The Governance System of the European Union

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Abstract: *The European governance is an institutional arrangement enabling the cooperation and the competition among the states, the individuals and the pressure groups looking to maximize their welfare. The European governance system is a multi-level non-hierarchical structure, and authority is shared among the supranational bodies, as well as among the latter and the Member States.*

The structure of the European governance system is influenced by the need to achieve a political balance among the stakeholders, in the environment of a permanent conflict among the public interest regulations and the "captive" regulations (George J. Stigler[1]), the latter being determined by the rent extraction/ rent seeking.

In this short analysis I describe the European governance, taking into account the policy-making framework under, "Two-pack", "Sixpack", and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) that increases the power of the supranational bodies[2] .

For this purpose I embarked on two different approaches: the economic theory of regulation (G. Stigler, G. Tullock, S. Peltzman, R.Posner) and the normative theories on power distribution. For the time

[1] George J. Stigler: „ The Theory of Economic Regulation. The Bell Journal of Economics and Management Science, Volume 2, Spring 1971.

[2] Commission and the European Court of Justice.

being there is no bridge between these two theories. However, in the specialised literature, the approach to European governance system is mainly based on the normative theories on power distribution (the integration theories).

The economic theory of regulation expresses the economic rationale of the decisions made by the EU supranational bodies and by the Member States at national level. This theory also helps the understanding of the behaviour at the supranational level of certain states whenever they negotiate economic policies (e.g. with regard to currency, energy, tax coordination). For this reason, the economic theory of regulation is the framework for adjust the inefficient institutions[3] whereas identifies solutions for public policies.

The normative theories on power distribution emphasize how the competencies are shared among the supranational bodies and the EU Member States, as well as inside them. These theories are important mostly to emphasize how the power distribution has an influence on resource allocation and which group controls the resources allocation[4] .

I included here both the neo-intergovernmentalism and the neo-functionalism dealt with by the specialised literature as integration theories, along with the competitive federalism.

Keywords: Economic theories of regulation, normative theories on power distribution, inter-jurisdictional competition, neofunctionalism and intergovernmentalism, competitive federalism, principal – agent.

[3] Useful study/working paper written by Daron Acemoglu: „Modeling Inefficient Institutions", National Bureau of Economic Research, Working Paper 11940 January 2006, and Cambridge University Press, 2006.

[4] Daron Acemoglu: „Modeling Inefficient Institutions", National Bureau of Economic Research, Working Paper 11940 January 2006, and Cambridge University Press, 2006

I. European governance

The EU governance system[1] evolved in 50 years, as a reflection of neo-intergovernmentalism. The European governance system is a multi-level non-hierarchical structure, and authority is shared among the supranational bodies, as well as among the latter and the Member States.

The European governance relies on regulations and subsidies granted to[2] Member States. In principle, regulations are targeted to mitigate the market failure, in the context of a non-optimal allocation of resources by the private operators. This means that whenever a discrepancy appears between the private cost and the social cost, namely a market failure, the public intervention is inevitable. I envisage only two situations: negative externalities and monopolies.

Within a distorted market, both the producer and the consumer seek to adjust their own costs, but they do not consider the social costs assumed by others, and this leads to negative externalities. From this point of view, the public intervention is "legitimate", although establishing the cost sharing pattern is important as well.

In a monopoly situation, the supranational bodies provided regulations so that

[1] Governance is a decision-making process of public policies and their implementation, shaped in accordance with the relations among different stakeholders whose actions pursue an intended welfare.

[2] Structural Funds, Cohesion Funds, agricultural Funds, loans.

both the producer and the interest groups operating on a certain market may not maximize their profit by creating barriers to the market entrance. It was much easier to preserve the monopoly rights through national laws, hence they were transferred to the supranational bodies, a fact leading to a lower rent of the political class. However, there are specific situations that remain uncovered by adequate European regulations. For instance, in the area of state owned enterprises, even if there is not a monopoly situation, both the managers and the politicians/policy makers maximize their political support and their rent, too. State owned enterprises set prices below the marginal costs and the competitive prices, hereby creating a market distortion. In order to rectify this failure, the supranational bodies intervene directly, but only in case of a dominant market position.

The intervention through subsidies is based on the New-Keynesian Dynamic Stochastic General Equilibrium Model-DSGE which builds upon the model set forth by C.I. Jones[3] (1995) for semi – endogenous growth (1995) and seeks to stimulate the aggregate demand. The study made in 2009 for the European Commission by Janos Varga and Jan in ít Veld[4] , which measures the potential macro-economic impact on the new Member States of the structural and cohesion funds allocation, shows that the funds transfer to the poorest regions has no positive conclusive impact[5] . In accordance with the sensitivity analysis, it is not very clear how the investments in infrastructure, education and vocational training will reach the hypothetical productivity targets[6] . The potential impact within the period 2007-2013 and until 2020 was evaluated based on the QUEST III model.

In this case, the EU subsidy intervention pursues an economic catch-up (political objective: convergence) by the less developed countries, but its effect is not only the welfare, but also an extra welfare loss, meaning a welfare transfer. The objectives may not be quantifiable, but the subsidy allows the individuals to attain the expected welfare and leads to a decline in the competition among the interest groups that pursue to extract the highest possible rent[7] . Therefore, in case that the subsidy is granted to the interest groups (Stigler, 1971), it is important not to let them turn into a control over the market entrance, which therefore entails the preservation of the monopoly rights. In this case, the regulations of public interest have a role to play in order to redress this situation and conse-

[3] Jones, C.I. (1995b), „R&D based models of economic growth", in Journal of Political Economy 103, p.759-783. Jones, C.I.

[4] Janos Varga and Jan in ít Veld : „A Model-based Assessment of the Macroeconomic Impact of EU Structural Funds on the New Member States", Economic Papers 371| March 2009, European Commission, Directorate-General for Economic and Financial Affairs.

[5] Janos Varga and Jan in ít Veld: „A Model-based Assessment of the Macroeconomic Impact of EU Structural Funds on the New Member States", Economic Papers 371| March 2009, European Commission, Directorate-General for Economic and Financial Affairs, p.1.

[6] Janos Varga and Jan in ít Veld: „A Model-based Assessment of the Macroeconomic Impact of EU Structural Funds on the New Member States", Economic Papers 371| March 2009, European Commission, Directorate-General for Economic and Financial Affairs, p. 17 – 20.

[7] Johan den Hertog: Review of Economic Theories of Regulation, Utrecht School of Economics Utrecht University, Tjalling C. Koopmans Research Institute, Discussion Paper Series 10-18, December 2010, p.34.

quently to establish a balance as regards the welfare maximizing, either at the European level, based on the competition and procurement policy, or at the local level, based on the public expenditure ceiling as a percentage of GDP

II - Efficient institutions: public interests versus private interests

Within the European governance there is a mix of regulations expressing, on one hand, a public interest - in case of a market failure or of an unstable market (for instance, the financial market) -, as well as regulations targeted to a private interest (as formulated by George Stigler, Gary S. Becker, S, Pelzman, McChesney) involving a wealth transfer associated to economic losses/deadweight costs.

Consequently, the evolution of the European governance system can be envisaged through the conflict between the regulations expressing the public interest and the "captive" regulations (George J. Stigler) which are determined by the rent extraction/ rent seeking.

Taking into account the interdependence relations among the member states (Robert O. Keohane, Joseph S. Nye[8]) and the intergovernmentalism theory of power distribution, the efficiency of the European governance (through its policies) is influenced by the competition among the rent seekers, as well as the cost of resources allocation (Gary S. Becker[9] , G. Tullock[10]) in each member EU state. The preferences of different individuals and pressure groups from each member EU state will determine the efficiency or, contrary the persistence of inefficient institutions at local level and supranational, as well. To detail this idea, local governance[11] does not always express a public interest, on the contrary, it is the outcome of the competition for rent seeking, either under the form of a payment (which represents the non-intervention cost) from the producer to the policy-maker/ politician (Fred S. McChesney)[12] in order to preserve an existing rent, or as a rent extraction, without creating welfare (G. Tullock, James M. Buchanan). Assuming this hypothesis, the inefficiency of the governance at local level, expressed in deadweight loss, shall be transferred to the European governance. Greece and Italy provide a telling example as regards the policies in the public sector and financial services.

But, similarly, the EU inefficient policies (issued by supranational bodies) could generate a market failure at local level or the strengthening of rent seekers. Specific examples in the regulation area can be provided. The public procurement regulated at European level brings about corruption

[8] Robert O. Keohane, Joseph S. Nye: „Power & Interdependence" (4th Edition), Longman Classics in Political Science, 1989.

[9] Gary S. Becker: „A Theory of Competition among Pressure Groups for Political Influence", The Quartely Journal of Economics, vol. XCVIII, August 1983, No.3.

[10] Tullock, Gordon: „The Welfare Costs of Tariffs, Monopolies, and Theft". Western Economic Journal 5 (3): 224–232, 1967.

[11] At the level of an EU Member State

[12] Fred S. McChesney: „Rent Extaction and Rent Creation in the Economic Theory of Regulation", Journal of Legal Studies, vol. XVI (January 1987), The University of Chicago.

owing to the high value threshold wherefrom competition begins (the tender). I take into consideration the case of Romania. At the same time, the delay in the liberalization of postal services as a result of the pressures exerted by several EU Member States impacted negatively on the postal services prices. Maintaining the monopoly over the universal-type postal services doesn't have an economic rationality, taking into account the development trends of the digital and communications technologies, where markets operate much more freely. The same goes for the energy market, especially in the renewable energy field, where subsidies distorted the market demand and enhanced the deadweight loss due to unprofitable investments [13]. But, the whole energy market is not deregulated which induce costs, and maintain an asymmetrical relationship with few energy suppliers. Additional examples are related with the financial markets which were inappropriate regulated until 2008 and now are over-regulated.

So, the dilemma is what kind of equilibrium policies has to be achieved by the European governance in order to have efficient institutions for both sides: supranational level and local level. However, this is much more important for local levels (EU members states) taking into account the persistence of institutions and the path dependence.

There is a large literature with regard to the "institutional persistence". Kenneth L. Sokoloff and Stanley L. Engerman[14], Acemoglu, Johnson and Robinson (2000) provided evidence on institutional persistence, which is decided by different social groups who are competing for rents. These social groups/pressure groups will set up efficient institutions („institutions of private property") for a better resource allocation with a low cost or they will prefer to preserve inefficient institutions/ „extractive institutions" for their own benefit[15]. Both strategies depend on the structure of the economy and the size of the pressure groups. In societies with a low inequality the pressure for rent seeking institutions/„extractive institutions will be mitigated by competition, as against those societies with inequalities in which a small elite will preserve those institutions which allow a significant rent extraction of wealth for its own benefit[16] . In this case, the European policies that aim institutional changes will have an asymmetric effect. Countries with a strong middle class will have more efficient institutions, whereas in countries with high social inequalities, inefficient institutions

[13] Value of the IRR is negative in the absence of subsidies.

[14] L. Sokoloff and Stanley L. Engerman: „Institutions, Factor Endowments, and Paths of Development in the New World", Journal of Economic Perspectives—Volume 14, Number 3—Summer 2000 —Pages 217–232

[15] Daron Acemoglu, Simon Johnson, James A. Robinson: Institutions and Economic Development, 2001, Discission Paper. Also: Daron Acemoglu, Simon Johnson, James A. Robinson: The Colonial Origins of Comparative Development: An Empirical Investigation", The American Economic Review, Vol.91, No.5, Dec. 2001

[16] Kenneth L. Sokoloff and Stanley L. Engerman: „Institutions, Factor Endowments, and Paths of Development in the New World", Journal of Economic Perspectives—Volume 14, Number 3—Summer 2000 —Page 223

will be eliminated more slowly. But then, the path dependence also has a strong influence on institution efficiency. The pattern of the property rights structures, old practices in policy making and policies[17] shape the present government policies (Scott E Page)[18] . The past and the present become inputs for the future policies[19] . So, the efficiency/inefficiency of the institutions at the supranational and local level depends on the previous policies and new opportunities in a specific order[20] . However, the governance is a dynamic process, so the present policies are influenced not only by the past, but also by exogenous factors such as information and new technologies (Scott E Page: path dependence versus phat dependence)[21] .

Taking into account, the institutional persistence, the path dependence and "phat dependence", the European policies shall have an asymmetric impact at the local levels.

On this line, I considered that the "two-pack", "SixPack" and Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) are tools which adjust inefficient institutions mostly at the local level (in the EU member states).

The "two-pack" and "SixPack" are both transitory policies focused mostly in the coordination of fiscal policies.

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) is much important, for allowing more power to the supranational bodies[22] within the macroeconomic policy [23]and augments the interdependence relations (both symmetrical and asymmetrical) among the EU Member States. TSCG gives wider power pole at the supranational level due to an enlarged sharing of competencies as against the economic governance mechanisms incrementally introduced 1997-2011[24] . The macroeconomic targets are more severe. The member States can have a 1% structural deficit if the public debt-to-GDP ratio is below 60%, and 0.5% if public debt-to-GDP ratio is above 60%. The strict control over public expenditure narrows the sources leading to inefficient policies in Member States: subsidies (which are the source of rent extraction) and taxes (with a distortion effect)[25] results in the economic adjustment of institutions.

The macroeconomic targets established by the TSCG do not automatically lead to a structural adjustment of institutions (in the

[17] Laws, secondary regulations and subsidies

[18] Scott E Page: „An Essay on The Existence and Causes of Path Dependence", The University of Michigan, June 20, 2005

[19] Scott E Page: „An Essay on The Existence and Causes of Path Dependence", The University of Michigan, June 20, 2005, page 7

[20] Scott E Page: „An Essay on The Existence and Causes of Path Dependence", The University of Michigan, June 20, 2005, page 14

[21] Scott E Page: „An Essay on The Existence and Causes of Path Dependence", The University of Michigan, June 20, 2005, page 14 - 15

[22] The European Commission and the European Court of Justice.

[23] Gives control power to the European Commission in the area of budget policies and consolidates the jurisdiction of the European Court of Justice as regards the control on the implementation of supranational laws.

[24] The Stability and Growth Pact (1998), Twopack (2011) and Sixpack (2011).

[25] Daron Acemoglu: „Modeling Inefficient Institutions", National Bureau of Economic Research, Working Paper 11940 January 2006, and Cambridge University Press, 2006, p.2

economic sense)., For enabling a structural adjustment, it should cut down the public expenditure share in the GDP, not in the least conditional upon the reduction of the structural deficit share in the GDP[26] . This approach would prevent a sideslip instead of making a correction "ex post". Then, TSCG fiscal policies core targets doesn't lead automatically to an institutional changing. That's why, the local governments (EU member states) have to intervene against those determinants of the inefficient institutional persistence. This is valid mostly in the EU member states with high inequalities. Besides, equilibrium between efficient and inefficient institutions is necessary to achieve by developing new experiments of the Tullock's model in order to increase the competition for rents, taking into account the asymmetric players' motivation and an increasing of the size of the groups[27] .

III. The normative theories on power distribution

Juxtaposition of two opposite theories: neo-functionalism and neo-intergovernmentalism and their influence on the European governance

3.1.The neo-functionalist theory

Neo-functionalism provides support to the pressure groups in favour of a power transfer from the EU Member States to its supranational bodies. This power transfer could bring about the increase in the economic interdependence among the EU Member States and a positive spillover process that create new incentives which, in their turn, lead to a chain of new interdependencies. In other words, a decision or a process becomes a prior condition to other decisions or processes having the same function, because the integration of a new field pushes towards the integration of other fields as well. The spillover process becomes the core mechanism of integration through two components: functional and political, both of them having at their basis the economic transactions and the redistributive policy achieved at European level.

The axiom underlying the neo-functionalist theory is insufficiently developed. The power transfer towards the supranational bodies is hardly a strict political target per se, because it is based on an economic rationale, as the rent seeking competition would take place at the supranational level and at a lesser extent at the local level. Under these circumstances, the pressure groups pursue the optimisation of the lobbying expenses, in order to keep them under the expected rent in order to prevent its dissipation (G. Tullock).

Neo-functionalism makes sense up to a certain point, at least in terms of what we could accept as a "functional spillover". However, a supranational body can acquire greater powers and new competencies only through negotiations among Member States. Similarly, a supranational body can acquire power over a Member State only through negotiation for this purpose. This implies that supranational bodies do not create power

[26] Radu Cristescu, Valentin M. Ionescu, Thomas Kleininger, Nicolae Mardari, Costea Munteanu, Mihail Neamtu, Wienfried Senker, Radu Șimandan: „Ordoliberalism and Social Market Economy", p. 23, Bucharest, 2011, Konrad Adenauer Foundation

[27] Gary S. Becker: „A Theory of Competition among Pressure Groups for Political Influence", The Quartely Journal of Economics, vol. XCVIII, August 1983, No.3, page 380.

per se, on the contrary, their power results from the Member States' political decision, although the neo-functionalist influence cannot be ruled out.

3.2.Liberal Intergovernmentalism[28]

This theory takes into consideration two assumptions. According to Andrew Moravcsik, the Member States are the main decision-making actors in the European Union, and their action is rational. Through negotiations among them, the EU Member States enter into agreements that express their options and interests. These agreements can also include a delegation of competences for the purpose of achieving a specific political objective. Decisions are made together by the EU Council and the European Parliament, although at a later stage each Member State has its own enforcement responsibility, the same as the supranational bodies which should ensure the management (the Commission).

The second assumption (A. Moravcsik) refers to the fact that the Member States' action is rational, with a view to maximize their utility[29] or in order to avoid the situation where, owing to non-cooperation, they could achieve a result expressing the inefficiency in Parentian terms ("bargaining problem"). Therefore, the decision taken at supranational level is the outcome of the aggregation through cooperation of each Member State's preferences.

[28] Andrew Moravcsik, Frank Schimmelfening: Liberal intergovernmentalism, Princeton University; Nicolae Paun: „Europe Finality", Publishing House of the European Studies Foundation, Cluj-Napoca, 2007.

[29] Andrew Moravcsik, Frank Schimmelfening: Liberal Intergovernmentalism, Princeton University.

Taking stock of the assumptions and of the decision-making mechanisms emphasized by the theory of liberal intergovernmentalism, the European governance can be examined through the principal – agent relation.

The principal – agent relation: the double role played by the Member States and by the supranational bodies

With regard to the exclusive and shared competencies, the supranational bodies and the EU Member States play a double role, both as a principal and as an agent. Based upon the delegation of responsibility, the agent enjoys the full autonomy of action on behalf of the "principal" actor. The European treaties establish this relation among Member States and the supranational bodies based on the competencies vested in each of them. For instance, the EU Member States have a control right on the Commission through the agency of the Court of Accounts. The opposite is also valid as regards the use of the Union budget.

The EU Member States have a right of political control over the European Commission, the same as the EU controls the Member States – in the regulation area - through the European Court of Justice. The fulfilment of the nominal convergence criteria provided by the Maastricht Treaty is an example of the role played by the Member States as "agents" of the supranational bodies. TSCG establishes a "principal" for the Council and for the Commission equally, while the Member States are "agents" for the implementation of the Treaty.

An information asymmetry could appear within the "principal" – "agent" relation, which influences the efficiency and the effectiveness of the decision made by the Council or by the Commission. For instance, the distortion of the statistical and economic data or failing to communicate them in due time weakens the Council's capacity of making the best decisions, as it happened with regard to Greece from the point of view of its macroeconomic situation. The information asymmetry brought about opportunist behaviour of Greece which generated costs to the "principal", then spread to the other agents (Member States). The information asymmetry phenomenon can be seen more often when the agent is a State and the "principal" is a supranational body. For this reason, TSCG is meant to diminish this asymmetry, setting a low target for the structural budget deficit, so that the Member States may have a low sideslip margin.

The agent State will choose one or several strategies in its attempt to maximize its utility /benefit from the greatest possible resource or "welfare" value, anticipating the actions of the other agent Member States in response to its actions, presuming that the hierarchy of topics (the entire spectrum of problems negotiated) is pre-established. Each strategy should result in actions to the possible moves of the other agents. The choice of the adequate strategy depends on the information as well as on types of interdependence relations among the Member States (symmetric or asymmetric)[30] . The agent States may have comprehensive information about each other and on the type of strategy they apply, which does not mean that the information is perfect, as no one knows how each of them will act. In this context, the cooperative approach to the game is the most probable solution, although some agent States will decline the game in case they do not maximize their respective utility (e.g., UK's unwillingness to sign the TSCG).

3.3. Competitive federalism [31]

Within the European Union a federal arrangement was set up with a multi-level governance which include, on one hand, sui generis supranational bodies, meaning that there is no equivalent for them within the public power of a Member State, irrespective of its form - federal or unitary – and, on the other hand, a "jurisdictional competition" emerges among or within the Member States striving to attract a capital, taking into account that a State is the only one that may use its authority/jurisdiction on the domestic level. This type of competition is enhanced by the free movement of capital, goods, services and persons.

Competing against each other, the Member States try to implement domestic policies liable to attract financial capital, technologies, knowledge and workforce. Therefore, each government seeks to gain a resource by issuing regulations, providing services"[32] . Both the direct taxes policy focused on attracting investments and the removal of administrative barriers are examples where the jurisdictional competition occurs.

[30] Robert O. Keohane, Joseph S. Nye: „Power & Interdependence" (4th Edition), Longman Classics in Political Science, 1989.

[31] From the perspective of the economic theory on federalism.

[32] Daphne A. Kenyon: „Theories of Interjurisdictional Competition", New England Economic Review, March/April 1997.

The jurisdictional competition aspects were analysed for the first time in the Tiebout model in 1956[33] which describes the local governments offer for public goods at different prices and the people perception on their utility.

The individuals will move from one jurisdiction to another one until they manage to maximize their own utility related to the public goods provided and to their payment capacity. Undoubtedly, the people's mobility is low in many cases, therefore the quality or the supply of public services needs to be optimized. The Tiebout model focuses on local taxation aspects and makes it possible to establish a balance between the individuals' preferences and the public goods supply. In other words, public goods are supplied depending on the revealed preference[34] (Samuelson) as well as on the aggregation of preferences. The Tiebout model can be completed by the Oates – Schwab[35] model which focuses on the economic competition among jurisdictions; this model examines the capital movement depending on taxation. In accordance with the model developed by Wallace E. Oates and Robert M. Schwab, jurisdictions (districts, regions) compete in order to attract capital stock, and for this purpose they alleviate the administrative taxes and barriers. The capital increase brings about new businesses and an increase in the revenues of the local population. However, this model has to be revised, if we presume that as entrepreneurs have a better evaluation of information than a local government. In such assumption, the entrepreneurs will not invest if they benefited of incentive taxation, only. Moreover, capital attraction due to a low taxation level has not always generated positive externalities. The free movement of capital between two close jurisdictions, for instance a town and a commune, will bring the workforce from the less developed area to the more economically developed area where efficient institutions draws in the workforce and, in this case, taxes have no longer a prevailing role.

[33] Charles Tiebout: „A Pure Theory of Local Expenditures" (1956).

[34] The consumers'preference is revealed by their consumption habits. The preference can be influenced by policies

[35] Wallace E. OATES and Robert M. Schwab: „Economic Competition Among Jurisdictions: Efficiency Enhancing or Distorsion Inducing?", University of Maryland, College Park, MD 20742, USA, 1988.

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23. Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances

24. Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies
25. Regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area
26. Regulation (EU) No 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area
27. Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States
28. Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, 2012
29. Maastricht Treaty