; and
4. an independent international competition authority.

There ought to be separate institutions for each policy field so as to facilitate specialisation and avoid an undue agglomeration of power and dubious deals across policy fields. With the exception of North Sea fishing and trans-European networks, international cooperation in all these policy fields should ideally be organised at the global level or, if this is not feasible, among all like-minded industrial countries (OECD, NATO). Only if additional partners cannot be found is the EU an optimal area of cooperation.

## Cooperation – for what?

The optimal design of international institutions depends on their purpose. International cooperation among governments may be required for four reasons.

First, the national barriers to international market transactions ought to be removed. In principle, it is possible and desirable to do this on a unilateral basis. But politically the liberalisation of trade and capital movements is more easily achieved by reciprocal international agreement – ideally far beyond the EU.

Second, a common market may benefit from a common or coordinated competition policy that prohibits international cartels, international mergers establishing dominant positions and national subsidies to national champions.

Third, international cooperation may concern cross-border non-market externalities. These may be positive, as in the case of defence, development aid or research, or they may be negative, e.g. with regard to pollution or ocean fishing. By contrast, if the international spillovers operate through competitive markets, i.e. the price mechanism, and if governments do not commit the mistake of pursuing more targets than they have instruments to pursue, there is no need for international coordination. For instance, national monetary and fiscal policies affecting interest rates in the rest of the world through the market do not require international negotiations, but merely an exchange of information. Indeed, monetary policy collusion and tax cartels are harmful because they lead to inflation and excessive taxation. International interdependence through the market is not a problem but a precondition for efficiency.

Fourth, there may be international economies of scale in the production of national public goods or networks such as roads, railways and pipelines. In most of these cases, however, bilateral cooperation is sufficient.

While the first two justifications require negative action (the prohibition of restrictions of competition), the third and fourth call for positive action – the coordinated provision by governments of certain goods, services and policies.

Negative and positive actions differ with regard to cost. The removal of restrictions of competition has only advantages. It improves the division of labour and strengthens competition. It increases both efficiency and freedom. By contrast, policies dealing with international externalities and economies of scale are costly. Harmonisation ignores the international differences in preferences, and while market integration strengthens competition among governments, political integration weakens it. International collusion and centralisation give politicians more power over the people. Political decision-making in international organisations is far removed from the people and leaves them little choice. Both freedom and democracy suffer. Thus, the cost of positive action may easily exceed the benefit.

Liberalisation and joint intervention not only differ with respect to costs, they also require different institutions. The institutions of a common market ought to be separated from the institutions of collective policymaking. Moreover, collective policymaking should not be centralised in one monolithic institution. A large bureaucracy and an agglomeration of power are to be avoided. An efficient division of labour requires specialised agencies.

## The institutions of a common market

Does the removal of barriers to trade and capital movements necessitate common institutions at all? A treaty without institutions may be sufficient. If the government of a signatory state violates the treaty, those who are adversely affected may complain with a court of that state. Are the courts impartial and sufficiently independent of the government in all 28 EU member states? If not, the Treaty ought to provide for an international tribunal or court.

Should its decisions be binding or not? The history of the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO) has shown that non-binding arbitration makes a difference. Usually, the losing government alters its policy – but frequently not enough. The Court of Justice of the European Union issues binding judgements. However dissatisfied one may be with its centralising adjudication, its record on trade liberalisation is impeccable. However, it is far too slow, and the chamber in charge should not include judges appointed by the plaintiff or the defendant.

When exporters sue a protectionist government, they generate positive external effects for other exporters. That is why, sometimes, groups of exporters file a joint complaint. However, if joining is costly, there may be a case for appointing a public prosecutor in addition. In the EU, the Commission acts as a 'guardian of the treaties'. It is quite active in this role. There are more than 800 infringement cases pending with the Court – many of them concerning the common market. If the guardian of the treaty is involved in various other dealings with the governments of the member states, there is a danger that the guardian will accept protectionist national policies in exchange for concessions elsewhere. Thus, the Commission as presently constituted is not an appropriate guardian of the treaties. If there is a public prosecutor in charge of the Common Market, he or she should not have any other competencies than this.

Protectionism is not only about tariffs and quantitative restrictions. National regulation of product quality may protect domestic producers against foreign competitors as well. Indeed, there are so many potentially protectionist product regulations that it is very difficult, if not impossible, to outlaw all of them in a treaty. They have to be dealt with one by one. Thus, the Court, in its Cassis de Dijon judgement (1979), opened the door for individual complaints against protectionist national product regulations.

However, the governments and parliaments of the member states have taken a different line. Instead of prohibiting the protectionist national product regulations one by one, they have facilitated the adoption of EU product regulations replacing the national product regulations. They have admitted qualified majority decisions about common internal market regulations. This was Article 100a of the TEC, as introduced by the Single European Act in 1987.

Article 100a TEC had two disastrous consequences. First, a spate of common product regulations poured out from Brussels. As one would expect from a regulatory cartel, they were highly restrictive. Second, the ECJ in 1989 extended Article 100a of the TEC to include the regulation of production processes, i.e. labour, environmental and most financial regulations. This was against the Treaty and deserves to be spelt out.

Article 100a, Section 1 of the TEC (now Article 114, Section 1 of the TFEU) limited qualified majority voting to 'the objectives set out in Article 8a'. Article 8a of the TEC (now Article 26 of the TFEU) contained only one aim, that of 'progressively establishing the internal market', and it defined the internal market as 'an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of this Treaty'. Since the free movement of goods, persons, services and capital can be obstructed by national product regulations but not national process regulations, Article 100a of the TEC did not permit qualified majority decisions about process regulations.

Two years later, the ECJ in its 'Titandioxide decision' (ECJ Case C-300/89) declared that 'by virtue of Articles 2 and 3 of the Treaty, a precondition for such a market [i.e. an internal market] is the existence of conditions of competition which are not distorted' (nr. 14). This was a clear breach of the Treaty, because Article 100a of the TEC expressly referred to Article 8a and not to Articles 2 and 3. Before the Treaty of Maastricht (1993), Articles 2 and 3 did not even contain the term 'internal market'. (They used the term 'common market', which had never included national product or process regulations.) Even though national process regulations are perfectly compatible with the free movement of goods, persons, services and capital, they were now subject to qualified majority voting because they may affect competition. The door was wide open for qualified majority decisions about EU labour and financial regulations. The UK has challenged several of these decisions, but the Court has always reasserted its position.

When the Treaty of Lisbon was signed in December 2007, Gordon Brown agreed to legalising the Court's breach of the Treaty. He accepted a 'Protocol on the Internal Market and Competition', which reads: 'The internal market as set out in Article 3 of the

Treaty on European Union includes a system ensuring that competition is not distorted.' He formally agreed to the City being regulated by a qualified majority of the EU member states.

Commission, Council and European Parliament have based all their process regulations of financial markets on Article 114 of the TFEU. The last British complaint against this was turned down by the Court in January 2014 in the European Securities and Markets Authority (ESMA) case (C-270/12).

The lesson is clear. The institutions of a common market must not include a body empowered to impose common regulations. This holds regardless of whether the regulations are product or process regulations and whether they are adopted by qualified majority or unanimity. The harmonisation of regulations ignores differences in preferences and leads to a higher level of government regulation because it raises the cost of escaping excessive regulation and reduces the voters' scope for comparison. The institutions of a common market – e.g. its court – ought to be confined to preventing national product regulations from protecting domestic producers against foreign competitors. National regulations would continue to bind domestic producers, and imported products that did not conform with these regulations would have to be clearly labeled. In a common market, consumers have more choice – also in quality. Of course, each government is free to adopt the regulations of other countries.

International competition is restricted not only by barriers to trade and capital movements but also by cartels. Domestic cartels can be taken care of by national competition policies. The national authorities have the strongest incentive and the best information to deal with domestic collusion. It is sometimes argued that they may not be sufficiently strict because they ignore the foreign benefits of their actions, but there is no evidence to support this claim. However, cross-border cartels and mergers raise problems of jurisdiction. The simplest solution is to agree on a rule determining which national competition authority is to be in charge. The Closer Economic Relations Agreement between Australia and New Zealand is an excellent example of such a solution. If joint decision-making is desired, the member states may set up a common competition authority that is politically independent. Unfortunately, the current competition policy of the EU is neither confined to cross-border cartels and mergers nor conducted by an independent institution. Power rests with a simple majority of the Commissioners, most of whom know nothing about the case at hand.

The prohibition of national subsidies to national champions can be left to a specialised court. Once more, a public prosecutor would be useful.

## Institutions for joint policies regarding external and scale economies

Negative cross-border external effects are incompatible with the classical concept of liberty. In John Stuart Mill's (1859/1962: Chapter 1, Paragraph 9) words, '… power can be rightfully exercised over any member of a civilised community against his will … to prevent harm to others'. In an international context, the different nations must be prevented from harming each other. This can be achieved by setting up a supranational authority or, as Ronald Coase (1960) has taught us, by negotiated compensation. A supranational authority is dangerous because it may abuse its power. It is more likely to do so than a national government because it is exposed to less competition. Freedom is better protected if the nation states unanimously agree on rules of compensation. However, the rules have to be enforced. This requires some mechanism of arbitration or a court. Moreover, a guardian of the treaty may be helpful. Let us consider some examples.

One of the most pressing problems of negative externality is cross-border pollution. It has been tackled by agreement – the Kyoto Agreement – under the auspices of the United Nations

(UN). The European states have agreed on an Emissions Trading System, which seems to work (although see Chapter 14).

Another example is Lake Constance. The countries bordering on the lake – i.e. Germany, Austria and Switzerland, or rather the provinces concerned – have established a joint commission for cooperation.

These examples show that problems of pollution are more likely to be global or local than exactly EU-wide. But there is also a common pool problem especially affecting a group of EU member states: North Sea fishing. The fishery fleet of one state inflicts negative non-market effects on the others, and each has an incentive to do so. As a result, the member states have defined some national waters, and they have agreed on national fishing quota for the rest. This is not the most efficient solution – auctioning fishing permits would be better – but it is feasible and better than nothing. Unfortunately, monitoring the quota is mostly left to the national authorities. Compliance among Spanish fishermen, for example, is said to be poor (see Chapter 10).

As these examples indicate, international agreements limiting negative cross-border externalities are practicable and to some degree effective. Decisions about the rules and the enforcement mechanism must be unanimous, but decisions within the enforcement procedure must not. Enforcement requires supranational monitoring as well as compensation and penalties to be imposed by a majority of the contracting states.

The EU deals with positive rather than negative cross-border externalities. The most important cases are defence, development aid and research. When a member state spends more on defence against potential external aggressors, the others are likely to benefit as well. When a member state increases its development aid to third countries, the other EU members will be relieved as well. If more money is spent on research in one country – be it by the government or the private sector, the fruits will sooner or later become available to all. In all three instances, however, the positive external effects extend far beyond the borders of the EU.

The EU boasts a Common Foreign and Security Policy, including a Common Security and Defence Policy (Articles 23–46 of the TFEU). However, the external benefits of national defence are not confined to the EU. They extend to all like-minded nations – notably the US. Thus, a more encompassing defence alliance such as NATO is more efficient. Indeed, there is a danger that the EU Security and Defence Policy weakens NATO. It is meant to reduce American involvement in Europe.[2] As long as NATO works well, there is no need for EU institutions in defence.

Development aid is of concern to all potential donors. It is a matter for all industrial countries (OECD) or even the UN. At the UN level, we have the World Bank Group, and the OECD has set up a Development Assistance Committee. The available research suggests that UN organisations tend to be less efficient than the other international organisations and that the OECD in particular is more efficient.[3] There may be diseconomies of scale that outweigh the gains from encompassing additional external effects. If that is so, there is a case for decentralising development aid – at the EU level or, even better, at the national level. Clare Short, a former UK Secretary of International Development and a member of the Labour Party, once declared in Parliament that 'the Commission is the worst development agency in the world. The poor quality and reputation of its aid brings Europe into disrepute'.[4] In these circumstances, the EU's role in development aid has to be reconsidered. Rather than administering development

2 See the section on 'The disintegration of NATO' in Vaubel (1999).

3 An econometric analysis by Vaubel et al. (2007: Table 5) shows that UN organisations employ significantly more staff (taking account of the number of member states, their tasks and so on). Artis (1988) and Vaubel (2009b) demonstrate that the International Monetary Fund is the least accurate forecaster of GDP growth and that the OECD performs much better.

4 The UK Parliament, Select Committee on International Development (2000), Ninth Report, Paragraph 73.

projects, the EU ought to provide a forum for mutual aid commitments conditional on the commitments of the other member states. A commitment procedure would be sufficient to internalise the positive external effects. If tied aid is banned, each nation could be free to spend the committed amounts as they see fit.

Subsidies to research account for approximately 9 per cent of the EU's budget. There is a Commissioner for Research, Innovation and Science. The Commission appoints a committee of scientists, the European Research Council, which invites applications, nominates referees and decides the allocation of funds. To the extent to which these subsidies generate additional research and inventions, all producers who are capable of using these inventions will benefit once the patents have expired. Since the positive externalities extend to all industrial countries, the subsidisation of research is better transferred to the OECD.

Within the member states, positive external effects from agriculture and the preservation of cultural heritage may justify government subsidies. But these benefits accrue overwhelmingly to domestic residents rather than foreign tourists. There is no reason to assume that the national authorities, ignoring the benefits to foreign tourists, pay too little in subsidies. Indeed, the national authorities have a much stronger incentive to pay the optimal amount of subsidy than have the majority of governments or parliamentarians of the member states.

Networks generate both economies of scale and positive externalities. If foreigners link to a national network, they raise its value to domestic users. Such external benefits may justify subsidies for additional users both at home and abroad. The EU does not pay such subsidies, however. If each member state has its own network, each has an incentive to link it with the others. The incentive is strongest among neighbours; it leads to bilateral coordination. To the extent to which there are substantial network externalities from non-neighbouring countries, a forum for negotiations and commitments may be required. There is no need for supranational policymaking. However, once more a tribunal of arbitration or a court may be helpful to ensure that the international commitments are honoured.

## Institutions for redistribution among member countries

Redistribution among the member states accounts for about one quarter of the EU budget.[5] Most of it is implicit, resulting from policies designed to raise efficiency. However, efficient redistribution is explicit and voluntary. In the EU, revenue decisions require unanimity among the member states, but spending decisions are subject to majority voting in the Council and the European Parliament. Ultimately, the cost of redistribution is borne by taxpayers. According to one proposal by the European Constitutional Group (Bernholz et al. 2004), any increase in the EU budget relative to EU GDP ought to require a referendum in each of the net payer countries.

## Conclusion

Why do the EU institutions differ so much from the ideal?

First, the founding fathers of the EEC were centralisers. They used the common market as a stepping-stone to 'political integration'. They intentionally set up institutions that went far beyond what was necessary to abolish the national barriers to trade and capital movements. Their institutions, quite predictably, developed a centralising dynamic of their own.

But there is a second mechanism that they may not have foreseen. Market integration reduces the autonomy of national governments in regulation and taxation. In a common market, a national government that introduces new regulations or raises

5 This is the sum of the negative balances of the net payer states divided by the budget.

taxes faces a strong adverse reaction in trade and capital flows. This explains why most national governments, after adopting the internal market programme in 1987, were ready to agree to a plethora of new union-wide regulations in the years to follow.

Third, also unexpectedly, in 1990 Germany achieved unification at the price of losing its currency and monetary autonomy. The malfunctioning of the European monetary union in the wake of the financial crisis has led to further centralising measures – especially in the euro zone. As Wolfgang Schäuble told the *New York Times*, 'we can only achieve a political union if we have a crisis' (18 November 2011).

In the absence of a fundamental institutional reform, the EU will continue on its path towards 'ever-closer union', regardless of whether this aim continues to be invoked in the treaties. The British renegotiation will reveal whether the evils of the current set-up can be overcome. I am afraid they are incurable.

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