Australian Government
Productivity Commission

Economic and Regulatory Reforms in Europe:

Past Experience and Future Challenges

Patrick Messerlin

Richard Snape Lecture
30 October 2007
Melbourne

© COMMONWEALTH OF AUSTRALIA 2008

ISBN 978-1-74037-234-3

This work is subject to copyright. Apart from any use as permitted under the Copyright Act 1968, the work may be reproduced in whole or in part for study or training purposes, subject to the inclusion of an acknowledgment of the source. Reproduction for commercial use or sale requires prior written permission from the Attorney-General's Department. Requests and inquiries concerning reproduction and rights should be addressed to the Commonwealth Copyright Administration, Attorney-General's Department, Robert Garran Offices, National Circuit, Canberra ACT 2600.

This publication is available in hard copy or PDF format from the Productivity Commission website at www.pc.gov.au. If you require part or all of this publication in a different format, please contact Media and Publications (see below).

Publications Inquiries:
Media and Publications
Productivity Commission
Locked Bag 2 Collins Street East
Melbourne VIC 8003

Tel: (03) 9653 2244
Fax: (03) 9653 2303
Email: maps@pc.gov.au

General Inquiries: Tel: (03) 9653 2100 or (02) 6240 3200

An appropriate citation for this paper is:

Messerlin, Patrick 2007, *Economic and Regulatory Reforms in Europe – Past Experiences and Future Challenges*, Richard Snape Lecture, 30 October, Productivity Commission, Melbourne.

JEL code: F02

The Productivity Commission

The Productivity Commission, is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long term interest of the Australian community.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by consideration for the wellbeing of the community as a whole.

Information on the Productivity Commission, its publications and its current work program can be found on the World Wide Web at www.pc.gov.au or by contacting Media and Publications on (03) 9653 2244

Contents

Productivity Commission

Richard Snape Lecture series

2007 *Economic and Regulatory Reforms in Europe – Past Experience and Future Challenges*

Patrick Messerlin
Director, Groupe d'Economie Mondiale
Institut d'Etudes Politiques de Paris

2006 *The World Economy in the New Millennium: A New Golden Age?*

Deepak K. Lal
James Coleman Professor of Development Studies
University of California Los Angeles

2005 *Will Asian Mercantilism Meet its Waterloo?*

Martin Wolf
Associate Editor and Chief Economics Commentator, *Financial Times*

2004 *Spreading Prosperity and Resisting Economic Divergence: The Significance of Richard Snape's Academic Legacy*

Anne O. Krueger
First Deputy Managing Director, International Monetary Fund

2003 *40 Million Aussies? The Immigration Debate Revisited*

Professor Max W. Corden
Emeritus Professor of International Economics
Johns Hopkins University

Foreword

Richard Snape capped a long and distinguished career as Professor of Economics at Monash University with a new and accomplished career at the Industry Commission and then as Deputy Chairman of the Productivity Commission. In the eight years that he spent at the Commission before his untimely death in October 2002, he played a pivotal role in overseeing our research program, as well as participating in major public inquiries.

This is the fifth in a series of lectures in memory of Richard Snape. With Richard's own interests and high standards in mind, the lecture series elicits contributions on important public policy issues from internationally recognised figures, in a form that is accessible to a wide audience.

This year's lecturer, Patrick Messerlin, like his distinguished predecessors, was a friend and colleague of Richard's. Professor Messerlin, from the Institut d'Etudes Politiques de Paris, is an influential analyst and author in the fields of trade policy and regulation. The theme of his lecture, concerned with regulatory reform within Europe, has considerably wider relevance, including for reform within Australia's federal system.

I am grateful to Patrick Messerlin for agreeing to come to Australia to present the Richard Snape Lecture for 2007.

Gary Banks AO
Chairman

November 2008

RICHARD SNAPE 1936 – 2002

Richard Hal Snape was Deputy Chairman of the Productivity Commission and Emeritus Professor of Monash University. He was a Board Member of the Australian Research Council, Fellow of the Academy of the Social Sciences in Australia and a Distinguished Fellow of the Economic Society of Australia.

PATRICK MESSERLIN

Patrick Messerlin is professor of economics at the Institut d'Etudes Politiques de Paris (or Sciences Po), the most prestigious French academic institution specializing in public policy. He is the director of the Groupe d'Economie Mondiale de Sciences Po (GEM) - an independent research unit seeking to improve the performance of French and European public policies in a global world.

Professor Messerlin is a specialist in international trade and trade policy. His current research interests include WTO issues, liberalisation in services and associated regulatory reforms. His latest books include *Europe After the 'No' Votes* and *Measuring the Costs of Protection in the European Community*.

Economic and regulatory reforms in Europe – past experience and future challenges

Patrick Messerlin[1]

About Richard Snape

It is an honour for me to give this lecture in memory of Richard, in the presence of Yvonne. I don't want to repeat here what the previous years' speakers have said on his profound professional skills – I concur completely with them. May I just give an illustration? His 1991 paper on subsidies in international trade caused some brows to become knitted in the economists' tribe. But, twenty five years later, this paper should be read by all the Doha negotiators, particularly in agriculture. Such a long lasting impact is not enjoyed by every economist.

I would also like to add a more personal note. When you happen to be a maverick in your field in your own country, as I was (am), it is vital that you find some support overseas. Richard gave me this invaluable support. He did it so well that, after a while, I did not restrain myself when talking with him for fear of saying something stupid in economics. I knew that the worst that could happen would be that he would look at me with his big smile, then he would become very serious before nicely putting me on the right track.

One last word. What I learnt from him is not to do 'reverse engineering' – that is so easy with today's economics and economic policy – but to stick as honestly as you can to what seems to make sense, if not fame. It is very rare to meet such people in your life.

[1] I would like to thank Ben Shepherd very much for his excellent comments and his very much appreciated editorial help, and the audience at the 2007 Snape Lecture for their questions and comments.

Introduction

After the fall of the Byzantine Empire, the early Russian tsars used to proudly proclaim that '*Moscow is the third Rome, and there will be no fourth Rome'*. Today, staunch EU critics and supporters alike would probably disagree with the tsars' statement. Both would argue that Brussels is a fit successor – its critics seeing the EU as an irrepressible 'regulator', its supporters as the ultimate model for world governance.

The reality is much more fluid and dynamic, and thus of far greater interest. How many people remember that, in the mid-1970s, some EU countries were the best ranked among the OECD countries in terms of the economic efficiency of their economic regulations? So what has happened to the EU over the last thirty years, and what has been the driving force behind these developments? Could the EU change course and, if yes, why and under what conditions? Harold Wilson used to say that a week is a long time in politics. That may be, but thirty years is nonetheless a very short time for a political entity, even one facing the formidable external pressures that Europe is now facing. The inevitable rise of China and India as hegemons in the future is only the most obvious of these pressures.

The approach adopted in this paper requires two preliminary remarks. First, the paper looks primarily at regulations dealing with the markets for goods and services. It only deals marginally with those for labour and capital, which remain largely in the exclusive hands of the Member States. ('Regulations' refer to both laws, and regulations *per se*.) Second, the paper tries to avoid the usual pitfall of many analyses of regulatory reforms, namely a *tsunami* of detail. Hopefully it has not fallen out of that frying pan into the fire of being too vague.

The paper is organized as follows. Part 1 provides a quick overview of the debate over the European 'Constitution', which – to my view – has imposed a substantial toll on the regulatory reform process through delays and lost substance. Part 2 presents the body of EU economic regulations: its rise during the last thirty years, and its increasing bias in favour of norm-setting regulations, as opposed to pro-competitive regulations.

In Part 3, I argue that the main force driving the growth of EU regulations is the desire to master a critical feature of the EU – its heterogeneity. Europeans themselves routinely recognize that Europe is 'diverse'. But very few have a good sense of just how striking that diversity has become: in economic terms, the gap between the leading and trailing EU Member States is several times larger than what is observed amongst the sub-national units of federations such as the United States, Australia, or Canada. In fact, the level of economic diversity amongst EU Member States is much closer to that of the Chinese provinces. Mastering this kind of heterogeneity by imposing convergence from the top-down is 'mission impossible'. Indeed, I suggest that it has largely failed. In sharp contrast, the EU's last thirty years reveal that the regulatory reform process is surprisingly competitive, heavily dependent on the capacity of each EU Member State to enhance the quality of its own regulations.

Part 4 documents the emerging, and still fragile, change of course in Europe, which seeks to learn the lessons of the disappointing results of the last three decades. The new approach relies more on Member States' initiatives, makes more use of cost and impact assessment of regulations, and is more friendly to a competitive regulatory reform process. There remains an EU dimension in this new course, best illustrated by the Services directive. This instrument provides important insights for services liberalization, suggesting a more efficient instrument than harmonization or mutual recognition – the principle of the country of origin.

Finally, Part 5 focuses on attention to the conditions necessary for making this new course a success. The most critical one is simple to state, but perhaps difficult to achieve: the European people themselves need to have a better understanding of the good reasons behind regulatory reforms.

1 Costly distractions: constitution versus reforms

The 'No' in the Dutch and French referenda in 2005 put an end to the ratification process of the so-called European 'Constitution'. This term was a conscious misnomer. The official title of the 2005 text was '*Treaty establishing a Constitution*', and indeed, its content is best described as an expanded compilation (the French text was 191 pages) of the no less than sixteen treaties that have shaped the EU over the past half century (see table 1). The failure to pass the 2005 text did not put even a provisional end to the constitutional debate. This is unfortunate because the debate has imposed delays on the regulatory reform process in Europe, and is distorting some of its key elements.

The 'ghost of Philadelphia'

The drafters of the 2005 text claimed that they were striking a European balance between economic and social regulations. For experienced Euro-watchers, this all had an uncanny sense of *déjà vu*. Such a balance – known as the 'European social model' – was already hotly debated during the Treaty of Rome negotiations in 1955–1956. It was then wisely decided to keep the social model issue within the scope of the Member States' powers. Since then, the issue has reared its head again on several occasions, triggering symbolic gestures by the proponents and

Table 1 **The sixteen Treaties having found the EU**

Dates	*City of signature*	*Usual name of the Treaty*
1951	Paris	European Community of Steel and Coal (ECSC)
1957	Rome	European Economic Community (EEC)
1957	Rome	European Community of the Atomic Energy (Euratom)
1965	Brussels	The Merger Treaty
1970	Brussels	The Budgetary Treaty
1972	Brussels	Acts of Accession of Denmark, Ireland and the United Kingdom
1975	Brussels	The Budgetary Treaty
1979	Athens	Act of Accession of Greece
1985	Lisbon, Madrid	Acts of Accession of Portugal and Spain
1986	Luxembourg, The Hague	The Single European Act
1992	Maastricht	The Treaty on European Union (TEU)
1994	Corfu	Acts of Accession of Austria, Finland and Sweden
1997	Amsterdam	The Treaty of Amsterdam
2001	Nice	The Treaty of Nice
2003	Athens	The Treaty of Accession[a]
2005	Neumunster Abbey	The Treaty of Accession[b]

[a] Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia.
[b] Bulgaria and Romania.

opponents alike, but leading to no decisions of substance. The best illustration of this is the British decision finally to sign the 'Social Charter' in 1997: for all the agonizing, the 'Social Charter' has generated very little substantive change in either British or EU social legislation (Pelkmans 2007).

The drafters of the 2005 text thought that they could solve the social model issue by a simple reference to the concept of a 'social market economy'. The term has a clear and positive meaning in one Member State (Germany) because it is closely associated with the 'German Miracle' of the 1950s. But in most of the other western Member States, from Britain to France to Sweden, it sounds like an oxymoron. Even worse, it sounds like a retreat from the market economies re-established only comparatively recently in the Central European countries, from the Czech Republic to Estonia. This ambiguity was crucial for strengthening the '*Non*' camp in the French referendum. But a point that is often neglected is that it was also critical in weakening the '*Oui*' camp, which was disappointed that the 2005 text did not provide the expected support for accelerating the pace of economic and regulatory reforms in France.

The debate over the 2005 text has magnified the divide between the European political class and Europe's citizens (Herzog and Gerken 2007). While the latter are looking quite sensibly to their security, happiness, and prosperity (see part 5), many European politicians tended to see the 2005 text as a step towards the restoration of Europe's grandeur. The most influential members of the Convention (the assembly of around 200 drafters of the 2005 text) seemed to feel some kind of kinship with the Founding Fathers of the United States. In short, the ghost of Philadelphia (the Congress establishing the US Constitution in 1791) snuck Banquo-like into the debates on the European text.

The French '*Non*' and the Dutch '*Nee*' should have closed the door to a debate posed in such terms. Only 18 Member States ratified the 2005 text, only two of them via a referendum (Luxembourg and Spain).[2] In contrast, six out of the seven Member States having not yet ratified the 2005 text, were planning to use the referendum procedure. The only country with pending ratification based on a parliamentary vote was Sweden, not the Member State that traditionally emits the strongest sense of satisfaction with Europe.

The 'Reform Treaty': current casualties and future troubles

Following the French and Dutch votes, European politicians should have done what the participants at the 1955 Messine Conference did. Frustrated by the (already French!) 'No' to the European Defence Community, they diverted Europe's energies to a new task – building a 'common market' – much more in tune with the everyday concerns of Europeans. They launched the negotiations for the Treaty of Rome.

Alas, the reaction of Europe's politicians this time around has been about as far removed from that example as could be imagined. They have provided a shining illustration of the famous phrase: 'Would it not be easier to dissolve the people, and elect another one in their place?' (Brecht 1953)[3]. All the Member States that have held the rotating (six month) EU Presidency since the 'No' votes have worked hard to resurrect the stillborn 2005 text, even though it is far more certain that a referendum in these Member States on that same text would result in a 'Yes' majority (based on Eurobarometer polls).

As a result, the draft of a new Treaty – called the 'Reform Treaty' – is expected to be adopted by 18 October 2007, then at the December Lisbon Summit of Heads of State and Government. It is hard to see how this new endeavour will not lead to renewed political troubles. Only 3 per cent of the provisions of the circulating text (eight articles out of 251) are substantially different from those of the 2005 text,

---

[2] In Spain, the massive 'Yes' (77 per cent of the votes) was nuanced by a very low turnout (42 per cent) compared to the average turnout in the elections since 1977 (74 per cent).

[3] Jean-Claude Juncker (Prime Minister of Luxembourg, Head of the Euro-group) provided a free (involuntary) translation of Brecht's sentence by saying before the results of the referenda: '*If it is a "Yes", we will say "on we go". And if it is a "No", we will say "we continue"'.*

with roughly 80 per cent of the provisions the same (Open Europe 2007). This feature will not escape the attention of the opponents of the 2005 text. Pressures will mount to get referenda in the countries that chose this option in 2005. Refusals to go back to such a procedure would deepen further the divide between European politicians and voters.

The toll that the EU institutional debate has taken on economic and regulatory reforms is not limited to delays, distractions, and ultimately distrust between the European political class and citizens. The current draft of the Reform Treaty reveals some long-lasting casualties of the institutional debate on the regulatory reform process, as suggested by the following illustration.

During the June 2007 Council of Heads of State and Governments (the highest EU body), which launched the drafting of the Reform Treaty, the French proposed dropping the terms 'where competition is free and undistorted', which qualified the internal market in the 2005 text (General Provisions Article 3.3, a key provision defining the EU goals). The other Member States kept mum, and the French proposal was adopted.

Two reasons were given by the French. First, a Constitution is not a text to jam with detailed provisions about competition. The problem with this argument is that the new text is officially a Treaty, and only a Treaty, with no reference whatsoever to a Constitution. So it is not at all obvious that competition should not be included.

Second, and more much importantly for the regulatory reform process, competition is seen by many French politicians as a word that the French people dislike, and one which contributed to the 'Non' majority. There is no evidence supporting such an interpretation. In fact, the polls point in exactly the opposite direction. Roughly 80 per cent of French people declare that they support 'competition' (*Crédoc poll quoted in Le Figaro*, 26 March 2006). A recent Pew poll indicates that 56 per cent believe that "people are better off in free market economies" (Pew Global Attitudes Project 2007) – admittedly, a low figure when compared to other industrial countries, but robust nonetheless when one takes into account the longstanding commitment to negative brainwashing in this area, which has been a hallmark of the French political elites on both sides of politics. In sharp contrast, French people with a positive opinion of EC membership have been a minority (48 per cent) since 1998, while those with a positive opinion of the benefits from the EC have been an even smaller minority (45 per cent) since 1993 (Eurobarometer 2007).

The Council's approach could be seen as a blatant example of political cynicism (Wolf 2007). This view is supported by the fact that all the critical – legally binding – existing provisions on competition remain in the circulating draft of the Reform Treaty. But, as preambles and general provisions (such as Article 3.3) are crucial in the traditional French approach to treaty interpretation, such a change may have additional spillover effects in the future.

To conclude, a better alternative to the Reform Treaty would have focused exclusively on the EU's functioning. The pragmatic approach launched by the Treaty of Rome has had an increasingly heavy downside – an institutional fuzziness on the sharing of powers and responsibilities. A new Treaty with a few provisions establishing the 'double majority' rule and clarifying the role of the Commission would have required a handful of pages. The resulting Treaty would have been quite different from the 2005 text, allowing Member States to use parliamentary ratification without giving the impression that they are ignoring the 2005 votes.

2 The body of EU regulations

The EU body of regulations – the *acquis communautaire* (hereafter the *acquis*) – has been adopted using complex mechanisms involving the Council (the EU 'government'), the Parliament, the Commission (the EU administration playing an initiative role and a go-between role (see concluding remarks)) and the Committee of the Regions (three-quarters of the *acquis* is enforceable at the regional level). A description of these mechanisms is beyond the scope of this paper. Suffice to say that the 'co-decision' principle (the adoption of a text by the Council, Parliament and Commission) can have surprisingly large and unexpected cost impacts.

The *acquis* consists mainly of regulations and directives. Regulations are binding laws directly applicable to all Member States. Directives, also bind results to be achieved, but leave the choice of form and method to national authorities. As a result, directives need to be transposed into national law before they can be enforced.

The *acquis* is important if only because it has been estimated that it generates 84 per cent of all the laws and regulations passed by Germany (Herzog and Gerken 2007). This estimate may differ from one Member State to another, and it does not take into account the regulations that vested interests manage to tack onto EU directives when they are transposed into national laws – the so-called 'gold-plating' of the *acquis* (Bertelsmann Foundation 2006).

This critical role of the *acquis* derives from two sources. First, on the internal side, the *acquis* is binding, and the Commission monitors the transposition and enforcement process in each Member State. This monitoring is done in great detail, with a regular list ('scoreboard') of the directives not transposed by each Member State. Such a detailed process contrasts strikingly with the absence and opacity of the information on existing directives at the whole EU level (see below). When a

Member State fails to properly enforce the *acquis*, or if it is too slow in doing so, the Court of Justice intervenes. It can even impose daily fines on the recalcitrant Member State.

Second, on the extra-EU side, the *acquis* is non-negotiable for candidate countries seeking accession to the EU. Such countries must incorporate the *acquis* into their own legislation prior to accession. This principle has forced the new Central European Members to transpose several thousand Regulations and Directives in just half-a-dozen years – a hard toll on good governance for countries having just escaped from half a century of Soviet rule and central planning.

Moscow on the Senne?[4]

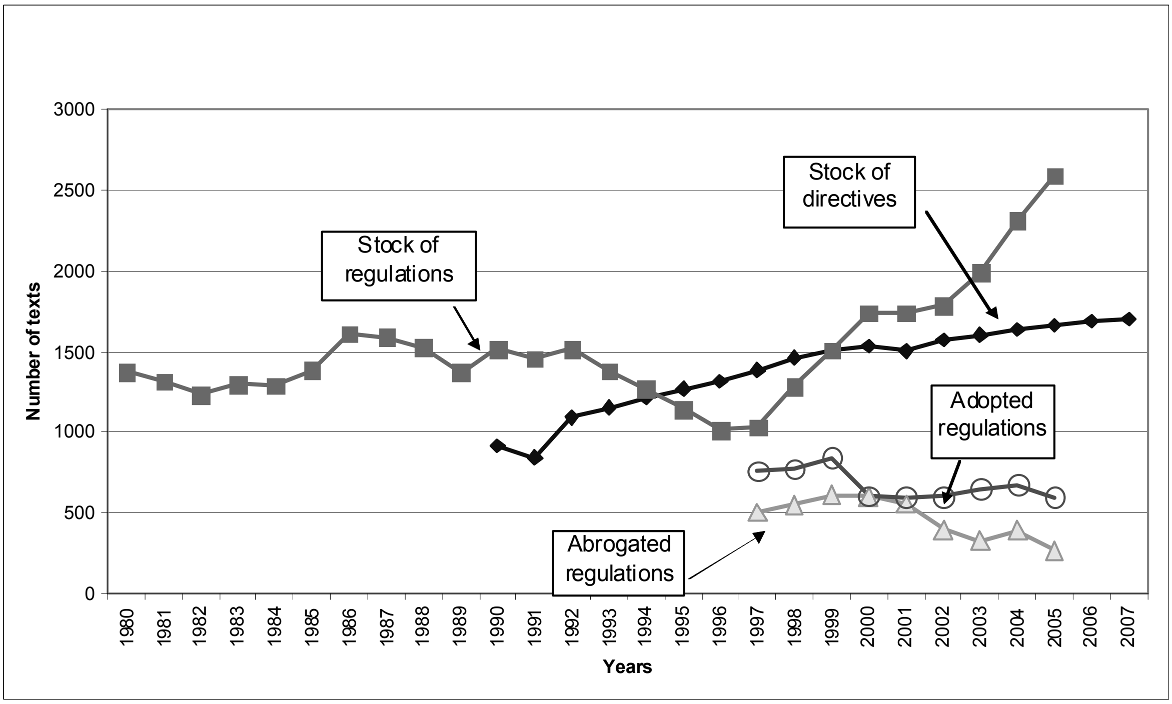
Is the EU really the regulator that many Euro-sceptics hold it to be? Answering this question is made surprisingly difficult because information on the exact size of the *acquis,* and on its evolution over time, is relatively scarce and imprecise. Official data on the number of regulations and directives are incomplete, time inconsistent, and often contradictory, even when they come from the same official source. For instance, the number of directives applicable on 31 December 1998 ranges from 1221 to 1470. The situation reflects two serious and basic flaws in EU governance: complex decision-making mechanisms; and a persistent unwillingness or inability to put together a more transparent system (which would provide an easy check on the problems at hand).

Figure 1 provides the best available estimates of the 'stock' of regulations and directives at the end of each year. The corresponding annual compound growth rate of the *acquis* from 1990 to 2000 is roughly 3 per cent, compared with an annual GDP growth rate of 2 per cent for the EU-15. The annual growth rate for the period 2000 to 2007 is 5.4 per cent for the *acquis*, compared with 2.2 per cent for the annual GDP growth rate of the EU-15.

Most of the growth in the *acquis* comes from directives during the 1990s, and from regulations since 2000. To demonstrate this, figure 1 includes the available estimates of the two different flows of EU Commission regulations for the period 1997–2005. It shows a massive regulatory turnover, with, on average, 678 regulations adopted and 467 abrogated. For the directives, the average annual flows are 28 adopted and two abrogated. That said, it can be rightly argued that the comparative advantages of a modern economy are generated by regulatory quality, particularly in services, which constitute 70 per cent of GDP in the EU (see below),

4 Brussels lies on a small river, the *Senne*, which, in French, sounds like *Seine*, the river that flows through Paris.

Figure 1 **The estimated growth of the 'acquis communautaire'**



and that such quality may require frequent modifications in the regulations. However, frequent modifications may impose large costs on the economy – best illustrated by the last years of deep 'regulatory fatigue' in the EU financial services sector.

The EU: Gulliver caught in his own chains

A better sense of regulatory burden in the EU requires a more detailed view of the structure of the *acquis*. Table 2 presents a breakdown of EU directives in force in 2000 and in 2007 by chapter, as defined by the EU during the accession negotiations with the Central European countries. It also gives a rough indication of the sharing of competence between the EU and the Member States required by the various chapters. Last but not least, table 2 makes an (admittedly heroic) effort to classify the directives according to two possible primary goals – competition-promotion or norm-setting. (Directives that do not fall easily into either of these groups are classified as having 'mixed' effects). This distinction is crucial from an economic perspective because, in contrast to the directives with a predominantly pro-competitive objective, those which are mostly norm-setting may be cost increasing and/or competition inhibiting.

Table 2 EU directives by chapter, 2000 and 2007

Chapter	Competency	Dominant goal[a] comp	norm	mixed	2000 nbr	2000 %	2007 nbr	2007 %	Growth rate
1 Competition	shared EU-National	100.0	0.0	0.0	10.0	0.6	10.0	0.6	0.0
2 Internal Market	EU (National)	44.0	29.0	27.0	137.0	8.9	169.0	9.9	2.7
3 Transport & Energy	shared National-EU	19.0	19.0	62.0	106.0	6.9	157.0	9.2	5.0
4 Enterprises	shared National-EU	5.0	93.0	2.0	470.0	30.5	490.0	28.8	0.5
5 Environment	shared National-EU	3.0	97.0	0.0	144.0	9.3	129.0	7.6	-1.4
6 Health & Consumer Protection	shared National-EU	0.0	100.0	0.0	532.0	34.5	583.0	34.3	1.2
7 Taxation & Customs Union	National (EU)	7.0	93.0	0.0	65.0	4.2	67.0	3.9	0.4
8 Employment & Social affairs	National (EU)	20.0	80.0	0.0	56.0	3.6	62.0	3.6	1.3
9 Statistics (Eurostat)	EU (National)	0.0	0.0	100.0	12.0	0.8	11.0	0.6	-1.1
10 Justice & Home Affairs	National	70.0	30.0	0.0	10.0	0.6	21.0	1.2	9.7
Total		**9.1**	**82.8**	**8.0**	**1 542.0**	**100.0**	**1 699.0**	**100**	**1.2**
1-3 Core economic programme	Various	36.0	24.0	41.0	253.0	16.4	336.0	19.8	3.6
4-6 Core norm-setting programme	Shared National-EU	2.0	97.0	1.0	1 146.0	74.3	1 202.0	70.7	0.6
7-10 Other directives	National dominant	16.0	76.0	8.0	143.0	9.3	161.0	9.5	1.5

[a] Estimated shares of directives with a pro-competitive goal (comp) with a norm-setting goal (norm) and with mixed effects (mix.). These estimates are on the directives of the year 2000.

Source: EU Secretariat-General, 30 November 2000 and 3 July 2007.

The twin aspects of 'competency' and 'dominant goal' interact with each other. Shared competence requires a consensus or qualified majority. The qualified majority is presented as representing important progress in EU decision-making because of its potential to eliminate or reduce blockages. This is an interesting proposition, which deserves to be tested rigorously. One potential difficulty is that Member States retain the ability to use cross-issue linkages to exert pressure in one area to obtain something in another. For instance, a Member State can always threaten to use its veto on issues still subject to consensus (for instance, taxation) to block texts, subject to a qualified majority, that would hurt its vital interests. The simultaneous presence of consensus and qualified majority rules thus tilts the voting system towards more consensus situations than would be expected based on a simple reading of the Treaties. The more often the consensus regime prevails, the higher are the risks of 'pork-barrel' tactics – and pork-barrel tactics are likely to be unfriendly to pro-competitive goals (see section below on harmonization and mutual recognition).

Table 2 paints a surprising picture, at least in terms of magnitude. Directives with a clearly pro-competitive goal represent only a small minority – roughly 10 per cent of the total – while those with a norm-setting function dominate. But this needs to be qualified. Pro-competitive directives tend to be wide-ranging in terms of enforcement: for instance, the directives on competition policy cover a large share of EU production. In contrast, norm-setting directives tend to have more narrowly defined goals (for instance, the size and position of rear-view mirrors in motor vehicles). However, a significant number of norm-setting directives cover entire industrial sectors (for example, the REACH directive on product safety covers the entire chemicals sector). It would thus be interesting to have a production-weighted breakdown of pro-competitive and norm-setting directives.

In short, table 2 depicts the EU *acquis* as a Gulliver programme of pro-competitive directives chained down by a large crowd of Lilliputian norm-setting directives. Ropes may be Lilliputian (though it is not always the case, as in the REACH directive) but they are numerous enough to hold back competition, at least in the sectors they cover. This broad conclusion deserves more detailed remarks by EU chapter.

The EU core economic programme defined by the Treaties since 1958 mostly corresponds to chapters 1 to 3. Chapters 1 and 2 have a dominant pro-competitive component. The sizeable share of norm-setting directives in Chapter 2 (Internal Market) flows from the 35 or so directives dealing with regulated professions, in particular defining the rules for the recognition of diplomas within the EU. Chapter 3 on Transport and Energy has a predominantly mixed outcome for several reasons. The Treaty of Rome provisions on transport were initially anti-market: the Treaty preserved the fragmentation that had arisen among the highly regulated transport sectors in the various Member States. More recently, there are serious problems relating to the inability or reluctance to deal with key obstacles to enforcement of the existing directives. A good illustration of this is provided by the directives in electricity. In the absence of much better physical infrastructure (interconnections between the national grids) these directives look like a free trade agreement in goods between two countries that are only connected by a small road leading to a narrow bridge.

Chapters 4 to 6 are driven overwhelmingly by norm-setting objectives. Surprisingly this is the case even for the so-called Enterprises chapter, which is dominated by technical regulations in fewer than a dozen sectors. There are roughly 240 directives for motor vehicles alone, along with 30–50 directives for each of half a dozen key sectors, such as capital goods, cosmetics, chemicals, and pharmaceuticals. The Health and Consumer Protection chapter has a strong agricultural component.

Foodstuffs destined for human or animal consumption, along with veterinary matters, account for two-thirds of the chapter's directives.

Lastly, chapters 7 and 10 are dominated by the competence of the Member States (except the four directives on the customs union). Two chapters deal with the labour market: the predominantly norm-setting chapter Employment and Social Affairs, and the chapter Justice and Home Affairs. The latter strikes a slightly more pro-competitive note because it deals with the directives on entry and residence. These directives are pro-competitive in the long run, even though limits to entry and residence have been imposed by many EU Member States on citizens from the new Central European Members.

3 'Mission impossible' for the acquis

The current size of the EU *acquis* raises a question: what has been the main driving force behind the expansion of the *acquis*, and its strong norm-setting component? The most frequent answer is based on political economy considerations. It is hard to mobilize the natural supporters of pro-competitive regulations, that is consumers. In contrast, 'mono-issue' lobbies unable to win their case in their own capital can go to Brussels for another bite at the cherry. For several reasons – from good ones (a more open mind) to bad ones (the desire to grab any possible bit of power) – the Commission may react to lobbies' requests more often and/or more positively than the Member States' governments. Such an explanation undoubtedly has a good deal of truth to it, but it cannot fully explain the rise of the *acquis*, and its norm-setting bias.

A fundamental reason may be the huge degree of heterogeneity among the EU's Member States. The *acquis* has been developed to fight against that heterogeneity by ensuring an orderly convergence process – the European 'dream'. In defining such an objective for the *acquis*, Europeans have tended to underestimate greatly the degree of heterogeneity within the EU; as shown below, it is much higher than what is observed in other comparable polities around the world. Hence, the *acquis* has been given a 'mission impossible'. But this failure hides a positive result, crucial for the future choices of Europe: the EU regulatory reform process happens to be much more dynamic – and competitive – than expected.

The EU: the most heterogeneous entity in the world

The EU is fixated by size, which has become its main rallying cry. It likes to describe itself as a 'Union', the third most populated entity after China and India, the world's largest economy, the world largest trading partner, the world largest donor of aid funds, etc. This fascination for size may reflect the fact that size is seen as a quick fix way of restoring Europe's grandeur.

But Europe's size comes with a high price – heterogeneity. Europeans often celebrate their diversity. Rather than a union, the EU could be better described as a community of at least four legal regimes (Anglo-saxon, French, German and Nordic), 27 Member States, 254 regions, three official capitals (Brussels, Luxembourg and Strasbourg), and 23 official languages, including one that has raised such acute problems (including how to write it) that three years of preparation have been necessary to introduce it fully into the EU legal process.[5]

This description is somewhat superficial, however, because it does not compare the EU with other large countries. Table 3 compares the EU with four large countries – three federations (Australia, Canada and the United States) and one centralized country (China).[6] Table 3 contains five basic indicators, providing for each of them the information for the whole entity and for the first sub-entity (the EU Member States, the States and Territories of the three Federations, and the Provinces of China) and the ratio of the largest (richest) sub-entity to the smallest (poorest) sub-entity. Information is also included for the EU before and after the two Eastern enlargements, that is, in 1995 and in 2004 (taken as a proxy for 2007).

The results in table 3 are quite astonishing. They reveal that the EU is much more heterogeneous than any of the three Federations, and that it is as heterogeneous as today's China (and probably more heterogeneous than tomorrow's China).

First, population size gives a sense of whether or not each entity really needs several layers of governance. Clearly, the mere size of Germany (the most populous EU country) and of Guangdong (the most populous Chinese province) justifies more power devolution than would be needed for California, Ontario or New South Wales (the largest States of the three federations). The 'largest/smallest' ratio is much bigger for the EU (especially if one ignores the three small Canadian Territories, with a ratio of roughly 130).

[5] The closest historical reference that comes to a European mind is the Austria-Hungary Double Monarchy.

[6] It would be fascinating to add India, but there is no available official data on Indian states. India may be as heterogeneous as China and the EU (though it runs on a common administrative language and legal regime). While China has the implicit unity provided by the Han people, India is like the EU – a sub-continent with a long trail of internal religious, ethnic and political fights.

Table 3 **Size versus heterogeneity, selected large countries**

	European Union					
	1995	2004	USA 2006[a]	China 2004	Australia 2004[a]	Canada 2006
Number of sub-entities	15	27	51	31	8	13
Population (millions)						
Whole entity	372	487	297	1 294	21	33
Largest sub-entity	82	83	36	97	7	18
Largest/smallest ratio	204	206	72	36	33	423
GDP at current US$ (billion)						
Whole entity	8 725	12 902	12 290	1 971	637	1 162
Largest sub-entity	2 523	2 741	1 616	194	227	491
Largest/smallest ratio	139	517	70	75	27	446
GDP at PPP (billion)						
Whole entity	7 624	12 332	12 227	8 776	666	1 188
Largest sub-entity	1 743	2 336	1 608	862	237	459
Largest/smallest ratio	124	307	70	76	27	459
GDP per capita at current US$						
Whole entity	23 484	26 476	41 532	1 523	31 306	35 617
Richest sub-entity	44 158	70 295	67 397	5 165	40 740	79 077
Richest/poorest ratio	4	23	2	10	2	3
GDP per capita at PPP						
Whole entity	20 520	25 306	41 316	6 781	32 709	36 405
Richest sub-entity	34 498	69 961	67 048	22 993	42 566	80 827
Richest/poorest ratio	3	9	2	10	2	3

[a] Excluding the capital territory.

Source: World Development Indicators, Statistics Canada, US Bureau of Economics and Census, Australian Bureau of Statistics, China National Bureau of Statistics.

Second, the GDP figures confirm the observations based on population. (Again, ignoring the Canadian Territories would decrease the Canadian ratio to roughly 130.) Three additional observations can be made. First, the recent extension to Central European countries has considerably increased the EU's economic heterogeneity, while leaving unchanged its demographic heterogeneity. Second, the GDPs on a PPP basis show that the economy of the largest Chinese Province (Guangdong) is already larger than Australia's economy. Lastly, the EU's largest/smallest ratio is substantially smaller in 2004, despite the fact that the EU's GDP is roughly the same at current exchange rates and on a PPP basis. This is because the PPP exchange rates are estimated on a Member State basis. By contrast, these ratios are stable for the four other countries, because the PPP rates are estimated on a country-wide basis.

Third, GDP per capita is the most interesting indicator of heterogeneity from an economic point of view. At current exchange rates, the EU was already the most heterogeneous entity in 1994, compared with the other industrial countries. It is now by far the most heterogeneous entity, with the richest Member State (Luxembourg) being 23 times richer than the poorest one (Bulgaria). China is second behind the EU, with a comparatively high richest/poorest ratio of 10.

If the GDPs per capita at PPP rates confirm the above results when comparing the EU with the industrial countries, they soften the comparison with China. More importantly, they provide information crucial to understanding future developments. The richest Chinese Province (Shanghai) is already 2.5 times richer than the poorest EU Member State (Bulgaria). Indeed, the nine richest Chinese Provinces, representing 450 million inhabitants (almost the whole EU), have a GDP per capita on PPP terms higher or equal to the GDP per capita of the fourteen poorest EU Member States. This is a key factor to consider when defining EU policy towards China, in particular its trade policy (Messerlin and Wang 2007).

Table 3 delivers a crucial message. The more heterogeneous is the entity, the more the optimal regulation should be allowed to differ in each one of the sub-entities, and the more valuable is some degree of freedom between the entity and the sub-entities. The balance between vertical and horizontal competition is a perennial question for federations (Productivity Commission 2005). It dominated the European debate of the late 1980s and early 1990s when the EU was setting up the Internal Market in services with the principle of subsidiarity, according to which actions should be taken at the lowest possible level of decision making. However, the interest in this notion has faded in Europe. It was assumed that, since the EU was a young entity, more centralisation would always be the right answer. This assumption led to the notion of subsidiarity being used only rarely in the mid- and late 1990s, precisely when it should have been most intensively used in the context of the Central European accessions, which increased EU heterogeneity considerably. But at that time, the urge to homogenize was overwhelming.

The 'state of the Union'

The 'European dream' rests on three credos. The first two are endlessly repeated: the EU's main function is to accelerate and consolidate the convergence process among the Member States, and the *acquis* is the key instrument for achieving this result. The third credo is unspoken: the goal of the convergence process has been implicitly defined as the situation of the founding Member States of the EU. In short, the EU convergence process has been conceived as a process whereby laggards would converge to historical front-runners by adopting the *acquis*.

As already noted, few Europeans recognize just how heterogeneous the EU is. Fewer realize that such heterogeneity has made it 'mission impossible' for the *acquis* to bring about orderly convergence. What follows provides evidence of how far apart the Member States are in 2006. This reflects the very limited impact the *acquis* has had even on the EU's founding countries, which have been exposed to it for the last half-century.

A first source of evidence relies on the regulatory indicators provided by the Doing Business database (World Bank 2007). These indicators investigate the scope and manner of regulations that enhance business activity and those that constrain it. Table 4 lists the nine major indicators, organized into five groups: the summary indicator, entrepreneurship (1 and 2), business relations with the authorities (3 to 6), the labour market (7), and the capital market (8 to 10). Table 4 provides the average percentiles for these various indicators. (The lower the percentile, the better is regulatory performance.) It covers four groups of countries: the EU founding Members, the other Western European Members that acceded to the EU between 1972 and 1995, and the Central European Members that have joined the EU since 2004.[7] Table 4 also includes ten 'reference' countries, namely the five main non-European OECD countries (Australia, Canada, Japan, New-Zealand, and the United States), two non-EU European countries (Norway and Switzerland) which have kept some degree of freedom with respect to the *acquis*, and three countries (Chile, Hong Kong, and Singapore) which have been a stable part of the group of emerging economies since the 1970s.

Table 4 provides four major results, most of which are quite surprising. First, the reference countries exhibit a level of regulatory quality significantly better than the one shown by the three groups of EU Member States, hence underlying the urgent need for reforms in Europe.

Second, contrary to widely-held belief, the EU founding Members are not front runners in Europe – this role has been taken over by the other Western European Members. Third, and even more surprisingly, the usual culprit for bad governance among the EU founding Members – the labour market – is not alone (and it is not even the worst). The performances of the EU founding Members in capital markets and in entrepreneurship (starting a business) are as bad as those in the labour market.

[7] The EF (EU founding Members) subset includes Belgium, France, Germany, Italy and the Netherlands. The EW subset (other Western) includes Austria, Britain, Denmark, Finland, Greece, Ireland, Portugal, Spain and Sweden. The EC subset (Central Europe) includes Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia (plus Cyprus in the case of the Economic freedom index).

Table 4 **The state of the Union: regulatory performances, 2006**

Ease of …	*Founding EUMS*[a]	*Western EUMS*	*Central EUMS*	*Reference countries*
Summary Indicator				
0 Doing Business	0.355	0.287	0.393	0.166
Entrepreneurship				
1 Starting a Business	0.291	0.290	0.375	0.117
2 Closing a Business	0.140	0.088	0.353	0.118
Relations with the authorities				
3 Trading Across Borders	0.257	0.192	0.357	0.148
4 Dealing with Licenses	0.371	0.315	0.485	0.230
5 Enforcing Contracts	0.323	0.203	0.316	0.153
6 Paying Taxes	0.488	0.361	0.489	0.236
Labor market				
7 Employing Workers	0.457	0.486	0.479	0.184
Capital market				
8 Registering Property	0.489	0.314	0.381	0.191
9 Getting Credit	0.266	0.223	0.266	0.108
10 Protecting Investors	0.470	0.397	0.428	0.173

[a] EUMS: EU Member States.

Source: World Bank 2007, *Doing Business*.

Last but not least, the Central European Member States are already on a par with the EU founding Member States in almost half the indicators, and not in those that one would expect. Their labour markets are not better regulated than in the rest of the EU, which makes it hard to talk about a 'race to the bottom' in terms of labour protection. In contrast, their capital markets enjoy a substantially better regulatory framework than in the founding Member States.

Table 4 is based on indicators that cover a broad range of regulations. One could argue that this means the table 4 over-emphasizes the impact of norm-setting directives, and hence is inadequate for capturing the impact of the pro-competitive directives of the Internal Market initiatives. These directives are concentrated in the network sectors, and more broadly in services sectors. Table 5 presents indicators constructed by the OECD, which focus on these sectors. The product market regulation (PMR) indicators range from zero (most pro-market regulations) to six (least pro-market regulations). Table 5 uses the same breakdown of countries as table 4.

Table 5 **Product-market regulation (PMR) indicators**

Rank	*Group*	*OECD members*	*PMR 1998*	*PMR 2003*	*Change %*
17.4	EF	Founding Members	2.2	1.6	-29.2
12.2	EW	Other Western EU	1.9	1.3	-28.3
23.3	EC	Central EU	3.1	2.0	-36.2
9.7	RC	Reference countries	1.6	1.2	-22.9
19.3		Other countries	2.4	1.8	-27.9

Source: Conway, Janod and Nicoletti, 2005.

Table 5 provides clear results. The EU founding Member States have improved their regulations in a pro-market direction, but they have done so at the same pace as the other Western European Members. They have been much slower in this respect than the Central European Member States. In other words, they are barely catching up. The EU as a whole has not substantially improved its relative position vis-à-vis the reference countries.

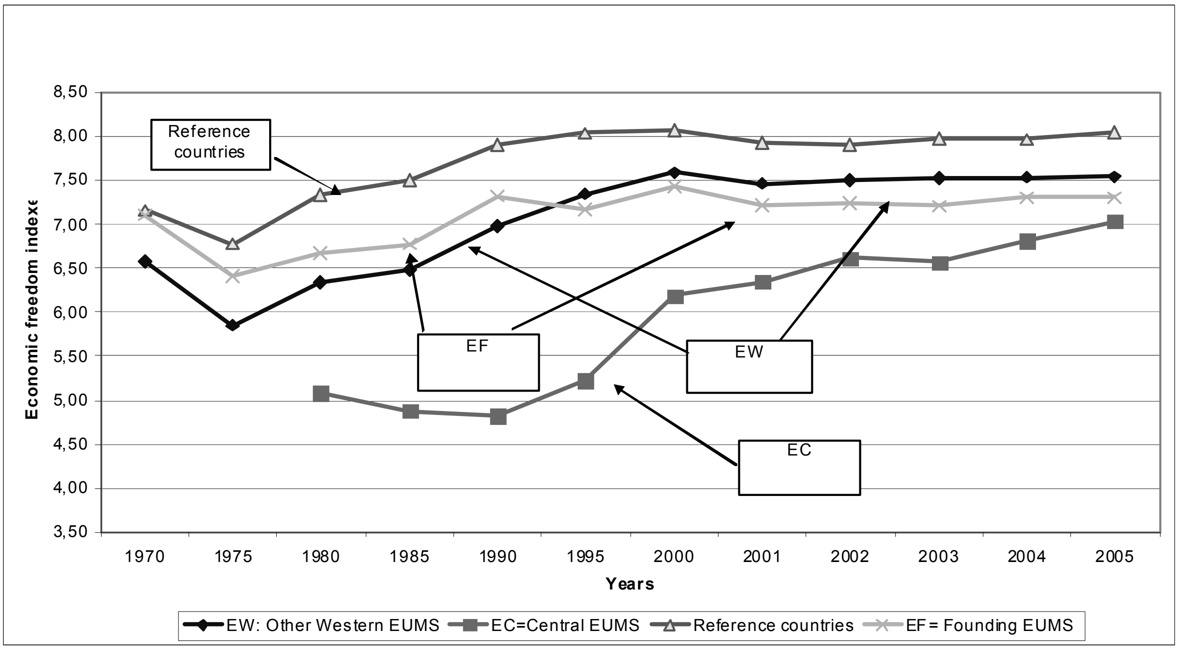
Regulatory reform: a process much more competitive than expected in the EU

The snap-shot observations above do not provide any sense of the nature of the regulatory reform process over the last thirty years. Economic freedom indexes (Fraser Institute 2007) can give some indication of this. Figure 2 illustrates the average economic freedom indexes for the same four groups of countries as above: the founding EU Member States (EF), the other Western European countries (EW), the Central European countries having acceded to the EU since 2004 (EC), and the reference countries.

In sharp contrast with the idea of orderly convergence to the model of the founding EU Member States, Figure 2 shows that some front-runners have become laggards, and vice-versa. In other words, figure 2 reveals an extremely dynamic – and competitive – regulatory reform process within the EU Member States, as well as between them and the rest of the world.

In addition, figure 2 suggests that the worsening performance of the EU founders compared to the other Western European Member States begins after 1975 (when the *acquis* emerges) and becomes manifest after 1995 (when most of the directives on the Internal Market in services were adopted). Moreover, most of the catching up of the Central European Member States occurred between 1990 and 2000: that is, mostly before the adoption and implementation of the *acquis* in these countries. Lastly, the gaps between the EU founders and the other Western European Member

Figure 2 **Economic Freedom Indexes, 1970–2005**

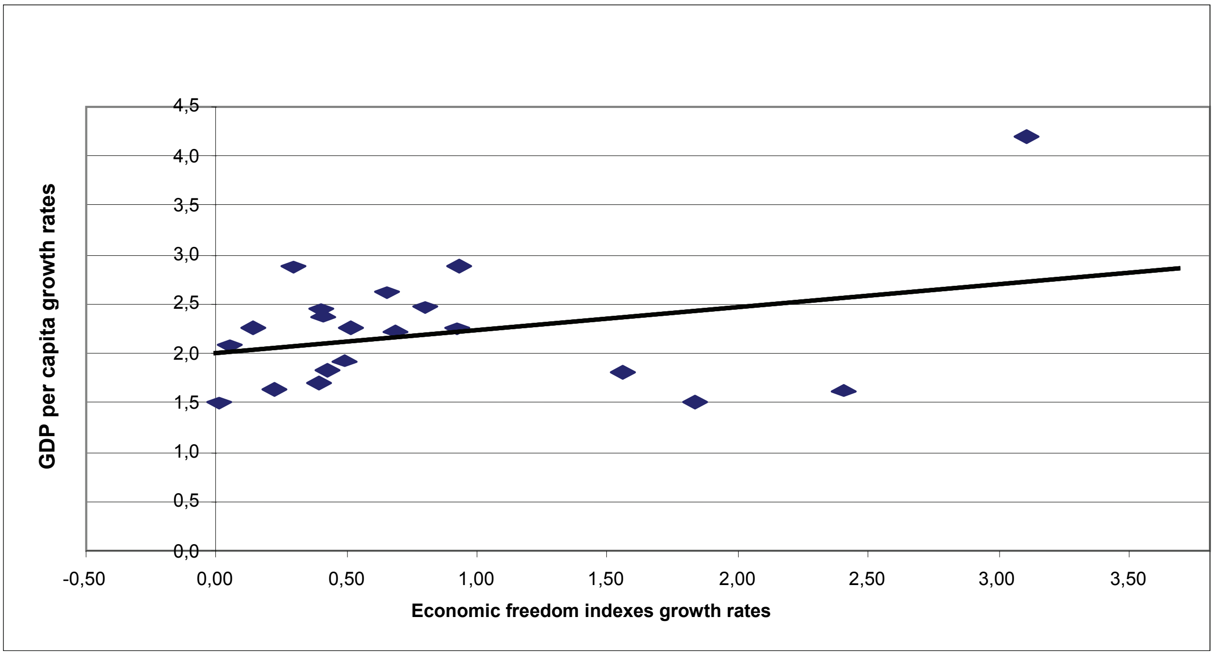


States on the one hand, and the reference countries on the other, have remained stable since 2000, and perhaps even increased in 2005.

Another interesting result flows from comparing the growth rates in average GDP per capita for each of the four country groups, and the corresponding Economic Freedom Indexes. Figure 3 illustrates one of these correlations between pairs of GDP per capita and freedom index for five periods (1975–2004, 1980–2004, 1985–2004, 1990–2004 and 1995–2004). Figure 3 illustrates the same positive correlation as the one found in other studies (for more details, see Fraser Institute 2007).

These results have an important corollary. They do not provide any evidence of a strong link between a race to the bottom and a competitive regulatory reform process. Indeed, they support the notion of a race to the top – better regulated countries tend to have higher growth rates.

Figure 3 **Economic Freedom Indexes and GDP per capita**



Looking at individual countries (rather than group averages) would provide more lessons. It would confirm the high level of fluidity in the relative positions of the countries, with clear regulatory improvement in some countries, and a relative decline in others. It would also reinforce the impression that, in recent years, even the EU front-runners may be losing ground to the front-runners in the rest of the world.

4 The Member States strike back

Since the late 1990s, a half-dozen Member States have made a serious come-back in terms of the regulatory reform process, defining their own objectives for 'better regulation' and developing their own instruments. Even more remarkably, these Member States have spent little time trying to convince the rest of the EU of the correctness of what they are doing. They simply go ahead and do it.

Germany's recent shift into this 'autonomous reformist-minded' Member State camp is crucial. The shift occurred following the reforms of the final year of Chancellor Schroeder's term, and continued after the election of Chancellor Merkel. The importance of this development is that the other large EU Member States cannot remain indifferent to it.

This effect can be observed with the Italian legislative elections in 2006, and the French presidential elections in 2007.[8]

Interestingly, changes at the EU level do not come so much from the Commission, which has had a hard time following this 'avant garde' for several reasons evoked below. Rather, they flow from the debate on, and the adoption of, a very special directive – the Services directive (Official Journal of the EU, L 376/36, December 2006). The adoption of a truncated version should be a big help in spreading the 'better regulation' initiatives taken by the 'autonomous reformist-minded' camp to the rest of the Member States. The rejection of its most innovative provision – based on the 'principle of the country of origin' – has opened a real debate on the way to liberalize services. That debate is only in its early days.

The 'Better Regulation' Member States' initiatives

Austria, Britain, Denmark, Ireland, the Netherlands, and Sweden have developed their own 'better regulation' strategies over the last decade or so. First, they have generated an increasing number of studies estimating regulatory costs in each country. Despite a narrow definition of these costs – only those generated by the administrative process – the available estimates are substantial. They range from 2 per cent of GDP in Germany (Institut für Mittelstandsforschung 2004) to 3.6 per cent in the Netherlands (Merk 2005).[9]

Even more interestingly for the dynamics of the regulatory reform process, these administrative costs reveal a very uneven playing field. Costs appear to be significantly higher for small and medium enterprises than for large firms, and they are mostly related to the enforcement of tax regulations. These features are interesting because they favour the emergence of pressure groups promoting their interests in a reform process (small and medium enterprises in the German case), and they define specific targets for action (taxation). The higher the targeted costs, the larger the welfare gains for the whole economy would be.

Second, the 'autonomous reformist-minded' camp increasingly uses the same 'standard cost model'. This is a method for measuring administrative costs, initially developed in the Netherlands. Administrations are required to estimate the time and money required to fill out all the forms they request. The governments of these six Member States have announced similar reduction targets of around 25 per cent.

---

[8] How firmly Germany has shifted to this camp is still open to question (Deutsche Bank Research 2007b).

[9] Both sources are quoted from Deutsche Bank Research (2007a). The EU Commission has provided its own estimates – EUR 600 billion, or 4.5 per cent of the EU GDP.

(There is some uncertainty as to whether the costs are net or gross in Germany and Sweden, and deadlines differ: 2007 in the Netherlands, and 2011 in Germany).

The standard cost model has clear limits. It only measures costs related to the information and reporting obligations imposed by a regulation, and does not take into account compliance costs. Of course, it also does not include a cost-benefit analysis of the rationale behind particular regulations. Its main benefit is to develop a procedure that can be used relatively easily, and which forces an administration to adjust its mindset to the notion that regulations generate costs. It does this without provoking a debate on regulatory rationale – an objective that would require Europeans to have a much better understanding of the regulatory reform process than they currently do, as stressed in section 5.

In comparison, the emergence of regulatory impact assessments (RIAs) in several Member States has been rather slow. The United States has a long tradition of RIAs, with the Office of Management and Budget (OMB) assessing the costs and benefits of enforced regulations (Hahn and Litan 2004, Hahn and Tetlock 2007). In Europe, RIAs tend to be developed more on an *ex ante* basis – assessing the costs and benefits of regulations before their adoption, or suggesting better alternatives to the provisions included in proposed regulations.

Table 6 indicates that as of 2005, only ten Member States had introduced RIAs in any significant way (with a global total higher than 5). Once again, the score of the founding Member States is systematically worse, and often by a substantial margin, than the score of the Other Western Member States. Indeed, it is often worse than the score of the Central European Member States.

EU institutions have had difficulties reacting to these initiatives, if one leaves aside the easy-to-be-made declarations of the Council. For reasons that are still unclear, the Commission has launched its own standard cost model. It has also undertaken RIAs since 2002. But this effort is not yet very convincing – and the Commission is reviewing its whole process. Decisions should be made by the end of this year (Cecott et al. 2007).

Table 6 **Regulatory impact assessment: the situation among the Member States, core indicators**

Group of MS	*Member States (MS)*	*Does a better regulation programme exist?*	*Does a specific RIA policy exist?*	*Are RIAs obligatory?*	*Are alternative instruments considered?*	*Do formal consultation procedures exist?*	*Core total*[a]	*Global total*[b]
2	Britain	3.0	3.0	3.0	3.0	3.0	10.0	9.1
2	Denmark	3.0	3.0	3.0	3.0	3.0	10.0	9.1
3	Poland	3.0	3.0	3.0	3.0	3.0	10.0	8.5
3	Latvia	3.0	3.0	3.0	3.0	3.0	10.0	8.2
2	Sweden	3.0	3.0	3.0	3.0	3.0	10.0	8.2
2	Finland	3.0	3.0	3.0	3.0	3.0	10.0	7.6
2	Austria	3.0	3.0	3.0	3.0	3.0	10.0	7.3
1	Netherlands	3.0	3.0	0.0	3.0	0.0	6.0	6.7
3	Hungary	3.0	1.0	3.0	0.0	1.0	5.3	6.4
1	Luxembourg	3.0	0.0	3.0	3.0	3.0	8.0	6.4
1	Germany	3.0	0.0	0.0	0.0	3.0	4.0	4.5
1	Italy	1.0	3.0	0.0	1.0	0.0	3.3	4.2
3	Estonia	0.0	0.0	3.0	3.0	0.0	4.0	3.6
3	Lithuania	0.0	3.0	3.0	3.0	0.0	6.0	3.6
2	Spain	3.0	1.0	3.0	3.0	0.0	6.7	3.6
3	Malta	3.0	0.0	0.0	0.0	0.0	2.0	3.0
1	Belgium	1.0	0.0	1.0	0.0	1.0	2.0	2.4
3	Czech Rep	3.0	0.0	0.0	3.0	0.0	4.0	2.1
2	Ireland	3.0	0.0	0.0	1.0	1.0	3.3	2.1
2	Greece	1.0	1.0	0.0	0.0	0.0	1.3	1.5
3	Slovenia	3.0	0.0	0.0	0.0	0.0	2.0	0.9
3	Slovakia	0.0	0.0	0.0	0.0	0.0	0.0	0.3
3	Cyprus	0.0	0.0	0.0	0.0	0.0	0.0	0.0
1	France	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2	Portugal	0.0	0.0	0.0	0.0	0.0	0.0	0.0
1	Founding MS[c]	1.8	1.0	0.7	1.2	1.2	3.9	4.0
2	Other Western MS[c]	2.4	1.9	2.0	2.1	1.8	6.8	5.4
3	Central MS[c,d]	1.8	1.0	1.5	1.5	0.7	4.3	3.7
All	EU-25[d]	2.1	2.1	2.1	2.1	2.1	5.1	2.1

[a] From 0 (worse) to 10 (best). [b] Based on a wider set of indicators (Messerlin 2005). [c] MS = Member States. [d] No available information on Bulgaria and Romania.

Source: European Commission, Communication COM (2005) 97 final, March 2005.

Preliminary evidence suggests serious problems with the Commission's existing RIAs (Messerlin forthcoming). First, although the RIAs are undertaken in-house, the rationale for the choice of topics is unclear. Commission's RIAs do not focus on issues that would seem the natural candidates for such an exercise, namely the issues under the EU exclusive competence, or those covered by the *acquis communautaire* or those involving a large share of the EU budget. Second, and more importantly, the Commission's RIAs do not deal with the basic questions that RIAs are normally expected to address – such questions are listed in the Best

Practice Regulation Handbook (OBPR 2007). For instance, the many recent RIAs on issues under EU exclusive competence (competition, fisheries and taxation) make no mention of the consumer interest (the term ‘consumer’ is used only three times in texts 100 pages long) or of possible regulatory failure – a particularly shocking silence in the fishery RIAs devoted to overfishing if only because the EU Common Fishery Policy grants massive subsidies to EU fishermen. Lastly, the Commission’s RIAs often seem to be undertaken *ex post* or at least too late to have any chance of influencing the decision-making process. In short, they look less like objective assessments of the rationale, scope, and shape of regulations, and more like justifications of decisions that have already been made.

The first tremor of the services directive: the ‘mutual evaluation’ process

In 2004, the EU Commissioner for the Internal Market, Mr. Frits Bolkenstein (a Dutchman well aware of his country’s initiatives on ‘better regulation’) tabled the so-called ‘Services directive’. His proposal grew out of the frustration generated by the absence of progress in the Internal Market in services. The Services directive covered sectors and topics not yet covered by previous directives. Much more crucially, it tried to offer an alternative liberalization model to the one found in previous directives, based on harmonization and mutual recognition.

The proposal faced unprecedented opposition – from the debate during the French referendum (when the ‘Polish plumber’ image was forged) to fierce fights in the European Parliament and Council. What was fascinating was the unholy alliance of opponents that the Services directive managed to bring together, from class-struggle-based trade unions to a host of private vested interests (such as the legal profession which is among the most protected in the EU). The target of this coalition was the ‘principle of the country of origin’ (see below), which was included in the directive’s initial version, but not in the final version adopted in December 2006.

Does the truncated version of the directive have any chance of making a substantial impact on the regulatory reform process in Europe? The answer is yes, for the following reason.

One source of EU law is the rulings of the European Court of Justice. Such rulings can, as with any jurisprudence, be reversed. However, the likelihood of such reversals is very limited for some topics, such as the prohibition of requirements based on nationality or the case-by-case application of an ‘economic test’ in order to be registered. The Services directive systemizes these rulings by prohibiting them explicitly (Article 14), thereby improving legal certainty in the Internal Market.

Much more importantly from the regulatory reform perspective, there are many other rulings that rely on the 'rule of reason', such as quantitative or territorial restrictions, requirements fixing a minimum number of employees, etc. Such practices have not been systematically condemned by the Court of Justice because they can make economic sense in specific circumstances. As a result, the risk of reversal is much higher, and could depend on the quality of legal procedures more than on economic substance. The level of legal certainty is therefore much lower.

The Services directive makes the elimination or the adjustment of these more controversial provisions (listed in Article 15) conditional on an assessment procedure of 'mutual evaluation'. Article 39 states that the transposition period should be used by the Member States 'to conduct a screening of their legislation in order to ascertain whether requirements reserving access to certain activities to particular providers exist in their legal systems' (General considerations, paragraphs 74 and 73). The evaluation process is 'mutual' in the sense that each Member State's reports are forwarded to the other Member States, which are allowed to comment.

The critical importance of the 'mutual evaluation' procedure flows from the fact that it defines a dynamic process of regulatory reform rather than a static liberalisation programme *per se*. That said, the lawmakers have imposed very tight deadlines on the mutual evaluations process: final reports should be ready by December 2009. This deadline might be unrealistic enough to cast some doubts as to the extent to which EU lawmakers realize the critical importance of the 'mutual evaluation' process. Time pressures are likely to favour 'quick and dirty' reports. However, despite these shortcomings, the key process behind regulatory reforms – assessing the costs and benefits of existing and future provisions – seems to have been shifted to the core of the EU agenda in a way that seems difficult to reverse.

The second tremor of the services directive: how to liberalize services

As indicated above, the Services directive was fundamentally a reaction to the frustration engendered by the disappointing spread of liberalization in EU services markets. The initial draft of the directive represents a huge contribution to the 'technology' of services liberalization in the form of the proposed 'principle of country of origin' (PCO).[10] The PCO is not included in the final version adopted by the lawmakers, but this is unlikely to put an end to the debate on how to truly liberalize services.

[10] The 1989 and 1997 Directives on Television without Frontiers already included a PCO provision. But it did not trigger any reaction because the audiovisual firms have been very careful not to use such a provision.

Understanding the huge progress represented by the PCO requires a clear understanding of the role of domestic regulations in shaping the comparative advantages of services providers. Domestic regulations should be seen as a critical part of the production function of domestic services providers. They are very similar to the production technology that is available to all goods producers in a country, and which these producers combine with their own, firm-specific, production technology in order to make the final product. This combination defines the comparative advantages of the producers. Similarly, the combination of domestic regulations with firm-specific legal technology determines the comparative advantages of a country's service providers.

This view explains the almost complete failure of harmonization, and the relative failure of mutual recognition, in services liberalization. Harmonization (defined as creating a new set of regulations to be substituted for national regulations) is similar to imposing the same production technology on all domestic and foreign producers of a particular good. It is thus easy to understand that, since it destroys a key source of their comparative advantages, both domestic and foreign firms alike, fiercely rejected it. When it amounts to imposing the host country's regulations on foreign service providers, harmonization is indeed non-discriminatory in a *de jure* sense. But this kind of national treatment is a severe handicap imposed on foreign service providers, since it deprives them of the comparative advantages embedded in their home country's regulations. That said, it is important to stress that these strong limits to harmonization are not inconsistent with the request often expressed by firms for harmonized regulations. When expressing such a desire, firms generally have in mind harmonized regulations that would be close to their existing domestic regulations. But when they realize that the proposed harmonized regulations would substantially differ from their existing regulations, firms oppose such a move.

Mutual recognition, on the other hand, only deals with non-core provisions, and requires harmonization of core provisions. Its success thus depends heavily on the scope of the core provisions to be harmonized. This core is defined by negotiations between the countries involved. The larger the scope, the less successful mutual recognition can be. As foreign and domestic service providers endeavour to include provisions that define their own comparative advantages in the core, inevitably the set of core provisions becomes too large. Thus there is considerable disillusionment, both within the EU and more broadly in the global trade community, with mutual recognition as a services liberalization instrument, and as an alternative to harmonization.

Moreover, by eliminating a critical source of the initial comparative advantages of service providers, mutual recognition also tends to reduce the incentives for countries to improve their domestic regulations. If they are excluded from the core provisions such improvements would not help domestic firms operating in foreign markets. As a result, the world dynamism of the regulatory reform process is not necessarily enhanced by international agreements based on mutual recognition. The push for regulatory reforms still relies predominantly on domestic considerations – hence, the observation above that many laggards remain laggards in a world dominated by the mutual recognition principle.

All these arguments lead to the conclusion – drawn by the initial draft of the Services directive – that the only way genuinely to liberalize services is to include governments in the competitive regulatory game, and recognize them as key providers of a part of each firm's production technology. This can be achieved by having them submit to the PCO. The PCO means that each service provider can operate under the regulatory framework of its origin country, which could be its national origin, or an origin defined by a conscious choice. It is the only principle that allows a service provider to keep and exploit fully the comparative advantages drawn both from the firm *per se* and from the country where it initially developed its operations.

5 Regulatory reforms: what for?

This section examines at the most important condition for the success of the regulatory reform process in Europe, namely the capacity of European people to realize that regulatory reforms do not only improve efficiency, but also something much closer to their daily life – 'happiness'.

A large number of Europeans – politicians and citizens alike – are convinced that economic and regulatory reforms improve economic efficiency and growth (or, in antiglobalizers' language, maximize the profits of multinationals), but that is all they do. Economists are largely responsible for this conviction to the extent that their work has almost exclusively focused on the relationship between reforms and efficiency (see above).

Such a focus generates the following problem. More efficiency and growth have only limited appeal in relatively affluent European societies. This is particularly the case for those European societies that are having difficulties realizing just how much the world is changing, either because they trade predominantly with other EU countries (as in France), or because they are less exposed to immigrants. (Most of the EU Member States have a much lower share of foreign-born residents than countries such as Australia or even the United States.) Such societies tend to develop 'Middle Empire' syndrome, as in post-fifteenth century China. As long as they do not feel that they are on the verge of an incurable decline – the word ‘decadence’ has been a buzzword in Paris over the last couple of years – they are not ready to undertake necessary economic and regulatory reforms for reasons of efficiency only. The Chinese case shows how long it can take to stop the decay, and how painful such efforts can be after a long decline.

Rather than efficiency, what tends to count in such affluent but protected societies is a sense of justice and a desire for happiness. In fact, this kind of justice is usually much more about fighting inequality than poverty. Inequality is largely driven by education, however, which means that regulatory reforms can amplify the impact of educational reforms, but they cannot substitute for them.

So what about happiness? Economists have some good reasons to be cautious about speaking out on such a fuzzy notion. But such caution can also be a form of blindness. What follows is an – admittedly heroic – attempt to present regulatory reforms in the context of happiness.

Figures 4 and 5 illustrate the relations between the level of happiness and two indicators of economic and regulatory quality for 49 countries. Both figures are based on the Quality of Life Index provided by The Economist Intelligence Unit for measuring happiness. Figure 4 is based on the Economic Freedom Index, and figure 5 on the summary indicator of the Ease of doing Business (see above). Both figures suggest a positive relationship between happiness and the quality of the economic and regulatory framework. Such a relationship also holds with other indexes of happiness.

How can such a positive relationship be interpreted? An attractive interpretation is strongly suggested by a point repeatedly made in recent years by many European politicians, from former Prime Minister Blair to President Sarkozy. Indeed, Sarkozy’s presidential campaign was almost entirely based on this point. It is that people derive happiness not only from consumption and leisure, but also from production and work. Better regulations offer people new opportunities to express their innovative abilities at work. Many Europeans are eager to achieve some objective during their life. It could be running a small shop or heading a large firm – that depends on the initial endowments of the individual in question, that is, the quality of their education. But good regulations are what make such achievements possible.

Figure 4 **Happiness and regulatory reforms**

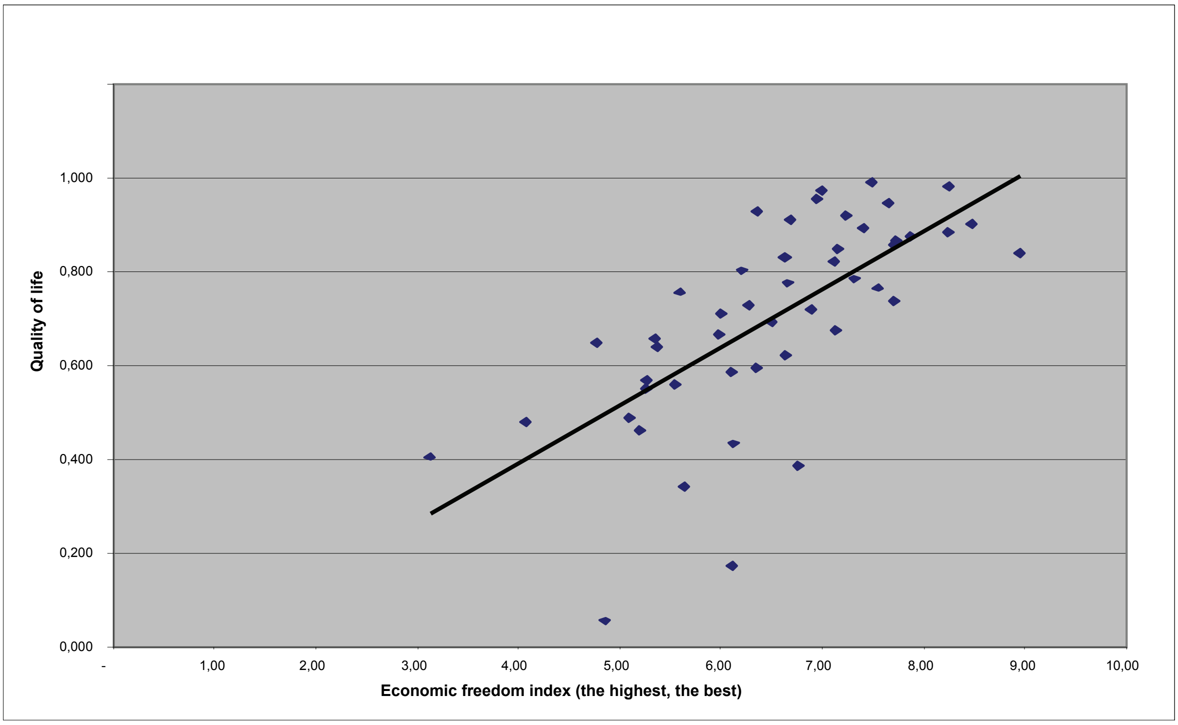
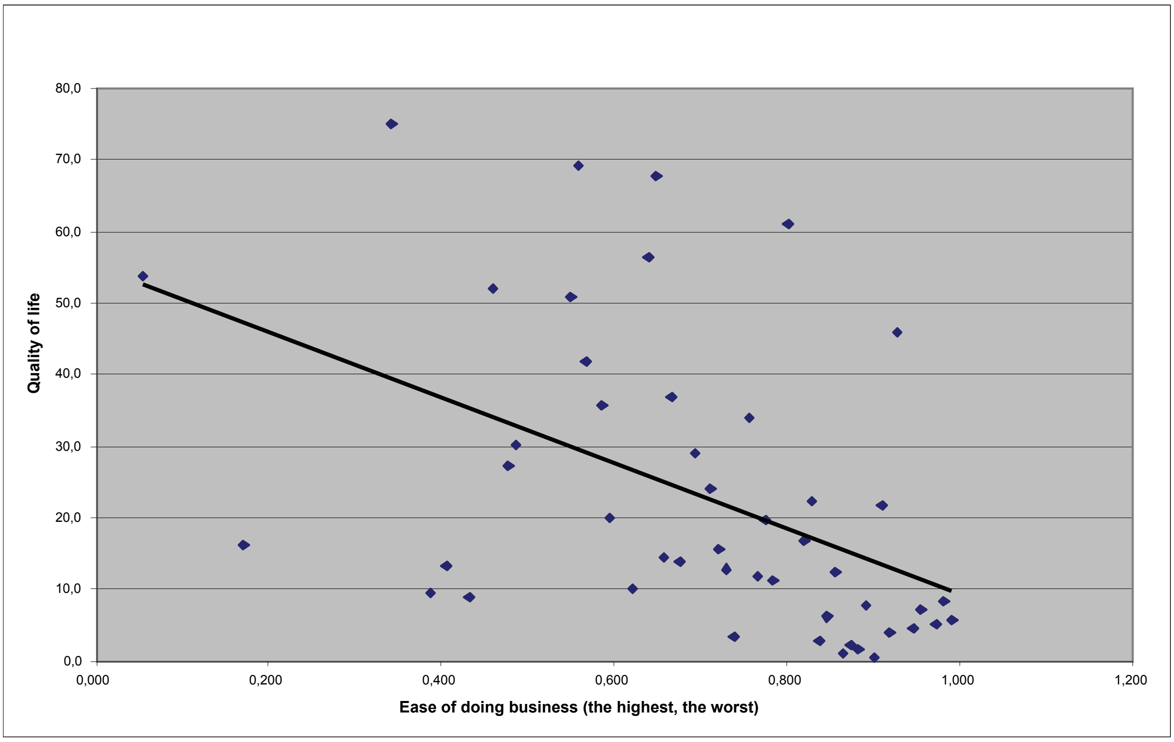


Figure 5 **Happiness and regulatory reforms**



6 Concluding remarks

A few months ago, Adam Posen from the Peterson Institute for International Economics wrote a piece provocatively entitled 'Liberalism needs central power'(*Financial Times*, 3 July 2007). He argues that 'the more the central body has authority over economic policy, the greater the liberalizing influence' and that 'subsidiarity is in many cases an invitation to corruption, entrenchment of incumbents and horse-trading of handouts'. His key point is that the EU Commission should get more power *vis-à-vis* the Member States, if Europe wants to make a come back. I disagree with this conclusion for two main reasons.

The first is based on a quick look at recent history. Had the Commission been a strong, central power in the 1970s and early 1980s, it would surely have crushed the Thatcher-era regulatory reforms that went on to conquer Brussels in the 1990s. Indeed, the early 1990s saw the Commission crush the ongoing reforms in Swedish agricultural policy in the name of the *acquis communautaire*. The reason for such pessimism is simple. The Commission has almost no political legitimacy, forcing its staff to push for measures that they may privately dislike, but which are dictated by the delicate balance of power amongst the political masters of the time.[11] Indeed, observers have noted an increasing tendency among EU Commissioners to vote as representatives of their own Member State rather than as a European decision-maker.

The second reason is the EU's unparalleled heterogeneity, as described earlier. Most observers have difficulties factoring in this aspect, because they tend to compare Europe to the United States (a much more homogeneous region). But this heterogeneity comes up again and again, and the Commission is the least well positioned to deal with it. For instance, the 2005 debate on the 'European social model' led many French opposed to the pro-market stance of the Services directive to believe that Denmark and Sweden would be their natural allies. But in the end, they found that the notion of a minimum wage, which is dogma in Paris, is anathema in Copenhagen or Stockholm.

All of these reasons might look defensive, and give the impression that nothing can be changed in Europe. Since tonight I have the luxury of speaking in a country that seemed hopelessly protectionist three decades ago, and that is firmly free-trade oriented today, let me tell you the positive side to my criticisms of Posen's remarks.

[11] The question '*Qui t'as fait roi?*' (Who made you the King?) represents the bottom line in European politics today. This question was put to Hugues Capet (elected King of France in 987) who founded the dynasty that ruled France until 1848 (with the exception of the Revolution and First Empire). It took five to six centuries for the French royals to eliminate the implicit threat it contains.

First, the Commission needs to be freed. Since it will not have any notable political legitimacy for a long time to come, its tasks should be clarified. Its role as an implementing agency should be clearly distinct from its role as an institution in charge of developing initiatives, and from its role as an evaluation agency. It is beyond the scope of this paper to propose concrete ways of bringing about such a clarification – perhaps it should be broken up, or perhaps there is some other solution (which could be a matter for discussions for the proposed 'Committee of wise men' (Bertelsmann Foundation 2007)). But the success of the EU endeavour has clearly blurred the frontiers between these three roles, to the detriment of all of them: implementation work is often distorted by new initiatives, the initiation role is burdened by mistakes in implementation, and the evaluation work looks suspiciously like a defence of past implementations and future reforms. Without some clarification, the Commission will be less and less able to promote European welfare.

Second, the EU's heterogeneity has a positive force that has gone unused for too long. The EU is a group of a half-dozen large Member States surrounded by eighteen small countries, which act as a kind of competitive fringe. Such a structure can be very dynamic, and indeed is quite close to the definition of a competitive market. The last two decades have made clear the capacity of small and successful Member States – Estonia, Ireland, the Netherlands and Sweden – to launch initiatives that first challenged and irritated the large Member States, but which subsequently were adopted by them.

A clearer understanding and better use of these dynamics are necessary. For instance, the principle of the country of origin may be difficult to introduce at the level of the whole EU. However, it might work well for a subset of willing Member States. Testing this principle in narrower circles may show that the fears it generated are misplaced, so long as things are properly worked out. After all, this is exactly what the half-dozen Member States with their new approach to regulatory reforms have done.

That said, the critical condition for success is a 'culture of evaluation'. Regulatory reforms should not been done blindly, as is too often the case in Europe today. They should be based on appropriate analyses, and explained to the European people. Because, ultimately, what will trigger regulatory reform is the understanding among Europeans that it brings not only efficiency, but also greater happiness.

References

Bertelsmann Foundation 2006, *International benchmark of administrative burdens related to selected EC directives in the Netherlands, Germany and Denmark*, Final Report, Bertelsmann Foundation, the Administrative Burden Department of the Dutch Ministry of Finance (IPAL) and the Danish Commerce and Companies Agency (DCCA), July.

—— 2007, *A chance for wise men*, Spotlight Europe no. October 07.

Brecht, B. 1953, *Die Lösung (The Solution)*, Buckower Elegies, Methuen, London.

Cecot, C., Hahn, R. W. and Renda, A. 2007, *A statistical analysis of the quality of impact assessment in the EU*, Working Paper 07–09, AEI-Brookings Joint Centre for Regulatory Studies, Washington DC, May.

Deutsche Bank Research 2007a, *Better regulation in Germany and the EU*, Reports on European integration, EU Monitor 47, http://www.dbresearch.com

—— 2007b, *Germany cresting the wave*, More growth for Germany, Current Issues, September, http://www.dbresearch.com

Eurobarometer, Annual, *Standard Spring Polls*, European Commission, Brussels.

Fraser Institute 2007, *Economic Freedom Indexes*, Report 2007, Economic Freedom Network, Vancouver.

Gwartney, J., Lawson, R., Hall, J., Sobel, R. and Leeson, P. 2007, *Economic Freedom of the World*, 2007 Report, Economic Freedom Network, Vancouver.

Hahn, R. and Litan, R. 2004, *Counting Regulatory Benefits and Costs: Lessons for the US and Europe*, AEI-Brookings Joint Centre for Regulatory Studies and Groupe d'Économie Mondiale at Sciences Po (GEM), http://gem.sciences-po.fr

Hahn, R. and Tetlock, P. 2007, *Has economic analysis improved regulatory decisions?*, AEI-Brookings Joint Centre for Regulatory Studies and Groupe d'Économie Mondiale at Sciences Po (GEM), http://gem.sciences-po.fr

Herzog, R. and Gerken, L. 2007, 'An article on the EU constitution', Centrum für Europäische Politik, *Welt am Sonntag*, Germany, 14 January.

Messerlin, P. 2005, *Europe after the 'No' votes*, Institute of Economic Affairs (IEA), London.

—— forthcoming, *Question on the Commission's Regulatory Impact Assessments*, Working note, Groupe d'Économie Mondiale at Sciences Po (GEM).

—— and Wang, J. 2007, *The EU trade policy towards China*, mimeo, Groupe d'Économie Mondiale at Sciences Po (GEM), http://gem.sciences-po.fr

Office of Best Practice Regulation (OBPR) 2007, *Best Practice Regulation Handbook*, Australian Government, http://www.obpr.gov.au

Pelkmans, J. 2007, *How social is European integration?*, Bruges European Economic Policy Briefings, Briefing no. 18, http://www.coleurop.be/eco

Pew Global Attitudes Project 2007, *Survey*, October, http://www.pew.com

Productivity Commission 2006, *Productive Reform in a Federal System*, Roundtable Proceedings, Productivity Commission, Canberra.

Wolf, M. 2007, A cynical plan for an unnecessary European treaty, *Financial Times*, 19 June.

World Bank 2007, *Doing Business*, Washington DC, http://www.doingbusiness.org