COVER SHEET

EU institutional reform: Evidence on globalization and international cooperation

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According to received wisdom, globalization fosters cooperation on economic governance at the international level since it hinders governments' ability to govern unilaterally. This hypothesis is difficult to test. Most economic integration is slow and clear examples of international cooperation are rare. The EU, by contrast, has seen rapid and well defined economic integration since the mid-1980s accompanied by equally rapid and well defined reform of its economic institutions. If the received wisdom is right, the EU's rapid economic integration should have been associated with a transfer of economic policy sovereignty to the supranational level. This paper marshals several strands of evidence in support the received wisdom, although the relationship in the EU is clearly two-way. Economic integration makes governments more interested in international cooperation, but the institutional reforms that facilitate such cooperation also facilitate deeper economic integration.

I. EU ECONOMIC INSTITUTIONS

Much of the policy that governs economic activity in EU economies is made by supranational (SN) decision procedures. Just as U.S. States are bound by Acts of Congress that their Congressmen oppose, EU nations must implement EU legislation even if they oppose it. Not all policy areas are subject to SN procedures. In sensitive areas (e.g. taxation and international

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migration) members have a veto, so nations are only bound to what they agree. Such inter-governmental (IG) decision making is the standard form of international cooperation (e.g. the Kyoto Protocol).

Discussion of how EU decision making has evolved requires some institutional background (see Richard Baldwin and Charles Wyplosz 2005 for details). Roughly speaking the lawmaking procedure follows the classic bicameral setup with the European Commission as the agenda-setting executive, the Council of Ministers as the upper house and the European Parliament as the lower house. However, the Commission and Council are unelected. Commissioners are appointed by members, and each member sends a minister to represent its interests in the Council. The European Parliament (EP) is directly elected.

Most EU lawmaking entails weighted voting called Qualified Majority Voting (QMV). Each Minister in the Council has a certain number of votes; populous nations have more votes, but much less than population proportionality would suggest. The Council's threshold for passage is about 70% of the votes. Member of European Parliament (MEP) have one vote each; populous nations have more MEPs but again fewer than strict proportionality would suggest. The EP's usual threshold is 50 percent. Since the Council's majority threshold is tighter, the EP's vote has little impact on national power. If MEPs voted on national lines, they would have little influence. Anything that attracted more than 70 percent of votes in the Council would easily pass the EP's threshold, so it is common to focus solely on the Council when it comes to national influence.

All this concerns 'secondary' law. 'Primary' EU law is embodied in the Treaties, starting with the Treaty of Rome (ToR). Collectively, these act like a constitution, establishing institutions, decision-making procedures, and allocating power between the EU and its members. Primary law can only be changed by the adoption of a new Treaty, which requires unanimous approval of all members and a majority vote by the EP. Four Treaties have been implemented over the past 25 years: the Single European Act (SEA), and the Maastricht, Amsterdam and Nice Treaties.

The final key player is the EU Court. The Court's rulings are the supreme authority in the EU on areas in which the Court has jurisdiction (most SN economic policy issues). Court rulings can overturn any national law or national court ruling and they have the force of law in all member nations. They cannot be appealed. While logically necessary given the supranationality, such supremacy is certainly the most unusual aspect of EU economic governance.

II. QUALITATIVE EVIDENCE

No type of EU lawmaking is easy but unanimous decisions are especially difficult. For example, massive cross-border VAT fraud (acknowledged and studied for more than a decade) costs members billions every year, but since decisions must be unanimous, the Council has for years failed to agree technical remedies (e.g. centralizing information or obliging cooperation among national VAT authorities). Until 1987, most EU economic policy was made on an IG basis (unanimity in the Council). Little got done beyond maintenance of the customs union and the Common Agriculture Policy (CAP).

One of the clearest signs of increased cooperation is found in the shifting of many policy areas from the IG basis (unanimity) to the SN basis (QMV). The biggest change came with the 1987 SEA. QMV became the decision rule for most issues pertaining to the Single Market (free movement of goods, services, workers and capital), thus switching an enormous swath of policy decisions form IG to SN. This shift is best thought of as an exogenous big-push initiative – something like the EU's equivalent of the Thatcher-Reagan pro-market reforms of the 1980s. With the SEA in place, the integration-minded Commission (led by Jacques Delors) rapidly expanded the range of areas covered by SN procedures using its agenda-setting power and the

ToR’s broad goals. Members reigned in this tendency by establishing three categories, or ‘pillars’, of policy in the 1992 Maastricht Treaty and explicitly limiting SN to first-pillar matters (basically the Single Market). In matters of defense and foreign policy (second pillar), and home and justice affairs (third pillar) decision making is IG.

Members are reluctant to expand QMV to new areas but the rising importance of immigration, and transnational crime and terrorism has led to the switching to QMV in several areas previously considered matters of purely national concern. I take this as qualitative evidence that EU members have reacted to globalization by embracing deeper international cooperation. Specifically, the Treaties in 1997 and 2000 moved a number of areas to QMV.

Additional qualitative evidence can be found in the EP’s growing power. Initially, it had a merely consultative role with no power to block or amend. It has gained power in each of the last four EU Treaties and will gain even more if the Reform Treaty is ratified. While the justification was that this lessens the ‘democratic deficit’, it also reduces members’ ability to set economic policy unilaterally. Since each nation could have vetoed this, they all must have approved of this restriction on their national sovereignty in economic policy.

The final bit of evidence is found in EU enlargement. Given the EU’s economic size, nations on its fringes are unable to control economic policy unilaterally. Their own industries demand that national policies mimic EU laws to avoid the cost of two sets of rules. Nations such as Switzerland and Norway resisted joining but have instead signed agreements that oblige them to implement most EU laws in exchange for equal access to the EU market. They have, however, no formal input into the lawmaking process. Most nations in Europe looked at this ‘regulation without representation’ and decided that they would have more control inside the EU despite

QMV. Enlargement, can thus be thought of as an indication that nations faced with deeply integrated markets feel they gain control from pooling their sovereignty on economic policy.

III. A MODEL OF THE FLOW OF EU LEGISLATION

The EU passes hundreds of legislative acts annually. This flow has gradually fallen over the past two decades and this might be taken as evidence against the received wisdom. This conclusion, however, overlooks the fact that the flow of laws is governed by the balance of decision-making costs and benefits. Since the received wisdom concerns only the benefits, I posit and estimate a model that distinguishes changes in decision-making costs and benefits.

Decision-making costs – in the sense of James M. Buchanan and Gordon Tullock (1962) – vary enormously over different policies. Some laws are passed in a single day; others take years. Roughly speaking, policies that entail international redistribution are more contentious and thus have higher decision-making costs. What determines which laws are proposed and passed? I suggest that laws are passed up to the point where the marginal decision-making cost just equals the marginal benefit. The neoclassical supply and demand curves are the marginal cost and marginal benefit curve, respectively, so I think of this as a supply and demand model of EU lawmaking. The payoff to this insight is that the decision-making cost is also an indication of its marginal benefit – just as the price in a competitive market is equal to both the marginal production cost and marginal benefit to consumers.

While decision-making costs are impossible to measure directly, political scientists Thomas Koenig, Brooke Luetgert, and Tanja Dannwolf (2006) have gathered a rich dataset that includes the number of days between each law's formal proposal and its adoption. I take this as a proxy for the average decision-making cost.

Figure 1 shows the available data (1985 to 2002 aggregated annually) on the number of laws and the mean delay. The data shows a clear drop in the number of laws passed. Is the reduced flow due to an inward shift of demand (marginal benefit), or an inward shift of supply (marginal cost)? To answer this, I estimate a supply and demand model.

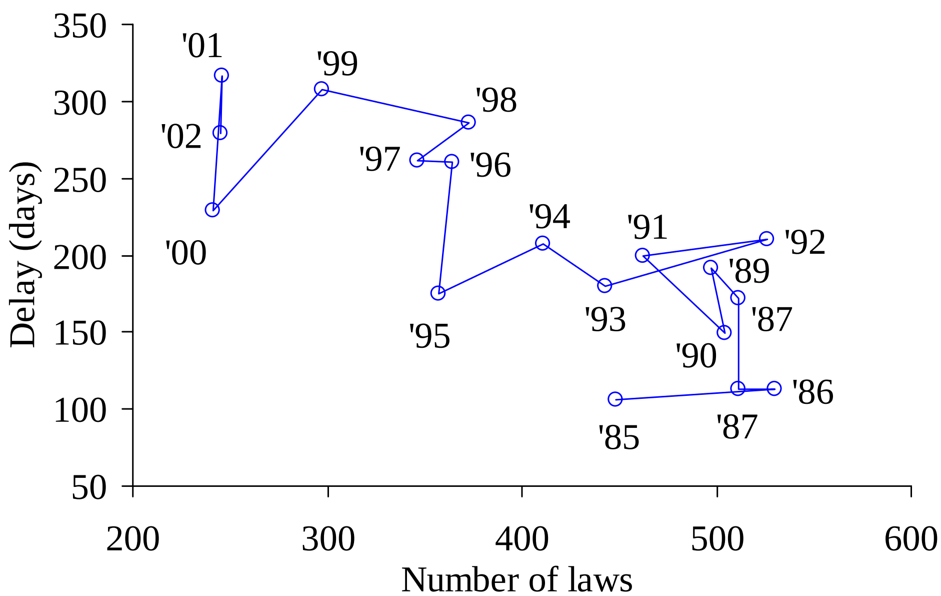

FIGURE 1–SUPPLY AND DEMAND FOR EU LAWS

The demand equation involves the delay (price) and demand-shifters. The received wisdom suggests that economic integration should shift out the demand for EU laws. My proxies for economic integration are dummy variables for the major pro-market Treaties (the SEA and the Maastricht Treaty). The supply curve is assumed to shift in response to the difficulty of decision making. Since laws tend to get more difficult to negotiate as the cumulative level of integration rises, I take a time trend as a simple proxy and use this as the supply-shifter in the first instance. The three-stage least squares estimation results are displayed in Table 1.

The first two columns show the estimated demand and supply curves. As expected, the demand slope is negative and the supply slope is positive (although not statistically different from flat). The variables of interest – the proxies for deeper integration – turn out positive but only the SEA is statistically significant. The supply shifter, as expected, is negative and significant indicating that the supply curve is gradually shifting to the northwest.

TABLE 1–THREE STAGE LEAST SQUARE ESTIMATES OF THE SUPPLY AND DEMAND FOR EU LAWS

	Demand	Supply	Demand	Supply
Delay	-1.05	0.13	-0.32	0.48
	(0.19)**	(0.32)	(0.14)**	(0.33)
SEA	85.1		40.7	
	(25.1)**		(16.6)*	
Maastricht	34.0			
	(25.4)			
Trend		-18.0		-22.7
		(3.7)**		(4.1)**
Overall Openness			-9.4	
			(1.5)**	
R2	0.73	0.56	0.93	0.85

Notes: Standard errors in brackets. * and ** indicate significance at 5 and 1 percent. SEA is 1 from 1987 to 1992 and Maastricht is 1 from 1994 to 1999, otherwise 0.

One standard measure of economic integration is overall trade openness as defined by the sum of imports and exports over GDP. When this is included as another demand shifter its influence is estimated as negative. This suggests the intriguing possibility that overall openness dampens the demand for EU cooperation while EU specific measures, like SEA, increase the demand.

Although these results require further exploration and an expansion of the data sample, they are broadly supportive of the idea that the equilibrium flow of EU laws balances the marginal benefit (demand) and marginal cost (supply) for laws with the delay acting as a proxy for the 'price.' Assuming the Commission proposes laws up to the point where the marginal cost equals the marginal benefit, the delay is a proxy for the decision-making marginal benefit as well as the marginal decision-making cost. As such, the rising delay is consistent with the hypothesis that globalization has increased the value of cooperation.

IV. SHIFTING POWER AND THE NATURE OF EU COOPERATION

In the words of its founding Treaty, the EU is both a 'union of states' and a 'union of peoples'. This principle shows up in the allocation of votes in the Council. A pure union of states would allocate equal voting power per nation (as in the UN General Assembly). A pure union of citizens would allocate power among nations so as to yield equal voting power per person (as in a proportional-representation democracy). The actual EU power distribution is a blend.

If the received-wisdom hypothesis is correct, globalization should have driven the EU toward the 'union of citizens' pole as nations become less able to govern unilaterally. As Annick Laruelle and Mika Widgren (1998) show, game theory allows a formal analysis of the blend between the union of states versus citizens. Here the analysis is extended to consider the most recent institutional changes – the Nice Treaty voting reforms, the subsequent enlargement to 25 then 27 members, and the proposed voting changes in the Reform Treaty.

The pure equipotent-states power-distribution is obvious; each member should have the same power. The pure equipotent-citizens distribution is more complex but well understood among voting theorist since Lionel Penrose (1946) first proved it; each nation should have a number of votes that is proportional to the square-root of its population (see Richard Baldwin, Erik Berglof, Francesco Giavazzi, and Widgren 2001 for the logic of this so-called Penrose rule).

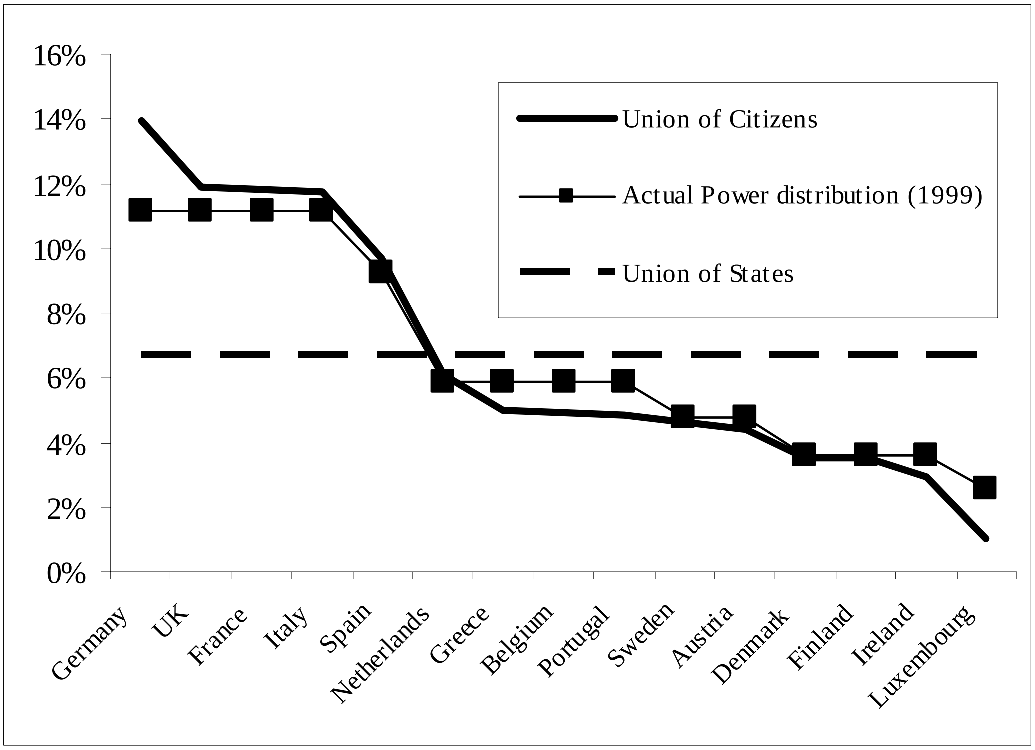

FIGURE 2: THE 2-UNION VIEW OF EU POWER DISTRIBUTION

But how does one measure the actual power distribution? Cooperative game theory provides a measure called the normalized Banzhaf index (NBI) of power. Roughly, the NBI indicates how likely a nation is to find itself in a position to "break" a winning coalition on a randomly selected issue, assuming that nations' yes-no positions are independently and identically distributed. Each member's NBI is calculated by working out all possible yes-no coalitions and using the QMV rules to identify the winning coalitions. Each winning coalition is then examined and the likelihood of each nation breaking a winning coalition is calculated and normalized so the NBIs add to unity. Deriving the NBI is calculation-intensive (there more than 1.3 million coalitions in the EU27) but straightforward. Note that Heikki Kauppi and Widgren 2004 demonstrate the relevance of such power indices by showing that they are excellent predictors of one of the most easily measured outcomes of power, namely members' shares of the EU budget. Figure 2 shows how the actual power distribution can be thought of as a weighted average of the two extremes, with least squares identifying the weighting.

The actual and equipotent-citizen power distribution changed with each of the six enlargements. Table 2 shows the estimated weight on the union-of-citizens distribution for each configuration. The weight was near 80 percent for most of the EU's history, but moved sharply up with the 2004 enlargement. The driving force behind this change was the Nice Treaty voting reforms (first applied to the EU25), which shifted much power to large members. The justification for this reform was that decision making with so many small members would be unmanageable under the old rules which gave small and tiny members power shares far in excess of their population shares. The proposed Reform Treaty rules will shift even more power to big members, especially Germany.

TABLE 2–EU POWER DISTRIBUTION AND UNION OF CITIZENS WEIGHTS

	Reform Treaty	EU27	EU25	EU15	EU12	EU10	EU9
Weight on Union-of-Citizens	1.06	0.92	1.08	0.78	0.79	0.84	0.82
s.e.	0.05	0.04	0.05	0.04	0.04	0.05	0.04
R-square	0.94	0.96	0.95	0.97	0.97	0.97	0.98

Notes: Ordinary least square regression of square-root population shares on NBIs.

The statistical results together with the qualitative discussion motivating the Nice and Reform Treaty voting reforms presents support for the notion that EU members have agreed to changes in their economic policy making institutions in order to maintain their ability to make SN decisions. This of course does not directly confirm the received wisdom. No causality can be ascribed to the correlation between the shift toward the union-of-citizens power distribution and progressive integration, but the correlation is consistent with predictions of the received wisdom.

V. CONCLUDING REMARKS

This short paper argues that deep economic integration in Europe reduced the effectiveness of unilateral economic policy making and members reacted by embracing deeper international cooperation. The process, however, was two-way – deeper lawmaking cooperation facilitated deeper economic integration and vice versa.

The state of globalization in most parts of the world is decades behind the degree of economic integration among EU nations, but the negotiating agenda of global and non-European regional trade agreements are expanding and now go far beyond border measures such as tariffs and quotas. If this trend continues, nations are likely to find it increasing difficult to manage their economic policies in isolation. The attraction of international cooperation on issues such as product standards, investment rights, intellectual property rights, financial markets etc. will grow. While the EU is unique in many aspects, the institutional and political reaction of EU nations to economic integration provides lessons for the rest of the world. As global integration deepens, nations are likely to find their interests are best served by deepening international cooperation on economic policies.

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