

# Economics of European Union Law

Edited by Paul B. Stephan



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*Edited by*

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ECONOMIC APPROACHES TO LAW

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# Introduction

*Paul B. Stephan*

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The economic analysis of European Union law occupies two broad categories. On the one hand, scholars have drawn on the lessons of welfare economics to explore how cooperation organized through the European Union can increase welfare. This is normative scholarship, inasmuch as it prescribes policy on the basis of predicted effects of a change in the status quo. The work's normative turn is consistent with a fundamental commitment to the European Union as a project. Its object generally is to guide policymakers toward a fuller realization of the European Union's potential.

On the other hand, scholars have also worked within the discipline of political economy to study the forces driving policymakers to form the European Union and to make particular choices about what the European Union does. This is positive scholarship, inasmuch as it explores particular legal institutions and actions in terms of a general model of economic behavior. Normative judgments may lie behind the choice of research topics or the simplifying assumptions of the model, but in general the work seeks to explain and predict rather than to guide.

Both kinds of analysis are represented in this volume, but emphasis is on political economy. This choice rests on a perception of the European Union as a remarkable institutional innovation. International lawyers have felt the need to invent a new category for it, as the traditional conception of 'international organization' does not do it justice. Instead, they speak of the European Union as a 'supranational organization', analogous to but still significantly distinct from a traditional nation state.<sup>1</sup> It is the blurring of the boundary between the national and the international that is the most fundamental aspect of the European Union's strangeness and fascination.

Because it is so remarkable, questions about what the European Union is and does should take priority over how to fix it. We need first to know why we got the European Union in the form that it has assumed. Its existence cannot be taken for granted, and, as the recent crisis over its Constitution reminds us, its survival is uncertain. Political economy addresses these kinds of issues.

In essence, political economy considers how the structure of political institutions affects political decisionmaking, given differences in the cost of political participation faced by various groups. The classic applied-political-economy insight, which goes back at least to Wilfred Pareto, is that democratic decisionmaking contains a bias towards trade protection, because domestic producers can act collectively to pursue their interest in suppressing import competition at a lower cost than can domestic consumers in promoting optimal competition. The homogeneity and intensity of preferences characteristic of producers, relative to the heterogeneity and dispersed preferences of consumers, explain this outcome.<sup>2</sup> When one sees an international organization such as the European Union that is ostensibly dedicated to reducing trade protection, then political economy asks how the institutional

design of the organization overcomes such a bias, if it does. A parallel issue is whether a shift of political decisionmaking from the national to the supranational level bolsters or impairs the influence of homogenous, well-organized interest groups (see Chapters 9 and 10, this volume).

More generally, political economy expands the range of economic theory by providing a positive account of collective decisionmaking that reduces welfare. In a world where welfare economics provided a comprehensive explanation for collective action, the use of political authority to distribute resources in a manner that reduces efficiency would occur only by ignorance or error. Political economy, in contrast, seeks to explain rent-seeking, that is the well-observed use of political authority to provide inefficient protection from competition to discrete groups. Unlike welfare economics, then, political economy can help identify means by which the European Union redistributes resources inefficiently.

This last point is critical, because so much of what the European Union does involves either direct redistributive transfers – payments under the Common Agricultural Policy and Cohesion constitute the bulk of its budget – or regulatory decisionmaking that has heterogenous wealth consequences.<sup>3</sup> Some of its actions undoubtedly have positive welfare effects, but it is hard to argue that all do. Political economy enables observers both to formulate a coherent positive explanation as to why particular actions or features of the European Union may diminish welfare and to predict when particular measures might be adopted in spite of their negative welfare effects.<sup>4</sup>

A second insight of political economy concerns the incentives facing bureaucrats. Since Max Weber, social scientists have observed a tendency of bureaucracies to aggrandize discretionary decisionmaking authority. Twenty years ago the economist William Niskanen developed a formal model of this phenomenon.<sup>5</sup> An important component of the European Union is bureaucratic, indeed one of the institution's gifts to the English language is 'Eurocrat'. A natural subject of research therefore is the nature and extent of the European Commission's authority in relation to other EU institutions and that of national governments.

Third, political economy models judicial behavior as constrained political decisionmaking, rather than as a disinterested deliberative process. It seeks to predict judicial decisions as a function of the appointment process, post-service career opportunities, and institutional constraints on judicial choices. It also considers the effect of choices about participation in the dispute resolution process on the outcomes of the process.<sup>6</sup>

The judicial system of the European Union constitutes a natural experiment to test this theory. Scholars working in the political economy tradition explore questions such as the existence of a tacit alliance between the European Commission and the European Court of Justice in rivalry with the European Council, or alternatively of rivalry between the Commission and the Court.<sup>7</sup> Working out how the Court operates within the context of the other institutions can provide insights into both the political economy of the European Union and general theories of judicial behavior (see Chapter 5, this volume).

This last point is important, because the economic analysis of the European Union departs in important ways from approaches that are popular among international relations and international law specialists who study the same subject. Many, although by no means all, of these scholars see the Court as emblematic of a commitment to an organic, holistic conception of the European Union based on idealism as much as interest. Within this framework, judges are constrained primarily by an ethic of appropriateness. In doing their work, they transmit

and protect values. The solution of collective action problems or the redistribution of wealth that may result is beside the point.<sup>8</sup>

Proponents of the values-oriented approach argue that it is richer and ultimately better grounded in reality, because it avoids the simplifying assumptions that economic analysis employs. It does not artificially limit explanatory variables to material interests, but instead posits that actors will sacrifice these interests in pursuit of higher values. It also corresponds to what the founders of the European Communities claimed they were doing, as well as to the accounts of present judges and other influential actors.

I will not rehearse here all elements of the debate over the tractability of values as a subject of social science research. If social scientists are to assign the role of independent variable to values, they at a minimum need to explain how these values can be defined and observed objectively. Even better would be a theory that could explain how particular values acquire salience. In the absence of these elements, values-based accounts of the European Court of Justice, and of the European Union generally, suffer from the general problem of nonfalsifiability.

Here I will make a narrower point. A specific concern attends using this approach with respect to the European Union. One cannot talk about the European Union without having some appreciation of international law. The foundation of the institutions is treaty law, even if, as some specialists maintain, the resulting legal system is *lex specialis* rather than an extension of general principles of international law. And international law has had an unhappy history of uncritical, and ultimately obscurantist, values-based theories.

For much of its history, proponents of international law saw it as a reflection of natural law that rested, ultimately, on theological claims. The values it furthered, and the arguments that justified its existence and content, relied on perceptions of God's plan for humanity, rather than on empirical research or social theory. By the nineteenth century the religious foundations of international law had been replaced by other, liberal values, but the tradition of basing the legal structure on core assumptions not subject to critical analysis continued. The divorce of international law from social science, coupled with the spectacular failures of its idealism that World War II embodied, led in the mid-twentieth century to a general discrediting of international law among scholars committed to positive analysis, whatever their fields.<sup>9</sup>

In this context, the assertion that the European Union represents a triumph of idealism over material interest seems to bear out Marx's famous aphorism about history repeating itself, the first time as tragedy, the second as farce. The point is not that the simplifying approach of economics is not incomplete – it indisputably is. But when scholars stray from research that rests on claims that can be subjected to critical analysis and empirical testing, they tend to invest their own values and aspirations in their project. How could it be otherwise? What can result is intellectual autobiography masquerading as an account of the European Union. And the criterion of academic success thereby shifts from the search for truth to the pursuit of a peculiar kind of clubbability.

The ambition of economic analysis is both more and less than that of values-based accounts. On the one hand, anyone employing economic analysis must acknowledge its limits. Its practice of simplified modeling necessarily omits much of the richness of social life. On the other hand, what claims it can generate, however incomplete, can be tested and falsified. The process of subjecting these claims to critical analysis in turn generates new insights and data that can lead to the development of more robust claims. Put simply, economic analysis may not tell us as much as we want, but it is less likely to lead us down dead ends.



As applied to the European Union generally, and to the production of law in the European Union particularly, this limited but rigorous approach has considerable value. It serves, if nothing else, as an antidote to two kinds of mystification that dog the study of European Union law. First, it counters a tendency towards what one might call legal exceptionalism, the claim that legal institutions are opaque except to those initiated in the mysteries of law. Second, it counters what one might call European privilege, the claim that the European project is too important to be subjected to sustained criticism.

Since scholars first began applying the tools of economics to law, they have encountered the argument that law is simply too complex a phenomenon to be explained with this methodology. Some economists have responded by exiling legal institutions from positive analysis. Among developmental economists, for example, the question of whether legal institutions matter remains controversial. But over the last 40 years the field of law and economics has built up a substantial body of work that demonstrates the power of economic analysis as a means of illuminating legal rules and institutions. Moreover, the emergence of institutional economics as a subdiscipline has led some economists to seek a richer understanding of how institutions operate and evolve.

As the work in this volume emphatically demonstrates, the new institutional economics embraces the study of the European Union. It illuminates the seemingly irrational proliferation of institutions with overlapping jurisdiction and competing assignments of competence. It also explains the lack of coherence in the European Union's policy, oscillating between *dirigisme* and the promotion of competition. As the work observes, a darker side to this confusion is limited transparency and a susceptibility to corruption (see Chapters 1 and 4, this volume).

Insights of this sort in turn trigger concerns about European privilege. The origins of the European Union can be found in the shambles of post-war Europe and the compelling desire not to repeat the catastrophe of 1914–45. Economic interdependence was never an end in itself, but rather a means of eliminating the main sources of Franco–German conflict. Since the end of the Cold War, the peacekeeping imperative has led to the embrace of the lion's share of the former Soviet satellites in Europe, again subordinating economic objectives to broader political ends. The goal of preserving peace in Europe supersedes all else.

From this perspective, critical analysis of the European Union can be seen as a threat to its fundamental mission. What do bureaucratic constraints on innovation and growth or increases in corruption matter in comparison to preventing Europe from reverting to the totalitarianism and murderous wars that occupied so much of the twentieth century? Surely the benefit of staving off this nightmare more than compensates for whatever costs the political compromises that go into its institutional design have generated.

This argument, although attractive, can morph into a much less helpful position, namely that any criticism of the European Union undermines its invaluable mission. Sometimes this reaction is buttressed by the suggestion that the critic must be aligned with the nationalist troglodytes that oppose the European Union root and branch. The result, unfortunately, is a tendency to shut down a useful discussion of the European Union's missteps.

A case in point is European Monetary Union. This step lowers the cost of transactions and perhaps contributes to the gradual development of a European political consciousness. But it also makes impossible a localized monetary policy and instead requires the use of transfer payments (which may be more subject to political contestation and corruption) as a response

to uneven economic conditions. Competition among central banks, which might lead to optimal monetary policy, is also reduced. It is, of course, much too soon to come to any conclusions about the ultimate wisdom of monetary union. But commentators have noted that this experiment in Europe-building might backfire, engendering regional jealousy and resentment that, under the right conditions, might tear apart the European Union (see Chapter 19, this volume).

As this last point indicates, the critical analysis associated with political economy also has implications for applications of welfare economics. To assess the welfare effects of a change in the status quo, the proponent must estimate the unintended as much as the intended consequences. How will interest groups respond to an action that will affect their interests? In light of the predicted response, what would be the net effect of the change? Does the change have secondary effects on the discretion and authority of particular European Union institutions, and if so how might that power be exercised?

Consider proposals to rationalize tax policy within the European Union through measures enforced by the Commission and/or the Court. A substantial literature exists on tax competition and its opposite, the imposition of discriminatory burdens on outsiders (see Chapters 7 and 8, this volume). In a world where European policymakers are motivated only by the desire to make good policy, all discriminatory burdens and much tax competition should disappear. The European Union institutions would solve the collective action problems that produce wasteful taxation. But once admit the possibility of rent-seeking at the level of the institutions, transferring more extensive authority over taxation to the institutions might lead to new difficulties.

Similar issues underlie the consideration of European-Union-wide business regulation. Pure welfare theory suggests that under conditions of low externalities, local regulation combined with supranational protection of producer mobility will generate desirable regulatory competition. Conversely, with high externalities policy coordination at the supranational level is optimal (see Chapters 11 and 12, this volume). But if we relax the assumption that European Union institutions are relatively safe from rent-seeking, these conclusions might change.

Consider specifically two policy areas that have attracted much scholarly attention, competition policy and corporate governance. Over the last 40 years European domestic markets have seen some reduction of cartelization, although it is unclear whether this has resulted from the Commission's enforcement of competition rules or from more general application of the Treaty of Rome's common market norms. Further complicating the story is the effect of regulatory competition with the United States as well as symmetrical efforts of the US and European Union enforcement bureaucracies to harmonize competition regulation. Artfully deployed, competition policy can become a means for pursuing trade protection. Whether the European Union becomes a mechanism for advancing consumer protection through more competitive markets, or the opposite, remains to be seen (see Chapters 13 and 14, this volume).

Supervision of the internal affairs of firms and of their access to capital markets is also an instance where regulatory competition might either promote or diminish welfare. Collective action problems exist, pointing toward European-Union-level regulation, but rent-seeking also is present at each level. The optimal assignment of regulatory competence between the European Union and the member states thus remains controversial (see Chapters 15, 16 and 17, this volume).

Finally, take the question of citizenship. Traditionally the concept of citizen implied the existence of a sovereign and a subject. As the European Union establishes itself as a mechanism for guaranteeing particular rights and privileges, it becomes easier to cast the European Union as a sovereign wielding higher authority than that of the member states. Should citizenship in the European Union itself be a matter of European law, or may the member states retain the power to decide, on a state-by-state basis, what it takes to become a holder of European rights? What conditions, if any, should the institutions attach to citizenship, independent of the requirements of national citizenship? (See Chapters 20 and 21, this volume.)

At the end of the day, one should view welfare economics and political economy as complementary rather than as substitutes. Inasmuch as the European Union remains a work in progress, policy guidance remains an important objective of all scholarship. The institutions and their practice are too new and have experienced too much reinvention to allow researchers to limit themselves to a straightforward account of the status quo. To the contrary, all research must embrace not just the reforms that have been implemented, but also those that have been proposed.

Topics as diverse as the effects of regulatory competition and the incidence of citizenship illustrate how welfare economics and political economy can operate in tandem to guide policy. The studies contained in this book identify both the welfare arguments that support changes in the competence of the European Union's institutions and the political economy pitfalls of particular pathways to change. In this light, the insights of political economy can serve not as obstacles to change – a traditional charge against the field – but rather as an extension of welfare analysis that increases the likelihood of successful reform.

More generally still, one should remember that the economics of European Union law is a very young field. None of the work in this collection appeared more than 15 years ago; much is research in progress. Scholars have only begun to work out the questions to be studied, and much applied research is badly needed. The good news is that the ongoing struggle to understand and reinvent the European Union provides those of us who use the tools of economics to study law with great opportunities for more and better work.

## Notes

1. Robert E. Scott and Paul B. Stephan (2004), 'Self-Enforcing International Agreements and the Limits of Coercion', *Wis. L. Rev.*, 551.
2. Vilfredo Pareto (1906), *Manual of Political Economy*, 1971 translation of 1927 edition, Ann S. Schwier and Alfred N. Page (eds), trans. Ann S. Schwier, New York: A.M. Kelley. For later work developing the same point, see Dennis C. Mueller (1989), *Public Choice II*, Cambridge: Cambridge University Press; Mancur Olson (1971), *The Logic of Collective Action: Public Goods and the Theory of Groups*, rev. ed. Cambridge, Mass.: Harvard University Press.
3. The 2006 Budget provides for expenditures of €111.9 billion, of which €42.9 billion will go for the common agricultural policy and €31.9 billion for cohesion. For the budget, see [http://ec.europa.eu/budget/budget\\_detail/index\\_en.htm](http://ec.europa.eu/budget/budget_detail/index_en.htm) (last visited May 19, 2006).
4. On the design of the European Union as both a potential means for promoting redistribution and as a check on this process, see Chapter 3, this volume.
5. Max Weber (1947), *The Theory of Social and Economic Organization*, trans. A.M. Henderson and Talcott Parsons, New York: Oxford University Press; William A. Niskanen, Jr. (1994), *Bureaucracy and Public Economics*, Brookfield, US: Edgar Elgar; William A. Niskanen (1985), 'Bureaucrats and Politicians', *J.L. & Econ.*, 18, 617–43.

6. Paul B. Stephan (2002), 'Courts, Tribunals and Legal Unification – The Agency Problem', *CHI. J. INT'L L.*, 3.
7. For the coalition story, see Chapter 6, this volume. For the rivalry story, see Chapter 2 in this volume.
8. E.g., Karen J. Alter (2006), 'Delegation to International Courts and the Limits of Recontracting Political Power', in Darren Hawkins, Daniel Neilson, Michael J. Tierney and David A. Lake (eds), *DELEGATION UNDER ANARCHY*, Cambridge: Cambridge University Press.
9. Martti Koskenniemi (2002), *The Gentle Civilizer of Nations – The Rise and Fall of International Law 1870–1960*, Cambridge: Cambridge University Press.

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19. Martin Feldstein (1997), 'The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability', *Journal of Economic Perspectives*, **11** (4), Fall, 23–42 654

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21. Michael J. Trebilcock (2003), 'The Law and Economics of Immigration Policy', *American Law and Economics Review*, **5** (2), Fall, 271–317 701

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Part I  
The Political Economy of the  
European Union



