



# Hung up on RED TAPE

Calls for harmonising regulation in the EU are distinctly off key, says the Institute of Directors' **GRAEME LEACH**

**A** key part of EU policy over the last 20 years or so has been the completion of what is described as an "internal market". This involves not just the removal of explicit trade barriers between EU countries but also, in many cases, the harmonisation of regulation. I strongly support – as does the Institute of Directors – the essential elements of a genuine internal market: the free movement of capital and

labour. I also support trade liberalisation, open markets and the creation of a comprehensive internal market, but the current reality falls well short of a genuine single market, and it is certainly not a free market.

It is obviously true that harmonisation of regulation reduces transaction costs because businesses do not have to adapt to different regulatory regimes. From a static perspective, the removal of these transaction costs through harmonisation of regulation represents an efficiency gain. However, harmonisation also prevents regulatory competition. From a dynamic perspective, the loss of regulatory competition will almost certainly entail large additional costs and inefficiencies. Regulatory competition can both restrain regulatory over-reach and also allow different approaches to regulation to be tried in different countries.

However, at the same time, we

should not assume that, without the harmonisation of EU regulation, we would have the perfect regulatory environment here in Britain. In the absence of rules and regulations from Brussels, we would still have rules and regulations imposed from London and many of those rules would be harmful.

## **Social, employment and environmental regulation**

Perhaps the most contentious forms of regulation are those covering social, employment and environmental issues.

what is known about the functioning of labour markets.

Wage rates are set by market forces and levels of productivity. Legislation affects the composition of the pay package, but not the pay level. If legislators in one country insist on extensive fringe benefits and regulation that, for example, improves safety standards, these will come at the expense of lower cash salaries. The total compensation level has not increased; it has merely been shifted from payment in cash to payment in

kind. But what affects employers' business calculations is the total cost of employing people, not the precise method of dividing non-pecuniary and pecuniary benefits between regulated and unregulated aspects of the total pay package. This reasoning applies both to employment regulation and also to health and safety standards for employees.

Even in the case of environmental standards, in most cases a similar logic applies. Environmental standards are about a trade-off between (perceived)

environmental quality and material prosperity. Local electorates in different places will make different trade-offs in this respect and, as long as there are no major inter-country spill-over effects, it is reasonable for legislation at country level to reflect this plurality.

In fact, the way in which the EU deals with these matters should be turned entirely on its head. The EU should be asking whether domestic legislation is designed to be trade

- **Social, employment and environmental regulation should not be determined at EU level**
- **The fundamental freedoms of the EU should be fully supported but we do not need to unify regulation to have free trade**
- **Regulation is used to raise rivals' costs and is becoming ever-more centralised**
- **Unfortunately, Britain not only "gold plates" EU regulation, it also encourages the growth of regulation both domestically and in Europe.**
- **The UK government should criticise Brussels, but it also needs to get its own house in order**

With few exceptions, regulation at the EU level is simply not necessary to liberalise trade within the EU. The notion that an internal market requires harmonisation of employment and social legislation is based on the fallacious 'race to the bottom' theory: the idea that countries with lower employment and social standards will gain an 'unfair' competitive advantage over the more stringently regulated ones. This runs contrary to most of

inhibiting or is significantly trade inhibiting in practice. If it is, the EU Commission should be trying to over-turn such regulation through the European Court of Justice rather than centralising regulation.

Harmonisation which is justified by the alleged need to create a “level-playing field” can be abused to pursue a strategy of “raising rivals’ costs”. An example of this would be the Working Time Directive, which was classified as a health and safety measure rather than a social policy measure, in order to avoid the requirement for unanimity. A specific example of attempts to raise rivals’ costs has been seen recently with the attempts to impose a financial transactions tax which would yield much of its revenue from one country – the UK.

A common market does not require a centralisation of economic or social policy competencies at the EU level. The desire to centralise competencies has to be seen as a political aim, not a requirement of economic policy.

### Gold plating

The irony is, however, that the UK government often makes the EU regulation that we so often complain about worse. There is considerable anecdotal evidence of the “gold plating” of EU regulation by UK regulatory authorities. But, worse than this, successive British governments



in the 1980s, there were no explicit minimum capital requirements for banks and insurers. Banks and insurance companies were required to publish information on the risks they were incurring, and the provisions they were

### Is there another way?

When the single market was first proposed, the British expected that a process called “mutual recognition” would dominate. This involves the different countries developing their own approaches to regulation, subject to some minimum level, and then trade taking place freely on that basis. Somebody in the UK could buy a product from a life insurance company domiciled in Holland and regulated by the Dutch regulator, for example. Countries would still be able to unify their regulatory systems through multi-lateral agreements outside EU structures if they wished – but this would happen through evolution.

Mutual recognition has been more or less abandoned and replaced by the centralisation of regulation in Brussels. This is regrettable and damaging for business. However, it is also very clear that we need to get our own regulatory house in order. Westminster can hardly complain about Brussels if it just rolls over and accepts everything Brussels produces and, indeed, is often cheering on those who wish to wind up our businesses in red tape.

**Graeme Leach**

*Chief Economist and Director of Policy at the Institute of Directors*  
[graeme.leach@iod.com](mailto:graeme.leach@iod.com)

## THE IDEA THAT EMPLOYMENT REGULATION SHOULD BE HARMONISED RUNS COUNTER TO EVERYTHING WE KNOW ABOUT THE FUNCTIONING OF LABOUR MARKETS

have often accepted, or sometimes even encouraged, costly regulation at the EU level. The clearest recent example of this is the regulation of the insurance industry (Solvency II). These rules impose detailed capital requirements, based on a complex risk-weighting system, on insurance companies. They have been driven by the UK and it is reported that they have so far cost British insurers £3bn – and the regulations have not even been implemented yet!

The whole approach is strongly at odds with the way in which the financial services industry in the UK has historically developed. Up until the

making to cope with them. Investors had an incentive to monitor financial service providers and penalise excessive risk-taking. This was therefore a largely self-regulating system. The current EU approach to regulation, which is built on the assumption that regulatory agencies can determine the ‘optimal’ level and composition of capital requirements through mathematical models, is very far removed from this tradition. But it is not an imposition by the EU on Britain. To a large extent, it has been driven by Britain which has moved away from its tradition of lightly-regulated financial markets in the last 30 years.