

1992, REGULATORY COMPETITION, AND BUSINESS

Jeanne-Mey Sun & Jacques Pelkmans

Centre for European Policy Studies, Brussels

Paper presented to the European Community Studies Association
Third Biennial International Conference
27 May 1993
Washington D.C.

DRAFT

(please do not quote without prior permission of authors)



CENTRE FOR EUROPEAN POLICY STUDIES
Rue Ducale 33
B-1000 Brussels
Tel.: (32.2) 513.40.88
Fax : (32.2) 511.59.60

1992, REGULATORY COMPETITION, AND BUSINESS

Jeanne-Mey Sun & Jacques Pelkmans

Centre for European Policy Studies, Brussels

I. Introduction and Purpose

'Mutual recognition' is one of the most important policy innovations to emerge from recent European integration. Originally formulated as a circumscribed legal doctrine by the European Court of Justice, it was swiftly seized upon by policy-makers who began exploiting it as a regulatory principle, to greatly facilitate the harmonisation process required for the EC-1992 programme. Its great merit is that, where applicable, it moves the Community away from the 'all-or-nothing' trap of harmonisation.

In several ways, mutual recognition among member states forms a complement to harmonisation, once it is agreed that harmonisation need not be 'total' or 'all-encompassing'. This is useful to the extent that there is no economic justification for pursuing such comprehensive EC regulation (which is the case in a majority of policy areas).

Another merit of mutual recognition is that it provides much greater room to apply the subsidiarity principle in a functional way. Given that the four economic freedoms of movement in the internal market are much more secure as a result of "1992", and taking comfort from the Court's consistent protection of the

single market's integrity, the Community can be much more relaxed than in the 1970s about the "remaining" regulatory powers of member states. At the same time, mutual recognition provides member states with a degree of regulatory autonomy which might have been impossible under the old "all-or-nothing" perspective.

This paper will address the next logical step in the shift away from "total" harmonisation: regulatory competition. Whereas mutual recognition is a static notion, regulatory competition is dynamic. The latter's relationship with harmonisation, however, is complex: for given, well-defined EC regulation it may act as a complement; in more radical thinking it may be viewed as an outright substitute for harmonisation by the EC Council of Ministers. Regulatory competition is only possible when there is mutual recognition; in turn, the latter is only possible when harmonisation is not 'all-encompassing'.

Given a single market and its regulatory principles (see Section III), regulatory competition refers to complex business-government interactions which occur at national level, leading member states to experiment with national regulation for market-strategic reasons (such as the 'competitiveness' of local business). Alternatively, a member state with restrictive regulation may be forced to respond to the adverse effects of its regulations for local business in the single market.

When regulatory competition is complementary with harmonisation, its processes begin after a certain degree of EC

harmonisation has been achieved; to this extent, its impact should be limited. By contrast, when regulatory competition is a *substitute* for harmonisation, the EC process does not commence with a certain degree of harmonisation in the Council. Rather, the ultimate goal - sufficient regulatory convergence among Member States such that justified regulatory objectives are achieved with minimum distortions in the single market - would equally, if not better, be accomplished through a process whereby member states experiment and compete with national regulation. Internal market forces would respond via variations in the flow of goods, services, and factors, forcing the adversely affected member states to react. Such an iterative process would eventually bring about a 'market-driven' regulatory convergence. Since market preferences would probably be better revealed by the dynamics of regulatory competition, than by bureaucracy-driven and politicised harmonisation in the Council, regulatory competition would further be a superior solution on normative economic grounds.

The present paper is a provisional attempt to better understand the scope and limitations of regulatory competition in the EC, as well as its costs and benefits. A full understanding can only be the result of a major research programme, both at the conceptual level of economic or political-economy models and at the level of careful case studies. Here, we shall concentrate on four questions. First, we ask what the place of regulatory competition is among the innovative set of 'guiding principles' of EC-1992, and especially its emergence

from mutual recognition. Second, the role of business-government interactions is addressed by stylising the possible processes of regulatory competition in the Community. This stylised representation makes it easier to identify when and where business-government interaction might take place. Third, the economic case for regulatory competition is briefly outlined, and its limitations are considered. Fourth, we discuss the proposition that regulatory competition, from a normative economic point of view, is a superior alternative to Council-driven harmonisation.

II. Regulation for Integration - What, How, and at What Level?

Before examining the emergence of regulatory competition in the context of the '1992' programme, it is instructive to recall some of the theories of regulation, which seek to explain why regulation is enacted in the first place. The economic justification for a certain degree of regulation in the internal market should be respected, while at the same time ensuring that associated distortions are minimised, and that prohibitive regulatory barriers between member states are removed as well as prevented from recurring.

The traditional, normative view of regulation posits that regulation is only economically justified when markets fail. Since market failures will damage general welfare, this theory holds that regulation is therefore designed to safeguard and improve the public interest. There are three such market

failures: externalities, market power, and imperfect or asymmetric information ¹. In a context of economic integration, these market failures also exist, and so the corresponding motives to regulate remain the same. However, there are two fundamental distinctions between the economics of regulation in a local or national setting versus that in an EC-type situation: first, different regulatory regimes may coexist, entailing a policy choice between hierarchy (ie. centralisation), coordination, or competition; and second, because economic integration is often an evolutionary process, there is an imperative to regulate *such that* greater economic intercourse is achieved.

The normative view of regulation (ie. what regulation 'should' do, and how regulators 'should' behave in the process) has since been challenged on the grounds that it does not adequately explain regulation in practice. Rather, a positive theory of regulation, to explain how regulators actually do behave, was needed. Beginning with Stigler (1971), economists have developed a theory based around the self-interest of regulators, rather than some idealised conception of the common good ². Specifically, regulators can be "captured" by the industries they are supposed to regulate: they come to equate the

¹ A fourth market failure is an inequitable distribution of wealth and income, but we do not discuss this here, as such wider distributional goals are more likely to be better accomplished by other instruments of public policy, namely the fiscal (tax) system. For a review of the three 'orthodox' market failures as a basis for regulation, see Kay and Vickers (1988).

² See Peltzman (1989), for a review of the positive theory of regulation, and its variants.

public good with these industrial interests, and in exchange for promoting such interests, appropriate some of the resulting rents. A primary explanation for capture is that asymmetries of information between the government and firms require the regulatory agency to be closely involved with firms on a day-to-day basis, with a resulting tendency to identify with the aims of the firms themselves. Variants of regulatory capture include *government capture*, in which the regulatory agency becomes too closely identified with the aims of the government itself (eg. the protection of employment in certain constituencies), and *bureaucratic capture*, whereby the aims of a regulatory agency come increasingly to reflect the individual aims of its staff (Gatsios and Seabright, 1989). The common thread running through all forms of capture is a departure from the pursuit of the public interest at large.

Another instance in which the outcome of regulation deviates from the common good is so-called "strategic" regulation, or the use of regulation as a trade instrument. Beyond the traditional use of tariffs, it is now widely recognised that most trade barriers are regulatory in nature. Technical standards and regulations, and state aids are examples of tools which can be used to shield domestic industry from international competition, with the result that output is lower than what allocative efficiency would define as optimal, and consumers face higher prices than they otherwise would have.

Although the initial motive to regulate may be market

failure, the regulatory outcomes produced under both regulatory capture and strategic regulation demonstrate that regulation - to improve market functioning - can itself fail. Assessing the merits of public policy then becomes an exercise of balancing the costs of market failure against those of *regulatory failure* (or more broadly, government failure ³). Only by undertaking such a comparative cost-benefit analysis can an argument for regulatory intervention be made in a given case. Although it is likely that there will always be some government failures associated with regulation, it is obviously desirable to keep these to a minimum.

Once the prior questions of "what" should be regulated, and "how", have been answered, the existence of a "federal" setting such as the Community adds a further dimension to regulatory policy: namely, at what level should regulation be undertaken? This third question interacts closely with the other two issues, since market failures (particularly externalities) can manifest themselves at an EC-wide level, thereby necessitating EC action (or at minimum, joint EC-member state action) ⁴. Further, the

³ Other sources of government failure (at the EC level, in a Community context) include: costly decision-making procedures, excessive centralisation (ie. a failure to delegate regulation to lower levels of government), incomplete regulation which has the effect of sustaining fragmentation in the internal market, ineffective enforcement of regulations, and inadequate consideration of the adjustment costs which regulations impose differentially on member states. (Pelkmans, 1990).

⁴ Other reasons for exclusive EC jurisdiction include the existence of economies of scale, which make federal regulation more cost efficient than separate national systems of regulation; sufficiently congruent voter preferences across the entire Community on a given issue; and efficient preference revelation mechanisms, such that EC institutions are properly informed about

costs of regulation, as exemplified by regulatory capture and strategic regulation, can also sometimes be reduced or eliminated by regulation at the federal (EC) level.

For instance, by agreeing to limit state aids (articles 92-94 EEC) and to prohibit "quantitative restrictions on imports and all measures having equivalent effect" (article 30 EEC), the member states of the EC have achieved both a greater integration of their economies, and significantly reduced the potential for strategic trade policy to mutually inflict costs on one another to the detriment of aggregate EC welfare.

Moreover, in a context of free movement within the internal market, the incentives for national industry to "capture" its national regulators are severely reduced (or, in the extreme, eliminated). Since regulators no longer have the power to limit or block competitive imports, it becomes futile for national industry to capture them - *for this purpose*. Rather, the imperative of remaining internationally competitive now dictates the reverse: industry should "capture" or otherwise pressure its national regulators to enact regulations which favour domestic competitiveness. If such pressure results in "deregulation", (ie. the removal of heretofore protective regulation), the political influence of the regulated industry should also decline: entry into the domestic market by foreign producers will dilute the power of the domestic industry vis-a-vis national regulators.

voter preferences. Each of these conditions underscores the difficulties inherent in applying subsidiarity in practice.

When regulation is a prerogative of the national (or other sub-federal) level of government, *regulatory competition* becomes a way both to integrate national economies fragmented along regulatory lines, and a way to reduce government failures like capture, excessive centralisation, and its associated decision-making costs. These, and other alleged benefits of regulatory competition are addressed later in the paper. First, we look more deeply at the place of regulatory competition in the context of the EC-1992 programme and its guiding principles.

III. The Emergence of Regulatory Competition from EC-1992

In this section, we provide a stylised, step-by-step explanation of regulatory competition as it emerged during the 1992 programme. Annex I is a visual complement to the discussion.

The key objective of any internal market is the stimulation of growth, employment, and allocative and cost efficiency. The means to these ends consist in removing barriers to inter-state trade and production, such that the free movement of goods, services, and factors of production is guaranteed both *de jure* and *de facto*.

In the early years of the Community, *total ex ante* (or prior) *harmonisation* of member state national regulations, at the Community level via directives and regulations, was the means by which integration was progressively achieved. In other words, the

objective was to replace national regulations with common regulations so that all member states would have the same regulations in a given policy area. However, when agreement on prior harmonisation was not reached as a result of deadlocks in the Council, free movement was simply blocked. Moreover, in those cases when it was eventually agreed, total harmonisation was costly in terms of both time and the quality of resulting legislation, and, as a strategy, was often disproportional (excessive) relative to the market failures it was designed to overcome ⁵. Finally, it was only applied to goods; service markets were left untouched.

It is therefore unsurprising that relatively straightforward 'harmonisation cases' remained stuck in the Council for long periods of time. For instance, the so-called "mineral water" directive took 11 years to agree! ⁶. With such slow speed and utter inefficiency, the EC's internal market would have taken centuries to achieve, and even then, its "accomplishments" would have been open to debate.

The notion of *minimum harmonisation* was therefore introduced

⁵ On the other hand, it is possible that national regulations which address market failures on a national level are inadequate when considered from an internal market perspective. For example, the negative externalities of pollution may be internalised within a member state (eg. firms which emit pollutants compensate surrounding localities), but not within the internal market (these same firms do not account for the less immediate environmental damage they inflict on neighbouring countries).

⁶ See Pelkmans and Vollebergh (1986) for additional examples of such failures.

as a way to harmonise only the "essential requirements" of regulations, namely those safeguarding (inviolable) interests such as "public morality, public policy, or public security..."⁷.

The adoption of this concept opened the way for the application of a complementary principle, that of *mutual recognition*. The origins of mutual recognition (as a *principle in judicial review*) lie in the famous 1979 ruling of the European Court of Justice in the so-called "Cassis de Dijon" case. One breakthrough provision of this ruling held that the importation of goods lawfully produced and marketed in one member state cannot be prevented by another member state if such goods fulfil the essential requirements enumerated in article 36 EEC. Rather, member state regulations must be "mutually recognised" and hence *free movement* within the Community must be allowed.

Although mutual recognition under article 30 EEC⁸ is far from sufficient to promote free movement, the case law of the European Court following *Cassis de Dijon* did help to expand the scope and application of mutual recognition. Essentially it holds

⁷ Article 36 EEC. The full text continues: "public security the protection of health and life of humans, animals, or plants, the protection of national treasures possessing artistic, historic, or archaeological value, or the protection of industrial and commercial property. Such prohibitions or restrictions shall not, however, constitute a means of arbitrary discrimination or a disguised restriction on trade between member states".

⁸ As mentioned above, the article which prohibits member states from introducing quantitative restrictions and all measures having equivalent effect between one another.

that, even if article 36-type essential requirements apply,

- mutual recognition is compulsory if the essential requirements are deemed to be 'equivalent' among Member States. Therefore, the detailed harmonisation of the past is no longer required, but is rather substituted by judicial review, rescuing free movement;
- and national requirements are maintained, measures must be proportional to the objective sought, and least restrictive for free movement, which again reduces distortions in the internal market considerably.

By refining mutual recognition as a principle in judicial review, free movement was helped, but constraints were still very considerable. So, *mutual recognition as a regulatory principle* was gradually developed. However, one cannot "observe" the application of this principle in practice. Instead, it operates against the background of the Court's doctrine of judicial review, as the Court has clarified:

- once member states have agreed on a harmonisation of the 'essential requirements', article 36 EEC can no longer be invoked by member states to hinder free movement;
- because 'minimum harmonisation' (that is, only of the essential requirements) would, by definition, make those requirements "equivalent", mutual recognition can be applied; and

- therefore, (minimum) harmonisation is a faster route to ascertain whether (essential) requirements are (actually) "equivalent".
- From a political point of view, therefore, an advantage of agreeing common minimum harmonisation in the Council, rather than waiting for the Court to determine the equivalence of essential requirements in each and every case is that it lends political legitimacy to any decisions reached thereby. Judges can only be so involved in regulatory matters until the situation is characterised as one of "government by the judiciary".

Later, two further extensions of mutual recognition as a regulatory principle were applied with tremendous impact:

- in the *standards* area, the "new approach" to technical harmonisation and standardisation, and the "global approach" to testing and certification⁹ expedited the practical implementation of mutual recognition; and
- in *services*, EC-1992 adapted the mutual recognition-cum-minimum-harmonisation idea to the financial services sector (with the Second Banking Directive as the breakthrough), and to telecommunications (with an original combination of the standards and the services

⁹ For further analyses of technical barriers in the EC, see: Centre for European Policy Studies (1992). *The European Community Without Technical Barriers*. CEPS Standards Programme Paper No. 1; Niall Bohan (1991). *The Annual Review of European Community Affairs 1991*. London: Brassey's for CEPS; and Michelle Egan (1993). *The Annual Review of European Community Affairs 1992*. London: Brassey's for CEPS (forthcoming).

approaches).

Although free movement was tremendously enhanced by all of these refinements, hurdles might still have remained, including:

- unanimity as the decision rule in the Council. This was cumbersome in all areas, but particularly where minimum harmonisation is indispensable (eg. product safety requirements); and
- national frontiers, which goods would cross, only to be hit with remaining barriers and (border) tax adjustments.

As a consequence, *qualified majority voting* was needed, not only to make (minimum) harmonisation possible but also to reduce the costs of harmonisation. Specifically, qualified majority voting has a potential to:

- make it difficult for one or a few recalcitrant member states to "extend" minimum harmonisation by detailing the 'essential requirements' beyond 'essentials'; and
- make it difficult for one or a few member states to veto a proposed EC directive, as this requires a blocking minority. If it proves impossible to achieve such a minority (which, on essential requirements, is much harder than with 'total' harmonisation), the minority countries are forced to 'innovate', find alternatives which are attractive or superior, or be overruled. This is likely to upgrade the quality of legislation and lower the costs of harmonisation.

Although the principle of free movement was enshrined in the 1957 Treaty of Rome, there was no presumption that this would necessitate a complete dismantling of internal frontiers. Indeed, it was only in the 1986 Single European Act, that the principle of *no internal frontiers* was explicitly written into the Treaty in article 8A.

There are three broad categories of frontiers: fiscal, physical and regulatory. Removing physical controls (other than for persons, which falls outside the scope of this paper) requires relatively unambitious harmonisation as long as fiscal aspects can be avoided. Some activities, however, do create problems because they require total harmonisation (eg. veterinary/phytosanitary measures) before mutual recognition of approvals becomes possible (and even that requires harmonisation). Fiscal frontiers are so sensitive that they require unanimity for (any) harmonisation, let alone, removal. While reducing the potential for tax evasion, these frontiers also prevent tax competition between member states.

Thus, with harmonisation and mutual recognition spreading rapidly over many product markets, and with fiscal and physical frontiers fading away, regulatory frontiers became at best "porous". If anything, they became 'regulatory demarcations' for goods as, in principle, they had always been for services.

However, with free movement being applied so much more rigorously and with a wider scope, even these regulatory

demarcations became increasingly subject to penetration by goods and services from other regulatory domains. Without internal frontiers, and by buttressing free movement with minimum harmonisation (or judicial review) in order to ensure mutual recognition, national regulatory systems became exposed to one another. As a result, *regulatory competition* and its dynamics became possible.

It should by now be clear that the potential for regulatory competition can only be understood by considering its interaction with the other three guiding principles discussed above (minimum harmonisation, mutual recognition, and no internal frontiers).

A fifth guiding principle - subsidiarity - is an equally crucial input into the emergence and operation of regulatory competition, though it does not figure in Annex I. This is because awareness and recourse to the principle in the Community context is extremely difficult to trace to a given point in time¹⁰.

Subsidiarity is a natural result of the emergence of two-layered government. It is an assignment principle of public functions; but its emergence is, in and of itself, a functional

¹⁰ In the economics of federalism, subsidiarity has always been a key principle. In the Community, however, explicit awareness and consideration of subsidiarity has only been fairly recent. It was first explicitly mentioned in the 1984 Spinelli Draft Treaty on European Union, and then in the 1987 Padoa-Schioppa Report. In the Single European Act, it is weakly mentioned in the section dealing with the environment, while in the Maastricht Treaty, it becomes a fundamental requirement of EC policy when jurisdiction is concurrent (article 3B).

and political revolt against the unquestioned and linear shift of ever more public functions to the EC level. Conversely, once it applies, member states cannot freely 'dispose' of powers to execute public (economic) functions as this may violate subsidiarity.

Applied in conjunction with harmonisation in the EC, subsidiarity raises the following issues:

- is it appropriate to regulate at EC level?
- if not, or not clearly, can member states deal with the matter (perhaps with inter-member state cooperation, but *without* harmonisation)?
- if yes, what and how much should be harmonised, and in what details can member states still differ (justifiably)?

With an understandable inhibition to go for regulation at EC level, the move "away" from national regulation may often lead to a relegation to the market rather than to the EC level by regulation. The idea that public policy should be closely associated with voters' preferences may thus be fostered by inter-jurisdictional regulatory competition.

On the other hand, regulatory competition and subsidiarity may be at odds with one another once the non-distortiveness of the internal market is seen as a 'public good', to be achieved simultaneously with subsidiarity. In other words, a purist subsidiarity view presupposes a purist view of the internal market. But that would greatly undermine the regulatory potential

of the member states, because regulatory competition is by definition (temporarily) distortive, though the precise duration of these distortions is uncertain (open-ended). Hence, with a purist view of the internal market, national regulation and regulatory competition would not, or would only barely, survive. Only when the regulatory differences, exposed by mutual recognition, minimum harmonisation, and free movement are "tolerated", can regulatory competition based on business-government interaction occur. It is to these interactions that we now turn.

IV. The Role of Business-Government Interactions

In this section, we stylise the EC process of regulatory competition, post 1985, as we believe it operates. Within this process, one can identify the "moments" where business-government interactions can be expected to occur. These moments, however, are not uniform; rather, they are opportunities for business behaviour, government behaviour, and their interaction. Whether these opportunities will actually be exploited is a function of a number of factors including: the cost differentials implied by differences in national regulations, the underlying competitiveness of the industry in question relative to its competitors in the internal market, the industry's ability and willingness to lobby national regulators to change national regulations, and the national regulatory authority's incentive to actually change national regulations. Annex II should be

consulted while reading the discussion in the text.

While the characterisation is a preliminary one, it may serve as a useful framework within which to examine detailed case studies of actual business-government interactions in the Community. It is only by conducting such investigations that the empirical validity of the schema can be tested and improved.

Beginning with a situation in which national regulations diverge, the means by which regulatory competition is introduced is explored. There are two possibilities. Either mutual recognition is applied, in which case the four economic freedoms of movement are recognised, differences in national regulation are exposed, and regulatory competition becomes possible.

In the other case, barriers to intra-EC free movement exist, blocking mutual recognition. Such barriers would be the result of ostensible "health or safety" requirements which national regulators impose in the absence of EC legislation harmonising these "essential" requirements. A firm trying to export to the member state which has imposed these restrictions faces three possible strategies:

(1) It could decide that the export market in question is of marginal business significance and cease attempting to penetrate it. Alternatively, it may actually conform to the national regulations of the export market, thereby incurring additional production costs, and defeating the purpose of mutual recognition

¹¹. Assuming, however, that the firm (and others in the same industry at home and in other parts of the EC) estimates that the export market is worth exploiting, it could:

(2) lobby the European Commission and/or its home government to begin infringement procedures against the offending member state (articles 169 and 170 EEC, respectively). This is the first moment of business-government interaction one can identify, and it occurs within a stylised "Court track".

The outcome of these interactions could be a removal of the barrier which originally blocked mutual recognition; an attempt in the Council to establish harmonised minimum essential requirements for the good/service in question (shift to the stylised "regulatory track" - see below); or an adaptation of the offending national regulation in conformity with the Treaty (ie. the regulation is adjusted so that it allows free movement and is more "proportional" to the market failure it seeks to combat). At this stage, business located in the offending regulatory jurisdiction will similarly have an incentive to interact with *its* national regulatory authority. Which, if any, of these outcomes will actually occur is thus a function of the relative strengths of the two member state governments, and the two opposing business interests.

¹¹ Either of these responses can be explained by the fact that going to the Court or pressing for a directive takes time, money, and other resources which a firm acting alone (or even together with its industry) may not be willing to expend. Adopting a "confrontational" strategy vis-a-vis the offending member state may also be risky for the firm in the long term, because of the deep hostility engendered between the two sides.

If none of these solutions is ultimately adopted, the firm/industry will have no choice but to take the case to the European Court of Justice (assuming that the former still believes the case is worth pursuing). At the Court, the defendant member state will naturally argue that its regulation conforms with article 36 EEC, while the Commission or prosecuting member state will argue that the national regulation violates article 30 EEC. If the Court rules in favour of the Commission/prosecuting member state, the offending national regulation will have to be altered such that imports from other member states are permitted free access¹². On the other hand, if the Court upholds the national regulation on the basis of article 36 EEC, the Council may have to seek a harmonised level of essential requirements, upon a proposal by the Commission ("regulatory track").

(3) While the exporting firm could begin infringement procedures, it could equally pressure its national government to get the Council to agree harmonised essential requirements. This is what can be stylised as a "regulatory track". At this stage, a second moment of business-government interaction will occur as the exporting firm/industry lobbies its member state to go for

¹² Note that the national regulation will still apply to the domestic industry, until or unless it is changed in response to domestic lobbying efforts (in the face of competitive disadvantages). Therefore, after the Court ruled in 1987 that the German "beer purity" law could not be used to block imports of beer from other member states, German beer producers continued to face the purity law (and still do). However, because the demand for beer is not purely a function of price, German beer producers have not been greatly disadvantaged by the ruling.

minimum harmonisation (or whatever level is most favourable for the national industry), while industry in the country which originally blocked mutual recognition will normally press its government to argue for a higher, more restrictive interpretation of the minimum essential requirements. The level of harmonisation ultimately established will manifest itself in the form of a Directive, whose legal basis is article 100A EEC.

At this stage, mutual recognition will be applied, free movement will be recognised, and differences in national regulations will be exposed. How do business-government interactions now fuel the process of regulatory competition?

While mutual recognition, the actual possibility of free movement, and differences in national regulations set the stage for regulatory competition, such competition will not actually occur unless economic agents react to these differences. There are two ways in which the expected reactions can be understood, both of which rely on the concept of arbitrage.

In the first case, mobile factors of production (capital, and to a much lower degree, labour) can relocate to the jurisdiction whose regulations are most favourable for the factor. Alternatively, arbitrage can occur even if factors of production are immobile. In this scenario, it would be goods and services which, through free movement, could be sold freely across the EC. Consumers and firms would then respond by purchasing the bundle of goods and services which most closely

approximates preferences for cost and quality. The scope or "margin" for either type of arbitrage is a function of the degree to which national regulations diverge. Therefore, if regulatory competition is introduced via a directive which establishes a certain level of harmonisation, the scope for arbitrage is correspondingly lower than if free movement had been recognised *without* any prior harmonisation.

By engaging in arbitrage, consumers, firms, and capital are in effect signalling their preferences for regulation to the businesses involved in producing these goods and services, and to national authorities which formulate and implement national regulations. We argue that business will respond in either of two ways.

Within the internal market, it could either relocate to another member state whose regulations are more favourable for the firm's operations, or it could "adjust" by trying to cut costs, or otherwise restructuring its activities so that it can overcome (at least to a certain extent) the immediate competitive disadvantages it faces relative to other firms operating under a lighter regulatory burden.

However, if industry has incurred large sunk costs to establish itself within a member state, or if restructuring would involve large reductions in employment, it would probably attempt (first) to lobby its national government. Because barriers to free movement can no longer be imposed, the purpose of such

lobbying efforts could only be either of two things. Business could either pressure the national government to find a "legal loophole" which would effectively limit free movement, without, however, completely blocking it ¹³. On the other hand, business could accept that free movement is now a fact of life, and press its national government to adapt national regulations in a way which reduces regulatory discrepancies, and therefore, the competitive disadvantage faced by national business.

The end result of these cumulative business-government interactions will be a "new" national regulatory regime. At one end of the spectrum, the new regime may be strongly convergent with those of other member states. The likelihood of this outcome is greater if no prior harmonisation *a la* articles 100 or 100 A (thereby preventing the future application of article 36 EEC) was initially established (ie. regulatory competition was either introduced by an initial application of mutual recognition, or by a Court ruling on the basis of article 30 EEC, for goods). At the other end of the spectrum, the new regime may be only slightly different from the former one if the level of minimum harmonisation established in a directive under the "regulatory track" is high, and therefore the scope for arbitrage, and the

¹³ The most prominent example of such a "loophole" is given by the famous Danish beer bottle case. In this ruling, the European Court held that the "obligation imposed by national legislation on manufacturers and importers, as part of a system under which the marketing of beer and soft drinks is authorised only in re-usable containers, to establish a deposit-and-return system for empty containers must be regarded as necessary to achieve the objectives pursued in relation to the protection of the environment so that the resulting restrictions on the free movement of goods cannot be regarded as disproportionate" (European Court of Justice, Case 302/86, emphasis added).

need for a defensive business response, is low. In this case, national regulators would have little incentive to alter national regulations since the competitive threat to national business would be commensurately lower.

In order to derive some preliminary indications about the robustness of this representation, we applied it to two case studies. Neither is "complete" in the sense that it illustrates the great complications and variety in the process of regulatory competition, from start to finish. The difficulty stems from the fact that the process takes time, is open-ended, and not so easy to observe first hand. Therefore, the following should only be seen as a provisional attempt to fit the schema to actual EC practice.

The European Chemical Industry: The Draft Directive on Upholstered Furniture¹⁴

This case illustrates the first stages of Annex II, namely the business-government interactions within both the "court" and "regulatory" tracks.

In 1988, the United Kingdom (UK) enacted national legislation stipulating that any upholstered furniture sold on the UK market must be manufactured with flame retardants. The Irish Republic (IRL) also followed suit by enacting similar

¹⁴ The following information was provided by CEFIC, the European Chemical Industry Council, Brussels, during an interview, May 1993.

national legislation that year. Because the other 10 member states of the EC had no national legislation on the matter, a divergence of national laws was created. Moreover, the UK and IRL refused to admit imports from the other 10 member states if these did not comply with their respective national legislations (though British and Irish upholstered furniture could enter Continental markets). The mutual recognition of continental national regulations was therefore blocked.

Led by the Federal Republic of Germany (D), the 10 continental member states took the UK and IRL to the European Court of Justice on the grounds that the latter had erected a barrier to the free movement of goods (beginning of infringement procedures under the "Court track"). While the 10 had the nominal support of the European Commission (CEC), the CEC did not feel that the 10 had a strong case, since the UK and IRL legislations could be justified under article 36 EEC. Ultimately, in 1990, the UK and IRL persuaded the other 10 to work towards an EC directive harmonising the essential requirements of upholstered furniture with respect to its fire behaviour (shift to "Regulatory track").

Within the regulatory track, business-government interactions were extremely intense. For the 10, the urgency of reaching agreement was driven by the fact that *furniture manufacturers* in these member states were excluded from the UK and IRL furniture markets, and would remain so until a directive was implemented. In addition, for all 12 member states, but especially for the UK and IRL, *flame retardant manufacturers* had

an obvious interest in getting a directive adopted which, by requiring the use of flame retardants in upholstered furniture, would virtually guarantee them a large volume of business.

As a way to coordinate and advance their interests in getting a directive adopted, the European Flame Retardants Association (EFRA), a sector group of the European Chemical Industry Council (CEFIC) was formed on 5 September 1990. However, the membership of this group was soon split: on one side, producers of halogenated flame retardants established a separate organisation, the European Brominated Flame Retardant Industry Panel (EBFRIP), while the producers of non-halogenated flame retardants remained in the original EFRA grouping. The formation of EBFRIP was a consequence of heavy political pressure; halogenated flame retardants are believed to be much more dangerous to health, safety, and the environment than their non-halogenated counterparts. The prime business interest of EBFRIP was therefore twofold: in addition to an EC directive stipulating that flame retardants must be used in the manufacture of upholstered furniture, EBFRIP also wanted to ensure that such a directive *would not exclude* the use of halogenated flame retardants.

Both EFRA and EBFRIP lobbied the CEC and the European Parliament (EP) to influence the content of the essential requirements which would be included in the directive. It is interesting, from a political economy perspective, to outline the positions of the different member states and their respective

industries (both furniture manufacturers and flame retardant manufacturers).

Of the member states, only D was strongly opposed to the idea of requiring the use of flame retardants in upholstered furniture. This opposition was justified on the grounds that all flame retardants are poisonous, and when used in furniture emit toxic gases which can be fatal for humans. Needless to say, D was even more strongly opposed to the use of halogenated flame retardants. However, given the unlikelihood of D securing a blocking minority in the Council on a directive which required the use of flame retardants in general, D therefore pushed, in the CEC (DG III, Industry and Internal Market), for a directive which would require flame retardants in upholstered furniture, but ban the use of halogenated ones in particular. The CEC proposal for this German-backed directive became known as the "PPBE Directive" (poly-brominated biphenyl ethers directive, or the directive which bans the use of PPBEs/halogenated flame retardants).

The UK and IRL, on the other hand, pushed for a separate directive in the CEC based on their national legislations. Their efforts were initially unknown to the Germans, while the Germans were unaware of the UK and IRL efforts. The other member states, apart from D, were not as actively involved, but in the process, Italy (I) managed to insert an additional test to the original UK and IRL essential requirement. This additional test, however, did not correspond to Italian national industry interests, but

rather to general public safety concerns.

On the industry side, *furniture manufacturers* generally believed that a directive requiring flame retardants in upholstered furniture was an inevitability, and so were unopposed to it. Rather, they actually saw merit in such a directive, since this would "level the playing field" in the EC furniture market, and prevent UK and IRL furniture manufacturers from applying different flammability standards to their products, according to whether these were destined for export or domestic markets ¹⁵.

As for *flame retardant producers*, it was mentioned above that all such producers stand to gain large advantage from the adoption of an upholstered furniture/flame retardants directive. In this regard, it is noteworthy that several German producers of flame retardants did not succeed in persuading the German government to withdraw its opposition to the use of flame retardants. Rather, it became necessary for firms such as BASF and Great Lakes to concentrate their lobbying efforts within a *European* trade association (CEFIC), and toward the CEC. Only after extensive scientific testing did Germany begin to accept that flame retardants (at least the non-halogenated ones) do not impose excess risks to health, safety, and the environment. In this sense, there was no "capture" of the German government by German industrial interests.

¹⁵ It was previously assumed that upholstered furniture without flame retardants was cheaper to produce than that with flame retardants. However, it has since been demonstrated that the reverse is true, by a margin of approximately 20%.

By the end of 1991, the EP began drafting its opinion on the two separate and mutually inconsistent proposals. It basically told the CEC to draft a single directive which stipulated which flame retardants could be used in upholstered furniture. In this way, the EP, under the direction of Environment Committee chair Ken Collins, and rapporteur Caroline Jackson, aided the position of EBFRIIP, which would now have more time to lobby the CEC, national governments, and/or plan for adjustment to a future ban on halogenated flame retardants, if such a ban were ultimately imposed. Given the British nationality of both Collins and Jackson, together with the fact that most flame retardant producers in the UK produce halogenated flame retardants, the position advocated by Collins and Jackson becomes more understandable.

All of the foregoing business-government interaction has so far been restricted to the regulatory track. What is the current status of the proposed directives? To summarise, a meeting in February 1993 on the legislative programme of the CEC was set to discuss one single proposal for a directive which would allow the use of both halogenated and non-halogenated flame retardants in upholstered furniture. However, before this meeting, the proposal was personally withdrawn (ie. vetoed) by Jacques Delors, President of the CEC, who invoked the subsidiarity principle as a justification. He argued that member states acting individually could more appropriately enact national legislation on the matter. Intense lobbying on the parts of both EFRA and EBFRIIP has since resumed, but for the moment, the proposed directive remains

in limbo.

This case study is therefore, as yet, an incomplete test of the framework set out in Annex II. However, it is possible to speculate on the regulatory competition which will be possible after an EC directive is finally implemented. The scope for such competition will be a function of the level of "minimum essential harmonisation" which is established in the directive. If, for instance, the directive does indeed permit the use of both halogenated and non-halogenated flame retardants, there will be scope for regulatory competition on the basis of what type of flame retardant is used in upholstered furniture. For instance, it is conceivable that market forces could eventually "drive out" the use of halogenated flame retardants if consumers and environmental groups deem that they are hazardous to human health and the environment, and thus switch purchases away from furniture produced with such flame retardants and/or demand that national regulations additionally stipulate the use of non-halogenated flame retardants. In this way, a movement to *ex post* convergence of national regulations, beyond essential requirements, would be observed, and this would be achieved without the additional resource costs of decision-making in the Council.

The European Banking Industry: The Second Banking Directive ¹⁶

Whereas the previous case study focused on the business-government interactions involved in establishing mutual recognition and free movement, the present example begins with a situation in which mutual recognition and free movement prevail at the onset, therefore permitting regulatory competition to actually take place.

The creation of an internal market for banking services from 1 January 1993 is primarily the result of the principle of "home country control" espoused in the so-called Second Banking Directive (89/646 EEC, 17 December 1989). The principle stipulates that branches of credit institutions established outside the home country, in another EC member state (the "host" country) will be subject to the regulations of the home country. In other words, the host country must "mutually recognise" the regulations of the home country, beyond the harmonised essential requirements ¹⁷.

¹⁶ The following draws from Karel Lannoo and Jorgen Mortensen. *Towards an European Financial Area*. Brussels: Centre for European Policy Studies (forthcoming).

¹⁷ These essential requirements are in turn set out in the following supplementary directives: the directive on solvency ratios for credit institutions (89/647 EEC, 18 December 1989) and the directive on own funds for credit institutions (89/299 EEC, 17 April 1989). The only allowable restrictions on mutual recognition in banking services are a "general good" clause, which permits host country regulators to impose additional regulations on banks, if this is deemed to be in the general interest. A second potential restriction is the right of host country authorities to impose additional conditions relating to the implementation of host country monetary policy and for the supervision of liquidity.

Given a situation of mutual recognition and free movement, how are differences in national banking regulations being arbitrated by consumers and firms?

One example is given by the case of the French bank Credit Lyonnais which introduced a high interest deposit account in Belgium before the Second Banking Directive came into effect. Because this type of account is not permitted in Belgium, but can be very advantageous for depositors, Credit Lyonnais attracted a substantial amount of business away from Belgian banks. Faced with such a competitive disadvantage (ie. more favourable treatment of foreign banks in Belgium than that of domestic banks), Belgian banks according to our schema should have pressured Belgian bank regulators to alter Belgian law and reduce the regulatory discrepancy. However, Belgian banks have thus far not exerted such pressure on the Belgian authorities. This highlights the difficulty of predicting exactly if, when, and to what degree, business-government interactions will take place.

In a separate, but similar case, Barclays Bank of the UK attempted to introduce interest-bearing current accounts through its subsidiaries in France. However, this effort was blocked by French authorities on the grounds that it would be against the interest of consumers, as it would result in higher fees on deposits for bank customers. The French government consequently enacted legislation banning similar banking products. While our schema predicts (or at least allows for the possibility) that Barclays should have pressured the UK or the CEC to take France

to the European Court of Justice, Barclays chose not to do this. Rather, it felt that such a confrontational approach could potentially damage Barclays' future relations with French authorities, and therefore accepted the French ban on their product.

Both of these banking examples therefore demonstrate the limitations of the Court track, or the willingness of business more generally to invest resources in order to uphold (as opposed to secure) mutual recognition and free movement¹⁸. Even more fundamentally, however, these examples underscore the unpredictable and complex nature of business behaviour in a context of regulatory competition. In order to understand with more certainty when business will exploit the opportunity for business-government interaction, at which level (national or EC) these will occur, and what form they will take, etc, one would require a robust theory of business lobbying. All of these difficulties serve to illustrate that the process of regulatory competition in the EC cannot be generalised by way of simplified models.

¹⁸ Note that because the bank was a subsidiary rather than a branch, the French authorities were not strictly required to mutually recognise British regulations. Therefore, in this case, Barclays faced an additional option: it could have altered the status of its subsidiaries, making them branches instead, though this would presumably have entailed costs which Barclays was not willing to incur.

V.1 The Economic Case for Regulatory Competition

While the "case" for regulatory competition in the EC context is usually assessed against the backdrop of a previous reliance on total, prior harmonisation (see next section), there are more generic economic reasons to support the use of competition among rules. Briefly, these can be characterised as follows:

- **Greater choice of regulatory systems:** If the four economic freedoms of movement are recognised, consumers and firms will be able to arbitrage among the differences in national regulations revealed thereby. With the free movement of goods and services upheld by the application of the mutual recognition principle, consumers in any given regulatory jurisdiction will be able to choose among commodities produced according to various other national regulations. To the extent that greater variety increases utility, consumer welfare will be enhanced. Further, when mobility rests with factors of production (capital, and in Europe, to a much lesser degree, labour), these factors can locate within the jurisdiction whose regulations most closely approximate their preferences; allocative efficiency will be improved ¹⁹.

- **"Disciplining effect" on national regulatory systems:**

With an choice of regulatory regimes, consumer and firm behaviour

¹⁹ Note that regulatory regimes here are considered to be given; they themselves do not react to this arbitrage.

can serve to tame the "Leviathan tendencies of government" (Sinn, 1990) ²⁰. According to this reasoning, government officials (politicians and bureaucrats) are self-interested individuals who maximise their utility subject to the constraint of being re-elected. Their utility is enhanced by raising tax revenues in excess of what is needed to finance the provision of public goods in their jurisdiction. In a context of regulatory competition, however, governments are forced to provide the public goods demanded by their constituents at the lowest possible tax rate: if they fail to do this, these constituents might leave the regulatory domain altogether (in which case the tax base of the regulatory domain would be eroded), or they might not re-elect the government. In this way, regulatory competition is said to exert a disciplinary function on government spending, in the absence of explicit fiscal constraints on the government's power of taxation (Hauser and Hosli, 1991).

• **Strategy for discovery, experimentation, and innovation:** Given a situation of imperfect information among economic agents (including regulators themselves) regarding the most desirable form and content of regulation, regulatory competition provides a market-driven way to "discover" which regulations offer "protection" that is demanded by the residents and firms of a given jurisdiction, and which are deemed superfluous. By "voting with their feet" ²¹, or by simply substituting purchases of the

²⁰ The Leviathan model of government behaviour is developed in Brennan and Buchanan (1980).

²¹ See Tiebout's seminal contribution on the finance of local public goods (1956).

"home" good or service with that of a good/service produced according to the regulations of another jurisdiction, consumers and firms will signal their preferences for regulation to their regulatory authority (or alternatively, make explicit the opportunity costs of certain inefficient regulations). Whenever governments recognise that domestic regulations are too costly for citizens or companies - relative to their objectives - they have an incentive (driven by vote maximisation, and the potential for tax base erosion due to the relocation of residents) to adapt the system in a way which may (or may not) copy successful solutions in other jurisdictions. This makes regulation flexible, and allows authorities to adopt measures in line with (changing) local preferences. In this way, regulatory competition uses the "market for regulations" as an exploratory device for finding the best institutional arrangements (Hayek, 1968, quoted in Siebert and Koop, 1993).

- **Local regulatory powers retained where possible:** Given the normative economic assumption that regulation should reflect as closely as possible the preferences of the people it is designed to protect, regulatory competition is a means to implement the subsidiarity principle. Moreover, when the application of subsidiarity prescribes that regulation be assigned to a sub-federal level of government, regulatory competition facilitates the revelation of regulatory preferences by consumers and firms. Following from the previous discussion on regulatory competition as a means of stimulating discovery, experimentation, and innovation, subsidiarity enhances the ability of economic agents

to signal their preferences to regulatory authorities, since they are "closer" to these authorities, than they would be had regulation been centralised.

VI. The Limitations of Regulatory Competition

While the foregoing has emphasised the benefits of regulatory competition, it must be stressed that regulatory competition is not an end in itself. Rather, in an integrative context, it must be seen as a means to achieve the optimal degree of convergence among national regulations. This convergence would indeed be driven by the market process outlined above, and would embody all of the attendant efficiency benefits described. Nevertheless, the case for regulatory competition should first and foremost be evaluated in terms of the policy outcomes it is expected to produce.

Assessed in this way, the key question is: how well does regulatory competition lead to an "optimal" degree of convergence of national regulations? We have seen in the previous section that business-government interactions in practice do not necessarily conform to the schema of regulatory competition put forward in Annex II. While it is still too early to pass definitive judgement on processes of regulatory competition, these preliminary indications underscore the difficulties inherent in modelling such interactions.

These complications, moreover, also exist at a more theoretical economic level. Most fundamentally, perhaps, is the question of whether regulatory competition will actually result in the convergence of regulations around a *unique, optimum* equilibrium. To the extent that preferences for regulation diverge in an internal market, and will continue to do so for the foreseeable future, regulatory competition cannot be expected to lead to such convergence around a unique equilibrium, though this may be beneficial on the grounds that different preferences are respected. On the other hand, there is no reason to believe that any or all of the various equilibria produced by competition among rules will be optimal ²².

The reason for this stems from the idea that consumers and firms cannot always accurately evaluate the cost-quality and cost-safety tradeoffs required to judge which regulations are necessary and which are not ²³. In these cases, a limited number of regulatory authorities, as opposed to numerous consumers and firms, will decide which cost-quality and cost-safety combinations are acceptable; perfect competition among economic agents in the market for regulations is replaced by oligopolistic competition among regulatory agencies, presumably with all of the instability properties predicted by standard economic theories of industrial organisation.

²² The following draws heavily from Majone (1992).

²³ Indeed, if this were not the case, the justification for regulation based on market failure (information imperfections in this instance) would be absent.

In addition, the dynamics of regulatory competition - ie. the time it takes for regulatory competition to achieve some degree of convergence - are a further complication. Even in a situation where regulatory competition could reasonably be expected to lead to a unique, efficient outcome, the process entailed may actually thwart such a result: if convergence toward the most efficient type of regulation is relatively slow, producers may commit themselves to alternative regulations which would be too costly or difficult to change at a later date, due to sunk costs.

Other more specific limits to a process of regulatory competition can also be enumerated. These, however, correspond to either of the two ways in which regulatory competition can be modelled: as a process of arbitrage between locations, in which factors of production are mobile and "vote with their feet", or as arbitrage by immobile factors for mobile goods and services.

When regulatory competition is seen as a process of arbitrage by mobile factors between locations, two key assumptions are critical: factors are (perfectly) mobile, and they will move in response to differences in regulation. Both of these assumptions, however, are somewhat unrealistic in practice. In the EC, only capital can be said to be mobile, and even then a distinction must be made between portfolio investments (which are highly elastic with respect to net rates of return), and direct investment, which is a function of a variety of factors (including market proximity/transport costs, infrastructure

quality and levels, and labour costs relative to skill and productivity levels). Given these caveats, the speed and intensity with which market forces will respond to regulatory divergences will be dulled, and the eventual outcome of the process will therefore be less pronounced ²⁴.

Another difficulty which arises from both locational theories and consumer arbitrage theories of regulatory competition derives from the role of regulatory preferences. If a given national market exhibits strong regulatory preferences, an entrant to that market (via either local production or exports) may have an economic incentive to produce according to these longstanding national regulatory traditions, rather than to exercise the right, upheld by mutual recognition, of operating according to home-country regulations. This, indeed, is the case illustrated by the banking example given in Section IV above. In such circumstances, the incentive of host-country regulators to adapt national regulations in line with those of the home country is limited, since firms in the host-country will feel commensurately lower competitive pressures to adjust ²⁵.

²⁴ When considering the potential for regulatory differences to affect the location of direct investment, a distinction should be made between the *relocation* of such investment, and the choice between locations when such investment is *additional* or *marginal*. In the former case, sunk costs would tend to limit the elasticity of direct investment with respect to differences in regulation, while in the latter case the elasticity would be much higher.

²⁵ A final issue which we do not address in great detail, but which again concerns both types of regulatory competition, is the potential for "zero" or sub-optimal regulation, as a result of the regulatory competition process. While some of the literature (cf. Siebert and Koop, 1990 and 1993; Oates and Schwab, 1988) refutes this proposition, the defense of regulatory competition is less valid once a distinction is drawn between

VI. Regulatory Competition versus Harmonisation

From an EC policy-making perspective, however, the most immediate issue is whether regulatory competition should operate in the complete absence of prior harmonisation by the EC Council. The argument in favour is that regulatory competition is a dynamic process. Its outcome would be that degree of regulatory convergence among member states which internal market forces will have revealed to be optimal. Given the many imperfections of the EC decision-making system, and having in mind pertinent examples of EC 'government' failures (in harmonisation) in the past, one should not expect such 'optimality' from Council-driven harmonisation. Hence, the inference that regulatory competition is a substitute, indeed a superior substitute, for prior harmonisation. Both lead (eventually) to a degree of regulatory convergence among member states, but the choice of regulatory competition would avoid the high costs of 'government failure'.

To assess this far-reaching claim, one should first return to the fundamental issues of 'why' and 'how' to regulate. As

pure *fiscal* competition (ie. on the basis of tax rate and base differentials) and *regulatory* competition, where the regulations concern the health and safety of goods and services. In the former case, the potential for a zero or sub-optimal tax rate is reduced if one assumes that the users and payers of public goods are equivalent (the concept of "fiscal equivalence", Olson, 1969). Once taxes are reduced beyond a certain level, the marginal costs of such action will outweigh the marginal benefits). On the other hand, when consumers cannot immediately, or even *ex post*, observe quality levels (eg. professional services), the potential for sub-optimal levels of regulation becomes more concrete.

noted in Section II, regulation should be pursued in such a way that government failures are minimised. It follows immediately that if there is national regulation in one or more member states which is not justified by market failures, there is already a social cost, and attempts to "protect" associated vested interests by pushing for Council-driven harmonisation would greatly augment those costs. In such instances, there is no case for prior (or any) harmonisation, and regulatory competition would be appropriate. Observe, however, that since EC regulation is not justified in the first place, regulatory competition does not serve as a substitute for harmonisation; it is merely the result of an absence of harmonisation which will expose member state regulations to internal market forces. It is then up to those member states affected to decide whether the costs they incur are worth the perceived benefits.

We should therefore concentrate on instances where regulation is, in theory, justified by market failures. The next question is then whether the EC regime provides a legal basis to act on the matter in question. For the free movement of goods, articles 36, 100, and 100A EEC would seem to present no difficulties. For services, the identification of corresponding Treaty articles is perhaps somewhat more problematic. In social affairs (and its close interdependence with the free movement of persons), the demarcation between EC, member state, and concurrent powers is much more complex. Even in the Social Protocol of the Maastricht Treaty, some issues are subject to unanimity, while for others, the EC is simply not competent. We

do not elaborate further on this "special" policy area, but wish to stress the *general* result that EC-wide harmonisation will remain blocked for as long as EC powers are lacking ²⁶. This raises the issue of whether the economic freedoms of movements will be able to operate free of constraints. If, and to the extent that, an absence of harmonisation is accompanied by constraints on free movement (eg. limitations on entitlements of social security benefits), regulatory competition will be preempted as well.

Therefore, only when regulation is justified in theory, and when the EC has the legal competence to act, may we return to our initial problem of choosing between total prior harmonisation and regulatory competition.

The answer to the problem hinges on a comparative cost-benefit analysis in a dynamic setting, and in a context of considerable uncertainty. First, one should specify the benefits and costs of regulatory competition, from the perspective of a time-consuming process of iterative regulatory adjustment. Second, this should be juxtaposed against a cost-benefit analysis of harmonisation itself. The exercise, however, is not a simple one, since harmonisation is today a multi-faceted policy tool: its scope, intensity, and modes are now typically varied

²⁶ This assertion assumes, of course, that voluntary coordination among member states for the purpose of achieving harmonisation is impossible or impractical, or that coordination if achieved is not credible (see Gatsios and Seabright, 1989, for an elaboration).

according to the issue at hand, and this is predominantly a result of the learning process the EC has experienced throughout the course of the EC-1992 programme. Moreover, harmonisation is now almost always decided by qualified majority in the Council, which further tends to reduce its costs and raise its benefits.

In keeping with these policy innovations, we outline below one possible framework according to which the comparative costs and benefits of harmonisation (in its various forms) and regulatory competition can be evaluated:

Table I: A Comparative Cost-Benefit Analysis of Regulatory Competition versus Harmonisation

Regulatory Competition (RC)	
Benefits	Costs
<ul style="list-style-type: none"> • permits more efficient preference revelation (market driven) • encourages competition as a strategy of discovery (Hayek), policy innovation, diversity, and experimentation • where technological advance has reduced the scope of natural monopoly (ie. market power as a market failure), RC is a way to "de/re-regulate" • local regulatory powers retained where possible • undermines vested interests in the internal market which would: <ul style="list-style-type: none"> • not be possible nationally (adjustment fears, capture, and "weak" state arguments); • not be easy with total prior harmonisation if alliances of vested interests can be forged (esp. in network markets - eg. energy, telecoms) 	<ul style="list-style-type: none"> • distortions in the internal market • duration of distortions open-ended • instability of regulation (national regulatory "drift") • potential for increasing regulatory restrictiveness

Harmonisation

Benefits	Costs
<ul style="list-style-type: none"> • "level playing field": <ul style="list-style-type: none"> • certainty for business (easier to plan adjustment strategies); • no legislative drift • no distortions between member states (though perhaps distortions for the entire internal market) • different <i>modes</i> available, can be tailor made for policy area: <ul style="list-style-type: none"> • essential requirements (minimum harmonisation); • framework directive; • sunset legislation • differing <i>intensities</i> can be agreed (ie. more or less detailed) • <i>scope</i> can be varied: <ul style="list-style-type: none"> • selectivity of harmonisation; • derogations can be granted 	<p><i>Where Unanimity Applies:</i></p> <ul style="list-style-type: none"> • not enough diversity in regulation • implied standards may be too high (disproportional to market failure) • may throttle innovation if harmonisation too rigid <p><i>[HOWEVER, Where Qualified Majority Voting Applies:</i></p> <ul style="list-style-type: none"> • reduces probability of costly cumulation of details and derogations • raises quality of legislation • encourages policy innovation because of coalition-building in the Council. [..] • harmonisation difficult to alter once in place; THOUGH, <ul style="list-style-type: none"> • not with sunset legislation; • not with minimum harmonisation (<i>because of remaining potential for RC and/or the delegation of standards setting to standards bodies</i>) • risks "capture" if: <ul style="list-style-type: none"> • there are federal supervisory regulators; • sectoral councils; • public ownership

A few words are in order regarding this characterisation. Beginning with regulatory competition, most of its benefits were discussed in the preceding section. There is, however, one benefit which is particularly relevant in the EC context. This is the idea that vested interests will be undermined when regulatory competition is permitted. Because national regulators no longer have the power to limit competitive imports, the "capture" of such regulators (in its traditional meaning) becomes futile. The net result is that heretofore protective legislation is exposed to (and indeed tested by) the market for regulations in the EC internal market.

On the cost side, regulatory competition is (by definition) distortive because it begins with only partial (or no) harmonisation. Such distortions can be expected to lead to costs whose magnitude are in turn a function of degree and duration. If initial regulatory divergences are large, and the "convergence" process is lengthy, then economic agents (particularly firms) may face considerable adjustment costs. National "regulatory drift" is one such adjustment cost. It results from the fact that national regulations may be altered several times in the course of "discovering" which regime is ultimately the most appropriate.

Another potential cost of regulatory competition is that it may lead to increasing regulatory restrictiveness across jurisdictions, rather than to its expected "deregulatory" outcome. An example of this is given by the case of registered nurses in the United States. When competition among the rules of licensing was allowed to run its course, states followed one

another in increasing the restrictiveness of licensing requirements for nurses; inflows of less-skilled nurses from other states provoked a levelling-up, rather than a levelling-down of professional standards (Peltzman, quoted in Pelkmans and Vanheukelen, 1988).

Turning to harmonisation, its relative costs and benefits are more subtle, since they are very much determined by the type of harmonisation applied. Generally speaking, the costs of harmonisation have been significantly reduced since the advent of the internal market programme and the institutionalisation of qualified majority voting. In addition, recourse to different modes and intensities of harmonisation has introduced greater flexibility to a procedure which was formerly characterised by excess rigidity. As a result of such innovations, harmonisation can generate a "level playing field" for business without the inflexibility of the past.

It is therefore somewhat unfair that the older and more costly form of harmonisation is often invoked as a *prima facie* justification for the alternative: regulatory competition. To the extent that obsolete examples of the "old harmonisation" are represented as the current reality of harmonisation, they are misleading, and their erroneous citation weakens the case for a complete substitution of harmonisation with regulatory competition. On the other hand, the mere existence and threat of regulatory competition as a realistic alternative to more recent forms of harmonisation disciplines the harmonisation process itself. The use of qualified majority voting in the Council, together with the no-internal-frontiers principle, further enable ministers to "promote" the regulatory competition alternative.

Given the foregoing comparative cost-benefit framework, the optimal regulatory solution in a given case would combine minimum harmonisation of the essential requirements with regulatory competition beyond this level. In other words, regulatory competition and harmonisation should be seen as complements rather than substitutes ²⁷, with the demarcation between the two determined on a case-by-case basis.

²⁷ Today, total, prior harmonisation is only seldom used (eg. veterinary standards and practices). At the other end of the spectrum, "pure" regulatory competition (ie. without any prior harmonisation) is also a rarity.

VII. Conclusions

This paper has tried to address four questions which were posed in the introduction:

- (1) how did regulatory competition emerge during the EC-1992 programme?
- (2) how and when do business-government interactions occur during processes of regulatory competition?
- (3) what are the merits of regulatory competition from an economic perspective? and,
- (4) what are the relative costs and benefits of regulatory competition versus harmonisation in an EC context?

With regard to the first question, the emergence of regulatory competition should be understood in relation to the set of regulatory principles which has guided the internal market programme. In other words, regulatory competition is only possible once mutual recognition, the four economic freedoms of movement, and the absence of internal frontiers is guaranteed. The principle of subsidiarity, moreover, plays an additional supporting role, though this role is less clear, since it depends on whether one views subsidiarity as a facilitator of market integration, or as a principle to be respected once an internal market is already "completed".

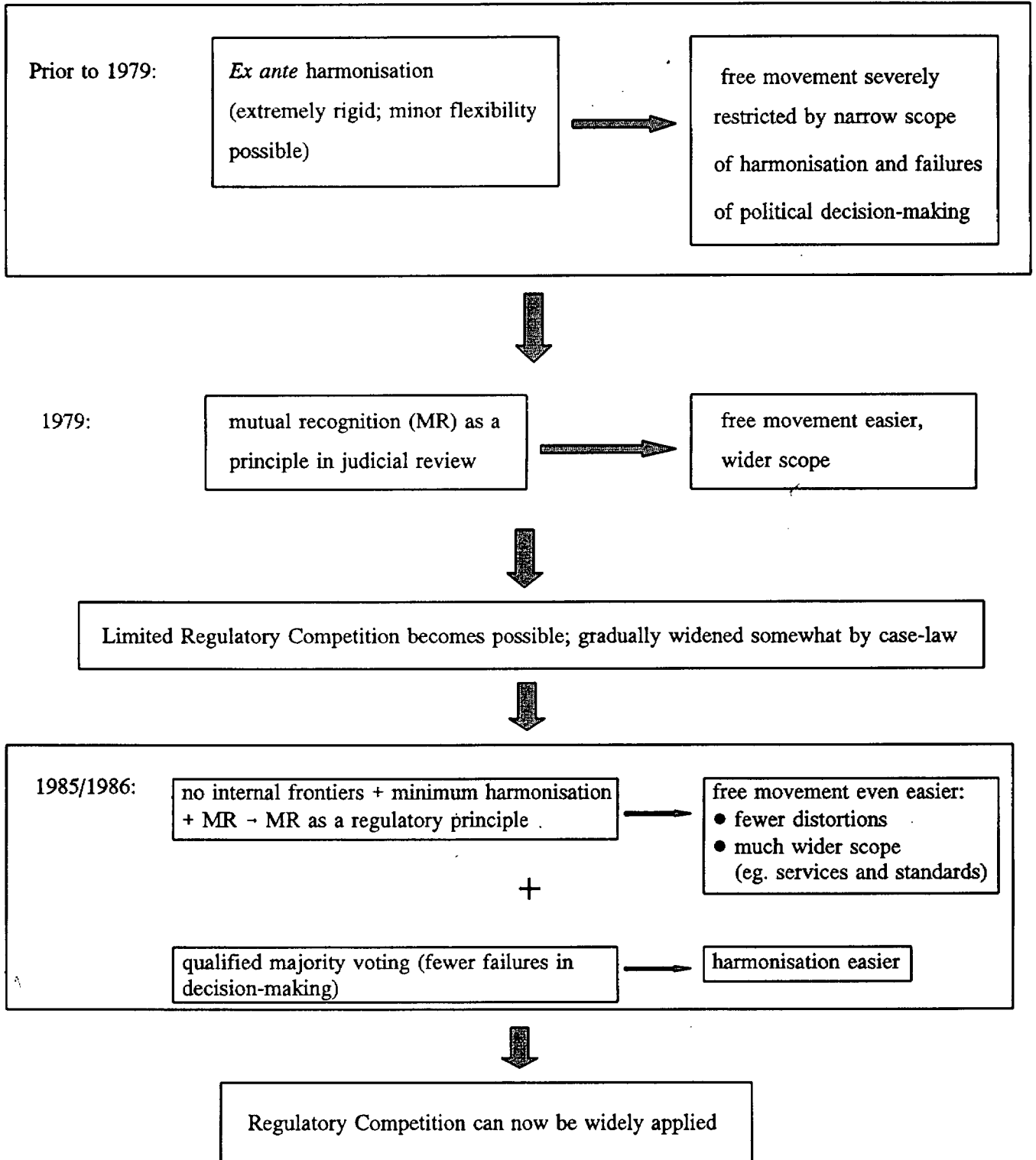
The role of business-government interactions in fuelling the process of regulatory competition is a complex and unpredictable one. While it is possible to construct a schematic representation of the process as it should operate in theory, examination of practical cases highlights the difficulties inherent in any

schema. It is indeed still too early to "observe" concrete examples of regulatory competition, operating from start to finish. More detailed case studies are therefore necessary before any definite conclusions can be drawn on the precise nature of business-government interactions.

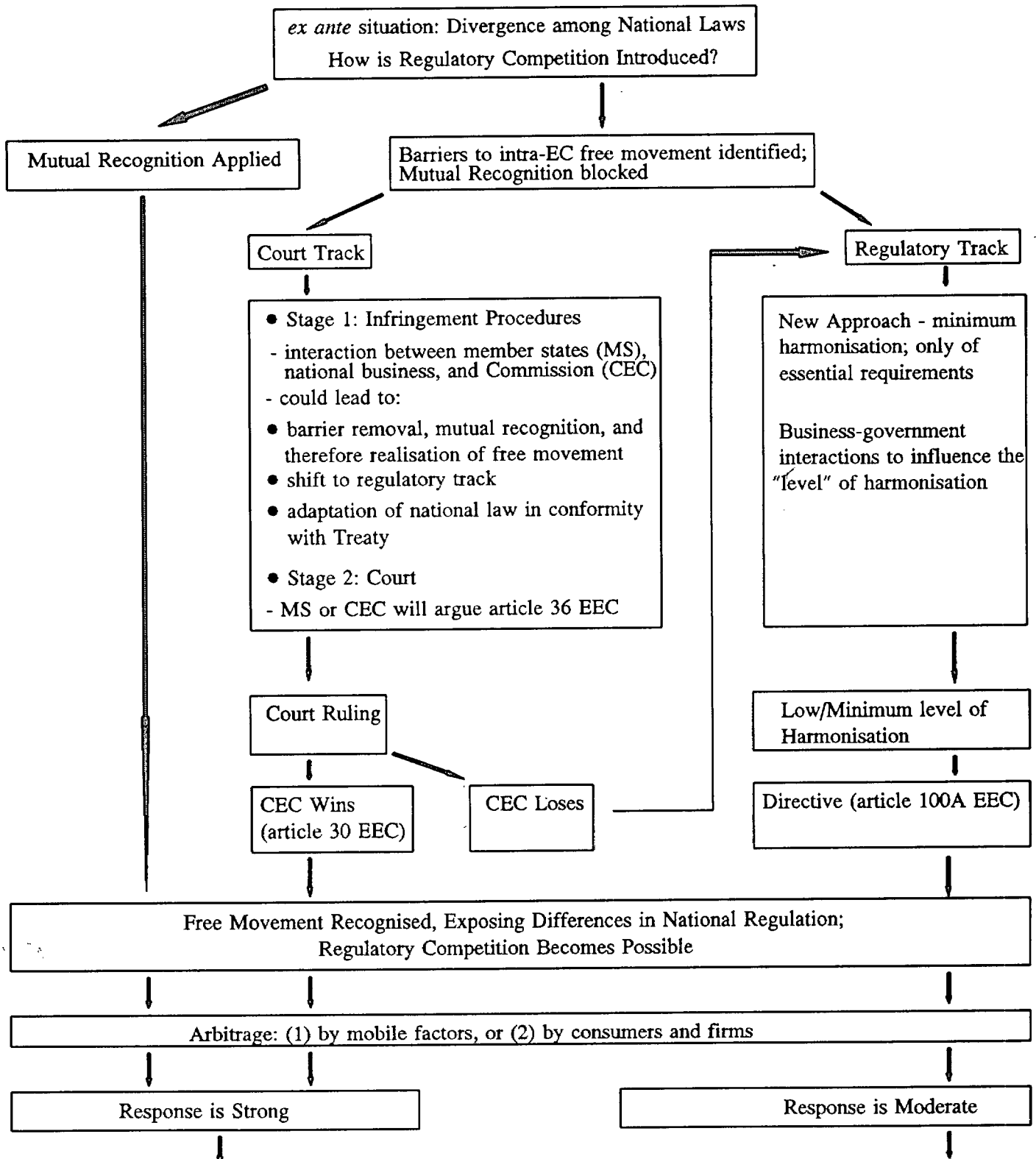
From an economic perspective, regulatory competition exhibits several worthwhile traits. Consumers and firms benefit from an expanded choice of regulatory systems and the "Leviathan" tendencies of government spending and regulatory oversight are said to be reduced (or more effectively controlled). In addition, regulatory competition is a market-driven way to determine the preferences of a population for regulation, while preserving local autonomy in regulation. There are, however, several limitations of regulatory competition from a theoretical point of view. The two most prominent relate to the questions of whether regulatory competition will, in fact, result in the *ex post* convergence of national regulatory regimes around a unique, and "optimum" equilibrium, and how long such a process will take.

Finally, a comparative cost-benefit analysis of regulatory competition versus harmonisation suggests that regulatory competition and harmonisation should be seen as complements, rather than substitutes, to one another, with the demarcation between the two determined on a case-by-case basis.

How Regulatory Competition Emerged from EC-1992

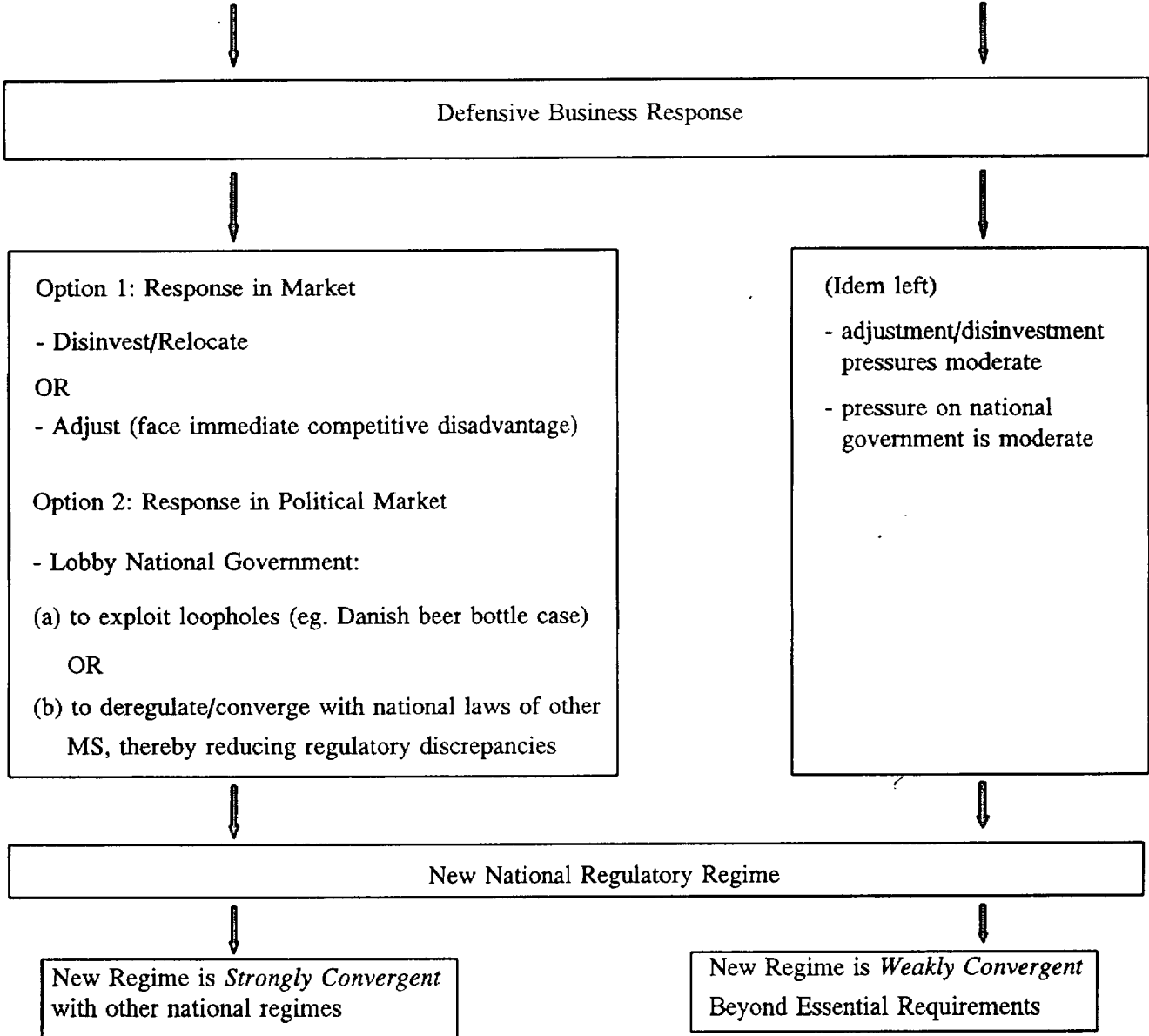


Tracking Regulatory Competition in the EC, Post 1985



References

- Abraham, F (1991). "Building Blocks of Europe's Single Market" in Tijdschrift voor Economie en Management. Vol. XXXVI. No. 4.
- Bernholz, Peter (1990). "The Completion of the Internal Market: Opportunities and Dangers Seen from an Institutional Perspective" in The Macroeconomics of 1992: Papers from CEPS Macroeconomic Policy Group. Brussels: Centre for European Policy Studies.
- Dehousse, Renaud (1992). "Integration v. Regulation? On the Dynamics of Regulation in the European Community" in Journal of Common Market Studies. Vol. XXX. No. 4. December.
- Dehousse, Renaud et al. (1992). "Europe After 1992: New Regulatory Strategies". EUI Working Papers in Law. No. 92/31.
- Donges, Juergen B. et al. (1992). "Unity and Diversity in Europe: An Argument for Less Harmonisation and Centralisation". Bad Homburg: Frankfurter Institut für Wirtschaftspolitische Forschung.
- Gatsios, Konstantine and Paul Seabright (1989). "Regulation in the European Community" in Oxford Review of Economic Policy. Vol. 5. No. 2. Summer.
- Hauser, Heinz and Madeleine Hosli (1991). "Harmonisation or Regulatory Competition in the EC (and the EEA)?" in Aussenwirtschaft. 46.
- Helm, Dieter (1993). "The Assessment: The European Internal Market: The Next Steps" in Oxford Review of Economic Policy. Vol. 9. No. 1. Spring.
- Kay, John and John Vickers (1988). "Regulatory Reform in Britain" in Economic Policy. October.
- Lannoo, Karel and Jorgen Mortensen (forthcoming). "Towards a European Financial Area". Brussels: Centre for European Policy Studies.
- Majone, Giandomenico (1992). "Mutual Recognition in Federal Type Systems". Revised version of paper presented at the conference on "Economic Integration in Federal-Type Systems", Melbourne, Australia, 13-14 August.
- Neven, Damien (1992). "Regulatory Reform in the European Community" in American Economic Association Papers and Proceedings. Vol. 82. No. 2. May.
- Nicolaides, Phedon (1992). "Competition among Rules". Maastricht: European Institute of Public Administration. July.
- Oates, Wallace E. and Robert M. Schwab (1988). "Economic Competition among Jurisdictions: Efficiency Enhancing or Distortion Inducing?" in Journal of Public Economics. 35.



- Pelkmans, Jacques (1987). "The New Approach to Technical Harmonisation and Standardisation" in Journal of Common Market Studies. Vol. XXV. No. 3. March.
- _____ (1990). "Regulation and the Single Market: An Economic Perspective" in Horst Siebert (ed). The Completion of the Internal Market. Tübingen: J.C.B. Mohr.
- Pelkmans, Jacques and Marc Vanheukelen (1988). "The Internal Markets of North America: Fragmentation and Integration in the US and Canada". Research on the "Cost of Non-Europe". Basic Findings. Vol. 16. Brussels: Commission for the European Communities.
- Reich, Norbert (1992). "Competition between Legal Orders: A New Paradigm of EC Law?" in Common Market Law Review. 29.
- Siebert, Horst (1990). "The Harmonisation Process in Europe: Prior Agreement or a Competitive Process?" in Horst Siebert (ed). The Completion of the Internal Market. Tübingen: J.C.B. Mohr.
- Siebert, Horst and Michael J. Koop (1990). "Institutional Competition. A Concept for Europe?" in Aussenwirtschaft. 45.
- _____ (1993). "Institutional Competition Versus Centralisation: Quo Vadis Europe?" in Oxford Review of Economic Policy. Vol. 9. No. 1. Spring.
- Sinn, Stephan (1990). "The Taming of Leviathan: Competition among Governments". Kiel Working Papers. Working Paper No. 433. August.
- Taylor, Leon (1992). "Infrastructural Competition Among Governments" in Journal of Public Economics. 49. November.
- Teutemann, Manfred (1990). "Completion of the Internal Market: An Application of Public Choice Theory". Economic Papers. Brussels: Commission of the European Communities, Directorate General II, Economic and Financial Affairs. August.
- Thomsen, Stephen and Stephen Woolcock (1993). Direct Investment and European Integration: Competition among Firms and Governments. London: Royal Institute of International Affairs.
- Vanheukelen, Marc (1993). "Beleidsconcurrentie in Europees Verband (Policy Competition in a European Context)" in ESB. 20 January.
- Walsh, Cliff (1992). "Fiscal Federalism: An Overview of Issues and a Discussion of their Relevance to the European Community". Paper commissioned by the Commission of the European Communities, Directorate General II, Economic and Financial Affairs.