

Chapter 1. Completing Europe's Internal Market:

The Single European Act in Perspective

The Puzzle of European Integration

In 1991 the European auto industry seemed to be in deep trouble. A controversial trade agreement between the European Union (EU) and Japan restricting Japanese imports had just been completed, and the chairman of Renault, the French automaker, Raymond Levy, was defending the agreement before a Committee of the European Parliament. His comments were defensive, reflecting the views of many at that time.

We are told that we must make adjustments ... but my enterprise [Renault] has already laid off 40,000 employees over the last five years. Europeans ... are subject to social exigencies. We have a debt to our workers . . . especially older workers; the social environment matters. For this reason the agreement is indispensable. The European auto industry needs eight years to adjust.¹

The fear in the industry was palpable. It wasn't just fear of the Japanese, but more generally of the changes being forced on this privileged industrial sector by a program of accelerated market liberalization. How had the industrial champions of Europe been brought to such a pass? What was this program of market liberalization, and what had brought it about?

In 1987 the member states of the European Union (EU) signed the Single European Act (SEA). It was a public commitment by each government to eliminate the barriers that continued to obstruct trade among them, and to open up Europe's markets by the end of 1992. This ambitious goal attracted plenty of press coverage, on both sides of the Atlantic, and seemed to give a dramatic new

impetus to the process of European integration. However, upon reflection, there was good reason to wonder whether the public rhetoric could be matched by the necessary, wide-ranging policy changes required of each national government and of the institutions of the EU. If the past history of the EU was any guide, these countries were going to find it very difficult to implement the terms of this bargain. Although the agreement was the first significant institutional modification of the Treaty of Rome (which established the EU), it was seen by many as only a "meager result" and a minor, incremental change (Corbett 1987, 268).

In the event, much of the "1992" project was accomplished, and Raymond Levy's fears proved to be exaggerated. Even the powerful automobile industry, which employed hundreds of thousands of people and faced an uncertain economic future, had to swallow a dose of market liberalization. Market segmentation was reduced, subsidies were subject to increased control and a variety of other regulations were harmonized. In other words, the results of the SEA exceeded past practices and expectations. On the other hand, old habits died hard. While subsidies were reduced they were by no means eliminated, and external trade remained subject to a costly regime of voluntary restraint on the part of Japanese auto makers. Overall, outcomes across the four issue-areas examined by this study ranged widely, from a significant change over the status quo to little or no change. Specifically, there was a dramatic increase in harmonization in the case of emissions control, increased transparency but limited reductions in the case of national subsidies, the development of a clearly defined if producer-friendly anti-trust regime, but changes in external trade policies which could be construed as positively retrograde. What was the constellation of political and institutional factors which explain these mixed outcomes?

There are good substantive and analytical reasons why these complex changes in policy warrant closer scrutiny. At the time, of course, many people in the U.S. had reservations about the prospect of "Fortress Europe". There was a fear that European integration would be accomplished at the expense of its trading partners, in other words that internal trade creation would be offset by the diversion away from Europe of U.S. and Japanese products. This proved to be an exaggerated danger, but the willingness of the EU to play a liberalizing role in international trade has remained uncertain. For example, the consequences of the EU's mixed economic policies are most acutely felt in the economies in the East struggling to make the transition from Soviet central planning. German leaders may promise Poland and others rapid membership in the European club, but Polish pigs cannot be exported to the EU, while Polish steel piping has been subject to anti-dumping suits brought by the EU Commission. This book develops a refined analytical framework which captures the interaction of special interests, national governments and the institutions of the EU that explains these contradictory policies.

The objective of this book is to move beyond broad-scale discussions of globalization and interdependence and develop the tools with which to analyze the actual policy-outcomes which shape economic integration. I begin with the role of national and private interests: the governing elites of the member states stood to reap political benefits if the SEA delivered economic gains, and many large and medium sized corporations trading in the European market would benefit from the elimination of barriers. Other firms and their employees, however, would face acute adjustment difficulties, and served as a significant check on the political process of integration. In my research I show how variation in the costs and benefits from integration across issue areas resulted in variation in the ability of governments and firms to combine in their efforts to shape the future of the European economy.

This account of firm and government preferences is then incorporated into an analysis of the heterogeneous institutional environment of the EU. The institutional environment varied across issue areas and as a consequence the independent effect of institutions varied. Furthermore, I also discover that the member states, on occasion, were able to refine the institutional environment in order to realize superior political and economic outcomes. In short, the explanation for the policy outcomes combines an analysis of preference formation and collective action problems with an analysis of political institutions. This approach gives new understanding to issues at the core of political economy: the way economic interdependence shapes the formation of transnational interests, and how institutional design--under certain circumstances--may foster policy-making which serves a general interest over the particular.

In this introductory chapter I place the research reported in this book in historical context. Specifically, I sketch the background to the SEA, and establish its significance in the light of the previous history of European integration. I go on to map the degree to which economic theory is a useful guide to expected outcomes. I then offer a brief summary of existing approaches commonly used to understand EU policy and then compare them with the salient elements of my own analytical framework. I finish by presenting a telegraphic account of my findings. Simply stated, they are as follows: the interests of firms and governments were determined by their exposure to economic adjustment. They were often able to act collectively in shaping outcomes, in ways occasionally structured by the institutional environment of the EU. I argue that this interaction between more-or-less well-articulated interests and various institutional arenas accounts for the observed variation in the level of integration and harmonization accomplished.

The Single European Act in Historical Perspective

It was in July, 1987, that the member states of the EU finally ratified the SEA. This was the first modification of the institutional architecture originally put in place by the Treaty of Rome, the treaty which founded the EU in 1957.² In it, and in conjunction with the accompanying "White Paper" published in 1985, these governments committed themselves to complete economic integration (defined here as economic openness and regulatory harmonization). This had always been the fundamental objective of the EU, but over the years it had remained elusive. The member states now set themselves the ambitious goal of finally eliminating the remaining barriers to trade, and harmonizing regulations across a range of economic sectors and issue areas before the end of 1992. This was to be the cornerstone of a concerted effort to revitalize the European economy and close the gap in productivity, innovation, and growth that seemed to divide European firms from their United States and Japanese competitors. It was hoped that the aggregate economic gains from increased openness would act as a spur to the sluggish economy, and promote a beneficial cycle of income growth and investment. (On the SEA see De Ruyt 1989; Taylor 1989; Moravscik 1991; Garrett 1992).

But the ability to realize mutual economic gains through international cooperation is always problematic. While cooperation might be sure to yield such gains *in the aggregate*, the adjustment imposed on privileged domestic interests is often the source of insurmountable political difficulties. For example, although it was understood at the founding of the EU that economic intervention by national governments distorted free competition, all too often in the past the member states had shown themselves willing to protect and subsidize large industrial and commercial enterprises. Even in the years between 1986-1988, long after the recession of 1982-3 was over, the average annual

expenditures by European governments on state aid represented 2.2% of the European Union's Gross Domestic Product (GDP) (Commission of the European Community (CEC) 1991a, 13). Like secret drinkers their public utterances embraced the virtues of sobriety, yet all the while they clung to the bottle in order to dull the political pain that would come from shaking off the claims of powerful clients.

The telegraphic account which follows of the first twenty-five years of European economic and political integration highlights its many past difficulties. In particular it will serve to emphasize three important points: a) the uncertain path of European integration--the way in which it has always been episodic, a function of political bargains rather than of some relentless economic logic, b) the role of divergent national interests and policies in giving rise to this unsteady progress, and c) (as a result of the first two factors) the significant limitations on European integration that persisted up until the passage of the Single European Act (SEA). Taken together these elements highlight the distinctiveness of the SEA, and its central place in the puzzle which motivates my research project. Given the political character of the integration process, the forces often arrayed against it, and its unsatisfactory record of accomplishments, it is hardly to be wondered that the accomplishments of the SEA were mixed, even if it did move the process of European integration forward further and faster than sceptics initially imagined. The explanation for these mixed outcomes that forms the core of this book will cast a new light on the many other dilemmas and obstacles that the EU has faced in the past.

The First Twenty Five Years

In the years immediately following the end of the Second World War Western the international community, under the leadership of the U.S., actively sought to establish international institutions which would foster economic stability and political security. Since interstate rivalry and economic instability in

Europe had been the source of both world wars, it was there that the search for appropriate international institutions was most energetic. Experiments with a wide range of regional institutions culminated in the establishment of the European Economic Community (EEC), for which an agreement was signed by six European countries, but not the U.K., in 1957. The Treaty of Rome was formally aimed at establishing a free trade area, but it is important to remember that it was, fundamentally, an economic means to a political end—that of amity and political cooperation. (On the origins and early history of the EEC see Milward 1984, 1992; Pinder 1991).

In its early years the EEC, or EU as it later became, succeeded in meeting many of the high expectations its founders had for it. Under the energetic leadership of Walter Hallstein, the first president of the European Commission (the supra-national body established to forward the purposes of the Treaty) progress towards the reduction of tariffs and the expansion of the authority of European institutions seemed impressive. The generally favorable economic conditions of the post-war period no doubt played an important part in lowering the political costs, while magnifying the economic gains associated with these developments.

This halcyon period was disrupted by the policies of the French leader General de Gaulle in the 1960s, who sought to protect French sovereignty. He was responsible for the *de facto* institutionalization of national vetoes in the Council of Ministers, the governing body of European institutions. He was also responsible for the exclusion of the U.K. from EU membership. Earlier progress seemed, as a result, to suffer a political check. However, with the fall from power of de Gaulle and the admission of the U.K., together with Ireland and Denmark, at the beginning of the 1970s, the pace of change seemed to pick up again. The last tariff barriers were eliminated at the end

of the 1960s, and in an effort to minimize the consequences of a profligate U.S. monetary policy the member states began to coordinate their exchange rates within an exchange rate mechanism known as the "snake."

But the 1970s was a period in which the industrial economies endured numerous economic shocks, beginning with the oil embargo in 1973. These occurred in the context of slow rates of growth and widely divergent national economic policies. As a result the level of coordination of policies across Europe actually declined as the decade wore on. The member states proved, for the most part, to be unable to maintain stable exchange rates. At the same time they resorted to divergent fiscal policies, state interventions, and other strategies which carried with them all kinds of negative collective consequences. In particular this was the era of the "national champion," a state sanctioned and subsidized firm in a key sector which was to act as an industrial and technological leader. Several auto companies were thought of in these terms (as will be discussed in greater detail in Chapter 3). The result was that by the end of the decade not only was cooperation within the context of the EU paralyzed, but economic performance had begun to sag. Europe seemed trapped by a combination of low growth, high inflation and increasing unemployment. It was at this time that people began to speak of both "stagflation" and "eurosclerosis" or "europessimism."

The shortcomings of the European economy became even clearer following the recovery in the West after the recession of 1981-82. While the United States and Japan recovered quickly, the EU's return to health was slow. Worse, it proved to be, by comparison, a "jobless" recovery. While the EU grew at an average annual rate of 1.9% between 1981-86, the U.S. grew at 2.9%, and Japan at 3.6% (CEC 1988e, 42). At the same time, unemployment in the EU remained stubbornly above 10% up

until 1986 (as a percentage of the civilian labor force), while in the U.S. it fell below 7% (CEC 1988e, 126).

At this point the preferences of the member states, which had diverged in the 1970s as each sought to solve their economic difficulties autonomously, now began to converge. Keynesian management of the economy had failed, and inflation was now perceived as more of a threat than unemployment; as a result monetary policies with a deflationary bias became widely accepted (McNamara 1997; see also Oatley 1997). At the same time European business had become much more regionally integrated and so found the existing barriers to regional trade increasingly burdensome. Finally, and partly as a consequence of the foregoing, the political balance in many European countries shifted to the right. Taken together all this led to the focus on a neo-liberal strategy of economic openness in the region. That is to say, the SEA and the White Paper were part of a general set of supply-side measures designed to stimulate demand and investment and therefore economic growth. Indeed, the agreement was one of the most important elements in a comprehensive European recovery (inasmuch as external liberalization was more politically acceptable than, for example, eliminating rigidities in domestic labor markets). However, it was also an enterprise that was likely to be very difficult to accomplish.

The Single European Act

The SEA was, therefore, a political project from which the governments of the member states anticipated political payoffs of some kind. Nevertheless, in spite of the shift in political and economic strategies in Europe in the 1980s, this project's success should not be thought of as inevitable. Its success is what makes it an interesting object of inquiry: a favorable (pareto superior) outcome was not

pre-ordained, it had to be realized by a process of political bargaining over numerous details which cut across issue areas and sectors, and which were subject to the institutional structures of the EU.

Significantly, these structures were deliberately modified by the SEA in order to foster rapid political progress. Indeed these institutional changes were the most important aspect of the SEA, rather than the particular policies it embraced, which were notable for their specificity rather than for their overall purpose (which was no more than the completion of the project envisaged by the original treaty). The crucial institutional change was that in issues relating to the internal market (which was the focus of the action program) super-majority decision-making was adopted. This was called "qualified majority" voting, under which the small states enjoyed voting power in the Council of Ministers somewhat greater than would be warranted by a strictly proportionate rule.³

Clearly, qualified majority voting was a less demanding form of self-rule than unanimity, and would lead to more decisions being taken more quickly (but see ?? for a significant empirical challenge to this view). The adoption of qualified majority voting would make it easier to realize the mutual gains associated with international cooperation. However, what of the costs inevitably commingled with those gains? It may be imagined that other aspects of the institutional arena would help overcome these political costs. The discussion will return to the question of institutional innovation in the conclusion, and examine the characteristics of the SEA with reference to the specific policy outcomes it fostered. For the moment all that I wish to observe is this: to the extent that the political costs of integration were ameliorated by an appropriate institutional technology, or re-allocated agenda-setting power, so the set of politically possible outcomes--in this case, liberalization and harmonization--was enlarged.

In conclusion, the puzzle posed at the beginning is a significant one; what explains the mixed

success enjoyed by the member states in their effort to increase regional openness and regulatory harmonization? The difficulties were significant, notwithstanding the underlying structural changes which had occurred by the middle of the 1980s which made regional integration more desirable. As noted, progress in European integration had encountered numerous stumbling blocks in the past--the old habits of tending to domestic political clients would be hard to break, even in good economic times. Yet much was accomplished, even if outcomes across issue areas varied. The chapters that follow will show how weighty domestic interests responded to the adjustment which was imposed on them, how the governments of the member states coalesced around specific policy outcomes, and how the institutional environment often framed--and directed--the political process.

The Economics of European Integration.

Before discussing the political economy of regional integration, it is necessary to establish the economic background. What does economics reveal about the winners and losers from integration? The degree to which economic outcomes are indeterminate will define the role to be played by politics.

Economic theory

The basic insight is that the formation of a customs union leads to trade diversion and trade creation; if the former outweighs the latter then the welfare effects of such a union would be negative (Viner 1950). A simple guide to the consequences of a customs union is the level of the common external tariff, and the complementarities between the economies of the member countries. If the common external tariff is as low as, or lower than, that member of the union with the lowest on joining, then trade creation is likely to predominate (see Krugman, 1995). This would also be likely where countries specialized in, and protected, different economic activities prior to joining (Lipsey 1960). These effects are static

effects, depending, as they do, upon the superior allocation of resources from the lowering of barriers-- they represent, therefore, a one-off gain. Other static effects relate to a reduction in market power and an increase in efficiency, and economies of scale and scope; under monopolistic competition joining a customs union may give firms specializing in specific niches the ability to reap greater economies of scale, which leads to trade within industry (Krugman and Obstfeld 1994, 124-133).

More interesting effects, albeit ones that are much harder to identify, are so-called dynamic effects. Integration may also stimulate investment, provoking a virtuous circle in which the expectations of future profit are self-fulfilling as businessmen invest in order to make the most of improved prospects. (On dynamic gains see Molle 1990, 103-111; on the investment effect see Pinder 1988, 40-41; Baldwin 1989). The formation of a customs union may also divert investment into it from other areas, investment being a substitute for trade flows. (On investment diversion see Mendes 1987, 85-90; Molle 1990, 231-237; Yannopoulos 1990; on investment as a substitute for trade see Mundell 1957; as a complement, Markusen 1983).

Econometric findings

The empirical record is reasonably clear: Davenport (1982) and Mendes (1987) suggest that there were measurable, if modest, gains for all the original member states; however, gains were greatest in the early years, as tariff barriers were eliminated. As for trade diversion, the results are encouraging-- mutual openness led also to greater openness to third parties (Frankel and Wei 1994). There seem to have been two reasons for this, one of which helps explain the other. The deepening of the EU was accompanied by the series of multilateral tariff reductions under the General Agreement on Tariffs and Trade (GATT). Frankel and Wei suggest an interesting reason which may account for part of the

success of the GATT rounds.

Leaders might not be able to obtain a majority vote in favor of multilateral liberalization . . . yet might be able to obtain a majority vote in favor of regional liberalization which, when completed, then shifts the economic incentive so as to [subsequently] produce a majority in favor of wider liberalization. (Frankel and Wei 1994, 23).

The effect on investment flows is less certain (Krause 1968; and Yannopoulos 1990). The European Free Trade Area (EFTA) member states, those who held back from joining the EU in the beginning, may have been penalized as U.S. investment was diverted into the EU, but the matter is not settled.

Taken all together, aggregate gains were realized by the member states of the EU--from static and dynamic effects, even if the latter were hard to disentangle. However, so much uncertainty exists about the models used to evaluate past performance that making predictions about the consequences of the SEA was very difficult (Tsoukalis 1993, 92). The Commission, in its now legendary study of the "costs of non-Europe," took a very optimistic view, even though its model relied largely on estimating the static effects of increased economies of scale (CEC 1988a, 1988c; for a review of other estimates see Hufbauer 1990, 7-8; on unrealized economies of scale in the auto sector see Owen 1983). There was an economic glow associated with the internal market program, but investment and the rationalization of production seems to have played the largest part (on investment see Tsoukalis 1993, 68; on the rationalization of multinational business see Dunning and Robson 1987).

The crucial political question, of course, was how the economic gains were distributed, both across and within countries. It is a core premise of neo-classical trade theory that greater economic openness everywhere and always yields increased aggregate economic gains. However, trade theory gives few guides to the *distribution* of gains in the absence of closely specified models of the

economies of the respective countries. This uncertainty is especially pronounced in the case of intra-industry trade, which is the characteristic form of exchange between advanced industrial economies, in particular the economies of Western Europe (on intra-industry trade see Grubel and Lloyd 1974; in the case of the EU see Greenaway 1987; Belassa and Bauwens 1988; Krugman 1989).

The "new" trade theory is well adapted to address this phenomenon as it accepts that traded goods are produced by large firms enjoying economies of scale subject to imperfect competition (Krugman 1979, 1986, 1987; Dixit 1983; Helpman & Krugman 1986; Helpman and Razin 1991). This approach does not usually call into question the presence of aggregate economic gains, but it does highlight the uncertainty over the distribution of those gains.⁴ It is this uncertainty which can lead to strategic behavior, economic and political, by which firms (and governments) might try to ensure distributional outcomes in their favor.

In summary, the discussion of the economics of EU integration yields two general points. First, the member states have enjoyed measurable, if modest, economic gains in the past from the EU; and the SEA was likely to yield more of the same in the future, although how much exactly, and through what economic processes, remained unclear. All would gain from the move to economic openness.⁵ Second, how the gains were to be distributed was uncertain *ex ante*, and subject to manipulation through strategic behavior. This behavior is at the core of the political story to follow. Not only did the member states of the EU have to overcome the cooperation problem inherent in the process of integration, but they had to do so under circumstances in which the costs of adjustment were *endogenous* to the political process. The costs of adjustment were to be determined by the policy outcomes produced by political cooperation--for example, by the use of side-payments (structural

funds, in EU parlance).

Explaining EU Policy Outcomes

My explanation for the outcomes identified at the beginning of this project relies on a combination of analytical approaches. In order to develop a systematic account of the preferences of states and firms, and of the manner in which they interact, I rely on the insights available from well-known theories of regulation and endogenous policy formation. This general account of the political marketplace is then situated within a systematic explanation for the way political institutions shape outcomes. Here I rely on the eclectic set of insights generated by the political science literature on institutions, which shows how they overcome transactions costs and yield stable political equilibria, but present monitoring problems for their principals.⁶ However, I begin by quickly reviewing existing approaches to European integration and E.U. policymaking, in order to highlight the analytical framework I have adopted.

Other approaches

Existing approaches suffer from various deficiencies. For example, standard approaches do not, except by implication, deal adequately with the issue of interest formation and aggregation. "Neo-functionalism" is a long established analytical approach for explaining the process of integration (Haas 1958, 1961; Schmitter, 1969). To be sure, it privileges the role of trans-national coalitions of interests in this process. But as an explanation it focuses on the relevant political mechanism, and takes for granted the preferences of actors and their ability to articulate them. In Haas' words:

A system of demands may develop in the programme of a national elite, seeking the support of kindred elites in other . . . countries, designed to establish a far-reaching series of policies realisable only in the framework of supranational institutions (Haas 1958:287).

He goes on to argue that once granted powers in one area or sector, supranational institutions constantly expand their authority and influence through a process of "spill-over"; a process associated not only with attitudinal change (although Haas argued that this was important) but also with practical necessities. It is constantly necessary to harmonize other, separate, national policies in order to make it possible for already integrated sectors to function (Haas 1958:297).

This model is echoed in more recent accounts of the process of European integration (Taylor 1983; Sandholtz and Zysman 1989; Peters 1991; Lodge 1994). Sandholtz and Zysman, for example, in discussing the SEA, highlight the role of an inter-elite bargain, in which government, business and "Eurocrats" all played a part. But no clear micro-foundations for the origins of various interests, or simple account of the structures of the political market place, are offered.

Alternative explanations tend to be pitched at the level of nation state and privilege interstate, that is intergovernmental, bargains (see the reply to neo-functionalism from Hoffmann 1966; see also Keohane & Hoffman 1991; Moravcsik 1991, 1998; & Garrett 1992). However, they too do not give a sufficiently elaborate account of the formation and articulation of interests. In the case of the SEA, for example, it is not enough to merely identify some group of interests who would profit from a particular interstate bargain and with whom government leaders must negotiate as part of some two-level game. Moravcsik (1993) indicates the way forward by insisting on the theoretical priority of an interest-based account of state preferences, before any analysis of an inter-governmental bargain can begin. The project that follows not only takes this as a starting point, but goes on to show how national, and transnational, interest-based politics takes over after the inter-governmental bargain is complete.

The existing approaches to institutions, until recently, are also subject to numerous objections.

In spite of the fact that neo-functional explanations for the process of EU integration place a considerable emphasis on institutions, they tend not to distinguish systematically between the roles played by different institutional actors within the EU. Nor do they show the way in which various actors, institutional or otherwise, interact, and what the consequences of the rules governing that interaction might be. For example, what is likely to be the systematic effect on outcomes when the rules governing the relationship between the member states and the Commission are changed? Neo-functionalists tend to neglect these kinds of questions, as do those who adopt an intergovernmental perspective.

Explanations pitched at the level of the member state add value to our understanding of the major political bargains which punctuate the development of the EU. However, this approach also has trouble accounting for the way power is exercised on a day-to-day basis within the institutions of the EU (For an example of the application of power indices to EU policy-making see Hosli, 1993; for an institutionalist critique see Tsebelis and Garrett, 1996.) Yet, in the execution of the ambitious plan to complete the internal market, it was "day-to-day" politics which determined outcomes, and the approach proposed here will be well-adapted to account for the intricacies of this kind of political process. Taking the discussion above as a point of departure, I discuss below the kinds of approaches I have relied on in this project.

Theories of regulation and endogenous policy formation

In assembling the building blocks of my analytical framework I begin with individual preference formation and aggregation. Ray (1981), following Peltzman (1976) and Stigler (1971) (see also Becker 1983), has proposed an analytical framework to explain which domestic interests become

mobilized and how their efforts fit into the political marketplace. It nicely accounts for the behavior of political leaders who seek to maximize some combination of voter and special interest support. What follows owes much to this framework. Let me begin with the preferences of firms over increased economic integration.

The literature on the domestic political economy of foreign economic policy-making (specifically on tariffs and tariff formation), consistent with the Stigler/Peltzman approach, offers a fully-developed set of variables to account for preferences, preference intensities and the organizational capacities of firms, such as geography, labor and/or capital intensity, asset specificity, industry concentration, and competitive efficiency. The structure of any particular industry can be evaluated in these terms, and specific predictions about its political performance generated (among many others, see Caves 1976; Cassing, McKeown & Ochs, 1986; for an overview see Nelson 1988; see also Magee, Brock & Young 1989). Likewise, in this project, I derive firm preferences and their ability to organize from the following elements: their exposure to adjustment costs, industry concentration, shared cost structures, and technological capacities. The Ray/Stigler/Peltzman approach gives a simple account of the ability of firms to organize, which is derived from group size and the benefits to be had from organizing. Small, organized interests seeking concentrated benefits are able to obtain protection or advantageous regulation from compliant politicians, who transfer wealth to them at the expense of large, diffuse, and poorly organized groups. The most valuable insight is that this is not a simple story of regulatory capture. Politicians must weigh the benefits to themselves of trade restrictions, which come in the form of campaign contributions or bribes or whatever, against the costs in lost votes from the exploited majority. Furthermore, the effective size of a successful rent-seeking group is limited by the costs of

organizing and the exposure to free-riders (see, of course, Olsen 1965). In short, within a constraint set by their ability to organize, an industry is able to obtain protection up to that point at which the marginal benefits to politicians equal the marginal costs of granting the favor (information asymmetries generated by a noisy political process will tend to favor narrower, better organized groups).

For my purposes the story runs in reverse, so to speak. An exogenous shift in the set of possible policy outcomes (that is, the new opportunity to realize mutual gains represented by the SEA) made a preferred political equilibrium available to the political leadership of the member states. They could now increase their political "maximum", if only slightly, by tending to the interests of the exploited majority through the economic gains from increased economic integration, and by imposing some costs (but not too many!) on narrow, organized interests (such as the auto makers) by eroding their rents. This would be accomplished by dismantling national barriers to trade and harmonizing regulations.

The virtue of the Stigler/Peltzman approach is that it specifies a political market, in which political coalitions are in balance, rather than a crude adding machine model, in which winners take all. As a result, outcomes are not a set of binary choices, favoring one coalition or another, but are more or less "weighted" in a world in which political outputs can be finely allocated between competing groups. This kind of approach is a good starting point for showing how the preferences of firms and the member states over increased integration interact. However, for private interests such as firms the strategic environment of the EU was significantly more complicated than that commonly supposed by this literature. There existed potential transnational allies, with whom cooperation might be fruitful, and supranational institutions, from which desired political objectives might be directly or indirectly obtained. It is necessary, therefore, to develop a theoretically informed account of when interests seek

transnational allies. Here the literature on cooperation problems and strategic interaction (or game theory) are of some help (see Olsen 1965; Rasmusen 1989).

Another complication is that policy outputs varied across issue areas. The “endogenous policy” literature tends to suppose that the particular political goals of group action have the constant characteristic of a "public" good for the interest group in question. The attributes of the group and its members determines whether cooperation is accomplished or not. However, in the context of economic integration a range of different regulatory and policy issues must be addressed. As a result different policies, or political goods, will be pursued. Some may be public goods, but some may be excludable, or private in character. This will surely lead to variation in firm preferences, and so in their ability to cooperate. This variation in potential policy outputs must be distinguished from or, perhaps, explained by the institutional environment.

Institutional analysis

The literature on institutions generated in the study of American politics can add to the analysis of the EU in two general ways: it can suggest how they induce outcomes (see, for example, Shepsle 1979) and, reasoning backwards from that, it can suggest why institutions are adopted (see, for example, McCubbins 1985). After all, institutions are surely chosen with a view to the outcomes that they generate. The discussion of why the institutions of the EU take the form that they do will be reserved for the conclusion of this project—relying on the insights generated by the empirical findings reported below. The question is likely to have a purely empirical answer as much as an analytical one. Here are addressed the ways in which institutions foster particular outcomes (for a good review of the issues that follow as they apply to the EU see Pollack 1996).

An increasingly well-understood characteristic of rules and institutions is the way in which they grant to a particular actor, perhaps a transnational institution, a privileged position by giving it the ability to make proposals and so set the agenda (Shepsle and Weingast 1984; Ordeshook and Schwartz 1987; Tsebelis 1994.) Those outcomes preferred by the agenda setter may then enjoy a strategic advantage.⁷ If it is an institutional actor who sets the agenda (for example, the Commission) then a systematic account of the origins of its institutional preference must be developed. If the institution is an agent for others (as is the Commission), and its preferences are different from the preferences of its principals (the member states who established it in the first place) as a result of agency drift, then the outcomes the institution promotes will be at odds in important ways with those preferred by its principals. Public choice offers an appropriate framework for developing such an account, in which governmental institutions displace the formal goals assigned to them with the private goals of institutional power and growth, from which the functionaries of the institution in question derive greater satisfaction (see, among others, Niskanen 1971; for a corrective, Miller and Moe 1983.)⁸

Institutions may also shape outcomes because they privilege certain actors. The rules of the game, whether *de facto* or *de jure*, may only grant standing or access to certain interests, and so only (or mainly) their preferences are considered when bargaining over proposals. This privileging could have nothing to do with an institution pursuing its own private preferences; the deck could be stacked in favor of private interests outside government as a result of the administrative rules written by the principals who established the institutions in the first place (see McCubbins *et al.* 1987).

Institutions also lower transactions costs and increase the efficiency of outcomes. As a result of Williamson's work (1985) political scientists now better understand how institutions solve the problems

associated with making contracts (see Weingast and Marshall 1988; Milgrom *et al.* 1990; on the role of international institutions in resolving these problems see Keohane 1984; Yarborough and Yarborough 1987; for a realist critique see Grieco 1988). It is very often difficult, and in the context of the EU surely impossible, to write a contract which specifies all outcomes, foresees all contingencies, and effortlessly regulates the behavior of all the parties to it. In effect the Treaty of Rome was, of necessity, incomplete. As a result the problem became one of governing the contract after the fact. Institutions help solve this problem: they increase transparency by obtaining and circulating information, they monitor compliance, and sanction the recalcitrant. These practices increase the ability of all parties to an agreement to make credible promises about future behavior.

Furthermore, because institutions may be perceived to be impartial, the solutions they propose for the resolution of coordination problems have credibility, and so are generally acceptable. Such acceptance is often suggested to be the case for the institutions of the EU, especially the Commission (see Majone 1994).⁹ This credibility also helps it to administer complicated political exchanges, in which side-payments are used to accomplish agreement across multiple issue areas, and through time.

One final property of international institutions is that they are convenient scapegoats for national governments--notwithstanding the fact that they were chosen by, and are supervised by, those same governments. Delegating power may help deflect blame, and so permit the member states, for example, to accept greater adjustment costs than would otherwise be possible (see Fiorina 1982; Weaver, 1989).

In summary the literature on institutions directs attention towards the power of agenda setters, differences in access, the interests of institutional actors, and the ability of institutions to lower

transactions costs and political costs. In the context of the EU these characteristics may foster various kinds of outcomes: efficient outcomes, outcomes tending to the interests of powerful groups or particular actors, and outcomes that expand the level of integration. In the analysis that follows in Chapter 2 the institutions of the EU will be evaluated for the way in which they share in some of the political properties identified above.

Interests and institutions

The discussion of how interests could be accounted for in this project, how governments might respond to them, and the variety of ways in which institutions mediate outcomes has not emphasized the most important analytical element in the explanatory framework offered below. This project does not simply add a linear model of interest formation and aggregation to a set of institutional variables. The crucial point, revealed by the empirical episodes I examine, is the way in which interests and institutions interact. This interaction is the most important element missing from existing approaches that seek to explain EU policy outcomes, for good reason. In a complex policy space with a variety of actors such interaction is very difficult to analyze in a systematic way. My objective will be to sift out the interaction between the institutional elements identified by Tsebelis (1994) and Pollack (1996) and the interests and political leadership analyzed by Peltzman (1976) and Ray (1981). Such an approach will supply a rigorous explanation for the complex policy outcomes which extended the boundaries of political and economic integration.

Overview of the framework

In summary, the analytical framework I have developed, based on the material reviewed above, isolates the following variables and yields a discrete set of expectations about the way in which they shaped

outcomes (the framework is fully developed in Chapter 2).

The preferences of governments represented the political balance between the interests of firms in sheltered sectors on one hand, and the interests of consumers and voters on the other hand. Firms were influenced, among other things, by their competitive strength, market location and technological orientation, which determined their exposure to adjustment. The costs and benefits of integration were therefore asymmetrically distributed between governments and firms in ways that varied across issue areas, creating a variety of different strategic environments for the actors involved. This, in turn, led to variation in the ability of governments and firms to cooperate in shaping EU policy outcomes.

This general picture of firm and government preferences and their ability to cooperate played out in each specific issue area in a predictable way. In the case of auto emissions, because firms specialized in different technologies and different products, the costs of regulation fell heavily on only a few of them. National governments were also divided in their exposure to environmental sentiment among their voters. Both groups were divided, and unable to act in a concerted fashion. In the case of state aid, firms were again divided, for some had stronger claims on public patrons than others. Governments had mixed motives. On one hand, they all shared an interest in shaking off the economic claims of poorly performing “national champions”, however, each feared that others might snatch economic activity with subsidies if they practiced restraint. In anti-trust, firms were united in their interest in tacit collusion at the expense of voters. Governments were also interested in a common anti-trust regime, but willing to set the rules of the regime at a low level. Finally, in the question of external trade (specifically, Japanese imports), firms were strongly united in their desire for continued trade barriers, while governments were divided between free-trade and protection.

This map of preferences, and the level of cooperation they fostered, occurred in an institutional arena where rules restricted the set of possible outcomes (in particular by excluding the *status quo*), and favored some coalitions over others, and some agenda setters over others.

Specifically, in the case of emissions control, agenda setting shifted from producers and governments to the institutions of the EU, in particular the Parliament, which accounts for the significant increases in the level of harmonization accomplished. In state aid, the governments of the member states agreed to rule changes that increased transparency and so increased their ability to overcome the strategic dilemma they faced. However, actual reductions were modest. In anti-trust, producers and governments would have allowed even more exploitation of consumers through anti-competitive practices, had it not been for the effectiveness of the rule-integrity regime in this issue area. Finally, such were the political forces opposed to external openness that formal institutional arenas played no part—an anti-liberal outcome was informally imposed on consumers and importers.

The roles played by firms and governments, and the character of the various institutional environments are displayed in table 1. In keeping with the emphasis I place on the interaction of interests and institutions, an inspection of the table reveals that outcomes cannot be inferred in a direct manner from the variables that I argue matter. To discover if firms and governments behave in the way I anticipate, and if institutions exhibit the properties claimed, a detailed analysis of each case is required, in which outcomes are inevitably the product of a partly contingent interaction among the various elements. But before saying more about each specific case, it is necessary to justify more fully why the auto industry itself is an appropriate object of inquiry.

/Insert table 1 about here./

The Automobile Industry

The auto industry has always been a politically sensitive issue in trade among all the industrial countries, and the subject of extensive and painfully protracted bargaining (Cowhey and Long 1983, and Dunn 1987.)¹⁰ For example, the "auto pact" between the U.S. and Canada represented a prominent example of managed trade between two very interdependent developed economies. It was ultimately transformed into the North American Free Trade Agreement (Keeley 1983, and Hufbauer and Schott 1992, 1993.) It is an industry typically characterized by segmented markets and protection, which has made it the subject of many econometric studies (see, for example, Smith and Venables 1991; Kirman and Schueller 1990; Bourdet 1988; Dixit 1988; and Mertens and Ginsburgh 1985.) Nowhere is it a likely candidate for a sudden move towards economic openness.

This political sensitivity is especially true in the European case. Roughly 8% of the EU's manufacturing work force was employed in the auto industry in 1987 (CCFA 1990, 11.) These employees were mainly to be found in six producing countries--the United Kingdom, France, Italy, Germany, Spain and Belgium. The industry was one of the most concentrated in Europe, in this respect similar to aerospace. Six mass-market producers controlled over 70% of the market by the late 1980s (CEC 1989e, 41; CEC 1990b, 54.) In the ten-year period between 1977-1987 the industry received over European Currency Units (ECU) 15 billion in subsidies (\$ 22 billion), roughly ECU 1,000 per person employed in the industry in 1987 (CEC 1990b, 57.)

In summary, the industry was politically sensitive because of the number of jobs at stake, easy to organize because of its concentration, and clearly favored by national governments in the past, judging by its impressive track record in extracting direct transfer payments. Furthermore, non-tariff

barriers and other distortions imposed additional welfare losses on consumers, and yielded rents to producers of more than ECU 3 billion a year (Smith and Venables 1991.) Since giving up these rents was sure to be painful, clearly the auto industry was one of the economic sectors most likely to block the single market program. In this sector the dilemmas faced by the member states was acute: here the trade-off between the general interest and particularistic claims was at its sharpest. If they could pull it off here, they should be able to realize their goals everywhere else.

This view of the industry as a crucial test case was shared by many commentators at the time. The passage of the SEA prompted many published studies, by academics, representatives of industry, and national governments, which constantly emphasized the importance for the industry of economic integration and the importance to the political program of the SEA of success in this sector (see, for example, Sadler 1992, Salvadori 1991, Smith and Venables 1990, Diekmann 1992b, Glatz 1989, Perrin-Pelletier 1988, Commissariat Général du Plan 1992, Assemblée Nationale 1992, and House of Lords 1990.) In the minds of many across the member states the automobile industry occupied a central place in the politics of integration.

Finally, there are good analytical reasons to examine the auto industry. It is possible to capture the interaction of interests and institutions in this case because the constellation of political forces at work was relatively clear. It was an industry in which a few well-organized, intensely strategic interests were fully mobilized in a well-defined (if complex) institutional environment. This clarity makes it possible to compare the expectations generated by my analytical approach with observed political activity as well as the actual policy outcomes, thus subjecting the approach to a clear test. In other words, it is an "easy" case from the point of view of analytical transparency, unusual for an area of

research made opaque by the variety of possible actors and the complexity of their interactions.

Explaining Liberalization in the European Auto Industry

The whole history of the EU shows that international agreements which realize mutual gains are always subject to collective action problems, and so been undersupplied. The purpose of the SEA was to overcome these kinds of problems and bring an end to political and economic stagnation and the divergent (and collectively inefficient) policy-making which sustained it. In the case of the politically powerful auto industry this ambitious program of political and economic cooperation was only partly successful. What accounts for this mixed success?

The chapters that follow are organized in a straightforward manner with a view to supplying a comprehensive, analytically informed answer to this question. Chapter 2 presents the analytical approach in such a way that a series of expectations about firm and state behavior and the role of institutions are fully developed. This is followed by a thoroughgoing examination of the history and character of the European auto industry, as it stood on the eve of the SEA. In particular I distinguish those elements which tended to help or hinder firm cooperation. I also define the policy objectives which were likely to be the focus of collective action by the auto makers and the governments of the member states. The existing (and formerly stable) pattern of firm-state relationships is also described, as well as the cross national variation in private industry associations. Finally, the expectations derived by my analytical framework, given the economic and political geography of the sector, are then scrutinized in the context of four case studies of EU policy making: environmental regulation, external trade, state aid and anti-trust. I present a brief account of my findings in each case below.

Automobile Emissions

Automobile emissions were finally harmonized across Europe in December, 1987, after protracted and divisive bargaining. The outcome appeared to reflect the interests of the mass-market auto makers because standards, while uniform for the first time, were low by comparison with US practice. This agreement was soon followed by another dealing with small autos. However, that outcome was much more favorable to those wanting high environmental standards, and imposed significant adjustment costs on the auto makers. This change in outcome is nicely explained by the interaction of divided interests in the context of a changing institutional environment.

The analytical approach employed in this project accounts for the change by showing why firms and governments were divided, and what the effect was of the institutional environment (which had been changed in important ways by the SEA). There was a lack of cooperation between firms on the level of regulation because of the way in which it imposed different costs on each. This proved to be crucial, because the institutional arena favored a coalition of governments, firms and others which preferred harmonized regulation at a high level instead of low but fragmented regulation. It is especially worth noting how elements in the European Parliament were given the power to set the agenda by rule changes incorporated into the SEA.

External Trade

The EU-Japanese agreement on trade in autos, which was adopted in July, 1991 was a very irregular international economic agreement, clearly contrary to the spirit and letter of the EU's obligations under the General Agreement on Tariffs and Trade (GATT) and at odds with the liberal purpose of the SEA.

Why did the establishment of a common external trade regime fall so short of free-trade principles?

The explanation is that mass-market auto producers, in direct contrast to the policy outcome in

emissions control described above, were united by a very strong interest in the outcome. This political weight was decisive.

The issues of external trade and transplant production were closely linked. While there existed a common interest among producers in limiting imports, there existed a powerful coalition among some governments of the member states for a liberal foreign investment. This cohesion was reflected in the outcome. The passage of the SEA meant an end to the patchwork of existing national practice and forced the issue of external trade onto the agenda, re-shaping the institutional environment by giving the Commission a significant role in international bargaining for the first time. However, this meant that industry interests were privileged, due to their cohesion and influence over the Commission. The auto producers' transnational industry association, renewed after the defeat over emissions control, further increased the political effectiveness of the industry (a renewal reflecting the forces that fostered inter-firm cooperation in this case). In the end, imports were capped for ten years while foreign investment remained unfettered.

Anti-trust

The single-market program meant increased economic openness, leading to increased competitive pressures, with increased efficiency, lower prices, increased growth and a variety of other beneficial effects as a consequence. However, the persistence of cartels and other anti-competitive practices would, of course, thwart the project no matter how many formal regulatory barriers were eliminated. But it was sure to be hard for the member states to agree on a common anti-trust policy. They may have wished for a single policy (the rapid rise of cross-border mergers and acquisitions following the SEA made multiple national practices an increasing burden), but choosing between, for example, the

very different practices of Germany and the U.K. would be politically very sensitive. What is more, the auto industry appears to have been generously treated where it might have expected significant constraints placed upon it by an EU-wide regulatory regime.

I show how the member states delegated power to the Commission, which enjoyed considerable discretion. However, the interests of member states were not overlooked by semi-autonomous policy choices of the Commission. The member states had little interest in specific policy outcomes, but some interest in an EU anti-trust regime which largely left untroubled the separate practices of the member states. On the other hand, firms shared an interest in tacit collusion if it could be accomplished, which was partly allowed them by escape clauses in the regulatory framework. However, I also discover that the Commission, due to a degree of legal autonomy, was able to check the influence of industry upon occasion.

State Aid

In the case of state aid the member states faced a more complicated strategic environment because of the fear that others might cheat. Industry rationalization was a likely consequence of the SEA, and a government could be tempted to subsidize a "champion" in order to ensure its survival in the event of a shake-out. Of course, if all governments did that then the benefits of the 1992 project would be lost. In the event, the institutions of the EU were adapted by the member states so as to mitigate this dilemma. Another problem was that while all the auto makers fed at the public trough in one way or another, some were better fed than others. This meant that state aid from national patrons was a divisive issue for firms, while for governments restraint would save them money, although injure established favorites.

As it turned out, policy outcomes were in keeping with the interest of the member states in reducing state aid. Constraints were placed on the level of state aid, but only slowly in order to keep the political costs of imposing these constraints as low as possible. By contrast, auto makers persisted in making claims on national governments, rather than presenting a collective demand for the resources needed to help them adjust. The issue area kept them divided. However, the Commission proved to be much less autonomous in this issue area; governments lobbied for their favorites and improvements over past practice were only incremental.

Conclusions

In the final chapter I conclude by showing how the elements in the case studies were consistent with the analytical framework presented in Chapter 2. I go on to draw out the implications of my findings for our understanding of institutional innovation and adaption. To the extent that this research shows the consequences for policy outcomes of political institutions, so it should be possible to make inferences about the political struggles I expect to observe over their control and their adaptation. I find in general that the institutions of the EU were closely circumscribed by the interests of the governments and firms that acted on them and through them. I also suggest that a subset of the important players in the auto industry, V.W. and the U.S. multinational producers, were better prepared to take advantage of regional integration because they were less enmeshed in longstanding client relationships with national governments.