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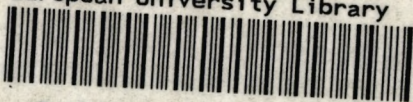
EUI Working Paper SPS No. 91/10

**Market Integration and Regulation:
Europe after 1992**

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EUROPEAN UNIVERSITY INSTITUTE, FLORENCE

DEPARTMENT OF POLITICAL AND SOCIAL SCIENCES

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Printed in Italy in October 1991
European University Institute
Badia Fiesolana
I-50016 San Domenico (FI)
Italy**

Market Integration and Regulation: Europe after 1992

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1. Introduction: Pigou vs. Musgrave

The Treaty of Rome envisages a single European market free of restrictions on the movement of people, goods, services, and capital. The logic of the Treaty seems to imply that once the individual markets of the member states of the European Community (EC) have been integrated, no further intervention in the economy is either necessary or desirable -- except to ensure that competition in the common market is not distorted and, arguably, to correct other kinds of market failure.

In Musgrave's well-known classification of the economic functions of government, these regulatory interventions belong to the allocative branch. The Rome Treaty assigns virtually no redistributive functions to the Community level, the only significant exceptions being the Guarantee Section of the Agricultural Fund and the Social Fund. Together with the Regional Development Fund (established by the Paris Summit of 1972) and development aid, these redistributive programmes absorb more than 70 per cent of the Community budget. However, the EC budget amounts to about 1.2 per cent of Community GDP and less than 4 per cent of the central government spending of member states; hence it is much too small to have any significant impact on the interpersonal, interregional or international distribution of

 Paper presented at the Conference on "Production Organization, Dynamic Efficiency and Social Norms", Rome, April 4-6, 1991. The author wishes to acknowledge the useful comments of the discussant, prof. Michele Salvati.

wealth. Because of its small size, the Community budget -- which by Art.199 of the Treaty must be balanced -- cannot be used as an instrument of macroeconomic stabilization policy, either.)

In short, although Musgrave's functional classification is still widely used in public discussions and in influential documents about the future of the Community such as the Padoa-Schioppa report (Padoa-Schioppa et al., 1987), its usefulness for understanding the likely evolution of the economic system of the EC is doubtful. The Musgravian scheme not only presupposes the existence of a full-fledged government -- while the EC will remain in a pre-federal stage for at least another decade -- but also reflects an interventionist philosophy at variance with the economic liberalism of the Treaty of Rome. Reliance on the Musgravian classification can mislead one into thinking that the integrated European market will be something a good deal larger than, but qualitatively similar to, the twelve national markets that compose it.

Paradox of subsidiarity

◀ In fact, the Community-wide market will be quite different from the mixed economies which historically evolved in the member states. On the one hand, the single market cannot come into being and operate effectively unless the capacity of national governments to intervene in the economy is drastically reduced. On the other hand, the majority of European voters are willing neither to accept a complete reversal of the prevailing socioeconomic order, nor to transfer to the Community institutions the powers necessary to carry out all the traditional functions of government. The completion of the Internal Market will ultimately reflect a compromise between these conflicting constraints and, as Jacques Pelkmans has rightly observed, the regulation issue -- what, how, and at what level of government to regulate -- is the core of the emergent compromise (Pelkmans, 1989).>

Regulation is a distinctive form of policy-making mainly concerned with the correction of various types of market failure:

externalities, monopoly power, public goods, inadequate or asymmetrically distributed information. According to the market-failure approach, state intervention should be limited to the provision of public goods, such as environmental protection or public health measures, and to increase the efficiency of the economic system by the use of regulatory instruments. This view of the economic rationale of government is firmly rooted in the Pigovian tradition. In *The Economics of Welfare*, Pigou not only discussed at length external economies and diseconomies and the case for government intervention, but also expressed his support of the American approach to regulation by means of independent regulatory bodies like the Interstate Commerce Commission (Coase, 1988).

It is fair to point out that recent years have seen a considerable broadening of the areas of interest of market-failure analysts beyond the cases envisaged by Pigou, especially to include incomplete markets and information failures (Stiglitz, 1988). An important recent development is the recognition that market failures provide only a *prima facie* case for intervention, since the costs of public intervention may exceed the benefits. Hence "regulatory failure" must also be considered. In fact, I shall argue that regulatory failures are even more important than market failures for explaining the delegation of regulatory powers to a supranational authority.

A frequent criticism of the market failure approach is that it is a normative, rather than a positive, approach. It provides a basis for identifying situations where the government ought to do something, tempered by consideration of regulatory failure. However, many political scientists and economists believe that analysts should focus their attention not on normative issues but on describing the consequences of government programmes and the nature of the political processes. Normative analysis, it is said, is irrelevant since policy outcomes depend, not on norms or ideas about the public interest, but on factors like the rules of

the political process, the incentives facing various participants in the process, and the changing configurations of power and interests in society.

The normative-positive dichotomy has played a large role in methodological discussions in the social sciences at least since Max Weber. It is not my intention to contribute to the debate, but since in this paper normative and positive arguments are intertwined, a few words about this issue may be justified. The first point I wish to make is that in the social sciences, including economics, the distinction between normative and positive theories is much less sharp than positivists and neopositivists used to think. Thus, in an important survey paper on "Regulation in Theory and Practice", Joskow and Noll have called "normative analysis as a positive theory" (or NPT) the theory which regards market failure as the motivating reason for the introduction of public regulation (Joskow and Noll, 1981; Peltzman, 1989).

The characterization is appropriate since the normative theory is often successful in explaining the origin and development of many regulatory policies. As Peltzman (1989:17) has written,

If there is an empirical basis for the NPT's continuing attraction for economists, it is probably its apparent success as an entry theory. Consider Hotelling's classic statement in 1938 of the natural monopoly version of the NPT. In this purely theoretical piece, railroads and utilities are presumed, without much evidence, to be the main real-world examples of natural monopoly. They also occupied most of the regulatory (including public ownership) effort when Hotelling wrote. This correspondence between the NPT and the real-world allocation of regulatory effort seems striking. Now consider the postwar expansion of regulation. In terms of the resources involved, the biggest single chunk is probably accounted for by environmental regulation, where the externalities aspect of the NPT scores another success.

Since Peltzman gives no reasons for the predictive success of a purely normative theory, I would like to sketch a possible explanation. A key point is that the relationship between social theory and social institutions is a dialectic one: the theory describes and evaluates those institutions, but at the same time those institutions which would otherwise be disconnected and unorganized, become conceptualized and systematized, and thus transformed, by theory. The dialectic nature of the relationship between theories and institutions has been clearly grasped by some legal scholars. According to Harold (J.) Berman, for example, the law contains within itself a legal science, a "meta-law", by which it can be both analysed and evaluated. In this way, legal argument becomes a constituent activity of the legal process itself, and the development of legal institutions is not artificially separated from the development of theories about those institutions (Berman, 1983).

A related point is also helpful for understanding the relation between normative discourse and institutional or policy change. Even when change is best explained by the political or economic power of groups seeking selfish ends, those who attempt to justify those changes must appeal to the merits of particular issues. Legislators, administrators, analysts, and the public at large wish to know whether the change is justified. All of them seek standards against which to judge the success of a policy and the merits of specific programmes initiated within the framework of that policy (Breyer, 1982; Majone, 1989). This explains why normative arguments are important for understanding policy developments and institutional change, even when they do not significantly influence specific policy-decisions.

This paper is about policy development and institutional change in the European Community. I have argued that because regulation is such an important part of EC policy-making, the market failure approach -- viewed as both a normative and a positive theory of policy-making -- is a better starting point

than Musgrave's functional classification for understanding the emergence of new structures of governance in an increasingly integrated European market. However, before discussing the problem of how regulatory authority should/will be distributed among different levels of government, we must explain the enormous growth of Community regulation in the last decades -- a development probably unanticipated by the drafters of the Treaty of Rome.

2. The Growth of Community Regulation

It is becoming increasingly difficult to understand the domestic policies of member states without taking Community legislation into consideration. This is particularly true for economic and social regulation. I do not mean to suggest that EC regulators attempt to replace or even closely supervise national regulators. Such a goal would be politically infeasible at present, and would in any case require a large increase of specialist staffs in Brussels and the creation of European regulatory agencies and inspectorates.

Comparing national and Community rule making in a number of policy fields one can see instead two different regulatory systems, with the second designed to coordinate and complement rather than replace or challenge the first. At the same time, one must keep in mind that Community regulation, when agreed by the Council, has primacy over national legislation. Hence, regardless of the intentions of the Commission, national regulators tend to lose power in an increasing number of areas (Vipod, 1989).

Economists and political scientists have paid insufficient attention to these developments. The vast literature on European integration and on policy-making in the European Community contains very few studies of the political economy of regulation at the Community level. So far, the most significant contributions to the study of EC regulation have come from legal scholars who are naturally more concerned with procedural

questions than with substantive policy evaluations or general theoretical explanations. Given the importance of Community regulation in so many areas of economic and social life, from banking and technical standardization to environmental and consumer protection, this scarcity of regulatory policy analyses is surprising and can only be explained by the absence of a suitable theoretical framework.

Aside from competition policy and measures necessary for the integration of national markets, few regulatory policies or programmes are specifically mentioned in the Treaty of Rome. The transport and energy policies which could have given rise to significant regulatory activities, have remained largely undeveloped. How, then, can one explain the continuous growth of Community regulation, even in the absence of explicit legal mandates? Take the case of environmental protection, an area not even mentioned by the Treaty of Rome. In the two decades from 1967 to 1987, when the Single European Act finally recognized the authority of the Community to legislate in this area, almost 200 directives, regulations, and decisions were introduced by the Commission. Moreover, the rate of growth of environmental regulation appears to have been largely unaffected by the political vicissitudes, budgetary crises, and recurrent waves of Europessimism of the 1970s and early 1980s. From the single directive on preventing risks by testing of 1969 (L68/19.3.69) we pass to 10 directives/decisions in 1975, 13 in 1980, 20 in 1982, 23 in 1984, 24 in 1985 and 17 in the six months immediately preceding passage of the Single European Act. >

The case of environmental regulation is particularly striking, partly because of the political salience of environmental issues, but it is by no means unique. The volume and depth of Community regulation in the areas of consumer product safety, medical drug testing, banking and financial services and, of course, competition law is hardly less impressive. In fact, the hundreds of regulatory measures proposed

by the Commission's White Paper on the completion of the internal market only represent the acceleration of a trend set in motion decades ago. The continuous growth of supranational regulation is not easily explained by traditional theories of Community policy-making. At most, such theories suggest that the serious implementation gap that exists in the European Community may make it easier for the member states, and their representatives in the Council, to accept Commission proposals which they have no serious intention of applying. The main limitation of this argument is that it fails to differentiate between areas where policy development has been slow and uncertain (for example transport, energy or research) and areas where significant policy development has taken place even in the absence of a clear legal basis.

Moreover, existing theories of Community policy-making do not usually draw any clear distinction between regulatory and other types of policies. Now, an important characteristic of regulatory policy making is the limited influence of budgetary limitations on the activities of regulators. The size of non-regulatory direct-expenditure programmes is constrained by budgetary appropriations and, ultimately, by the size of government tax revenues. In contrast, the real costs of most regulatory programmes are borne directly by the firms and individuals who have to comply with them. Compared with these costs, the resources needed to produce the regulations are trivial.

It is difficult to overstate the significance of this structural difference between regulatory policies and policies involving the direct expenditure of public funds. The distinction is particularly important for the analysis of Community policy-making, since not only the economic, but also the political and administrative costs of enforcing EC regulations are borne by the member states.

As already noted, the financial resources of the Community go, for the most part, to the Common Agricultural Policy and to a

handful of redistributive programmes. The remaining resources are insufficient to support large scale initiatives in areas like industrial policy, energy, research, or technological innovation. Given this constraint, the only way for the Commission to increase its role is to expand the scope of its regulatory activities.

Thus any satisfactory explanation of the remarkable growth of Community regulation must take into account both the desire of the Commission to increase its influence, and the possibility of escaping budgetary constraints by resorting to regulatory policy-making. Such an explanation differs not only from traditional theories of Community policy-making, but also from the economic theory of bureaucracy as formulated, for example, by Niskanen (1971). In Niskanen's model an administrative agency can maximize its budget, subject to the constraint that the budget covers the cost of producing a given level Q of service, because only the agency's managers know the true cost function $C(Q)$. The funding body -- Congress or Parliament -- knows only its utility function $U(Q)$ and thus cannot determine the level of Q such that the first order condition $U'(Q) = C'(Q)$ is satisfied. This allows the agency to request a budget larger than the one which maximizes the net benefits of those who provide the funds.

The crucial assumption of this principal-agent model is that the size of the budget is positively and monotonically related to such goals of a bureaucrat as "salary, the perquisites of office, public reputation, power, patronage, output of the bureau" (Niskanen, 1971:38). For the reasons given above, this is not a plausible hypothesis for a regulatory agency. In fact, public choice and other economic theories of regulation (Stigler, 1971; Peltzman, 1976; Phillips and Zecher, 1981; Becker, 1983; Mackay et al., 1987) make no use of the hypothesis of budget maximisation in modelling the behaviour of regulatory bodies. In these models, regulators maximise their utility not by concealing their true cost function but by providing benefits, through

regulation, to a variety of interest groups. Moreover, both Niskanen's model of budget maximisation and the economic theories of regulation assume that the type of service provided by the agency, though not the level of activity, is essentially fixed. In other words, the administrative or regulatory functions have already been assigned; the models only attempt to predict how those functions will be performed. In the case of developing supranational institution like the EC, the assignment problem, that is, the definition of competences, is the crucial one. This fact justifies our assumption that the EC Commission attempts to maximise, not its budget but its influence as measured by the scope of its competences. The available empirical evidence seems in fact to support the hypothesis that the utility function of the Commission is positively related to the scope rather than the scale of the services provided.

Another important element in a complete explanation of the growth of Community regulation is the interest of multi-national export-oriented industries in avoiding inconsistent and progressively more stringent regulations in various EC and non-EC countries. Community regulation can eliminate or at least reduce this risk.

A similar phenomenon has been observed in the United States, where certain industries, faced with the danger of a significant loss of markets through state and local legislation, has strongly supported federal regulation ("preemptive federalism"). For example, the American automobile industry had good reasons to prefer federal regulation of air pollution because of the threat posed by different and inconsistent air pollution standards and also because it feared "a kind of political domino effect, in which one state legislature after another would set more and more stringent emission standards without regard to the costs and technical difficulties involved ... Federal legislation was preferable to state legislation -- particularly if federal standards were set based on technical presentations to an

administrative agency rather than through symbolic appeals to cost-externalizing politicians" (Elliott et al., 1985:331).

Thus the car industry, which during the early 1960s had successfully opposed federal emission standards for motor vehicles, abruptly reversed its position in mid-1965: provided that the federal standards would be set by a regulatory agency, and provided that they would preempt any state standards more stringent than California's, the industry would support federal legislation.

Analogous reasons explain the preference for Community solutions of some powerful and well-organized European industries. Consider, for example, the "Sixth Amendment" of Directive 67/548 on the classification, packaging, and labelling of dangerous substances. This amending Directive 79/831 does not prevent member states from including more substances within the scope of national regulations than are required by the Directive itself. In fact, the British Health and Safety Commission proposed to go further than the Directive by bringing intermediate products within the scope of national regulation. This, however, was opposed by the chemical industry, represented by the Chemical Industries Association (CIA) which argued that national regulation should not impose greater burdens on British industry than the Directive placed on its competitors. The CIA view prevailed thus ensuring that in this as in many other cases, Community regulation would in fact set the maximum as well as the minimum standard for national regulation (Haigh, 1984).

Similarly, German negotiators pressed for a European-wide scheme that would also provide the framework for an acceptable regulatory programme at home. German firms, concerned about overzealous enforcement by national inspectors and afraid of an environmentally conscious public opinion at home, wanted a full and explicit statement of their obligations to be defined at the EC level. Moreover, with more than 50 per cent of Germany's chemical trade going to other EC countries, German businessmen

and government officials wished to avoid the commercial obstacles that would arise from divergent national regulations (Brickman, Jasanoff and Ilgen, 1985).

The European chemical industry had another reason for supporting Community regulation. In 1976 the United States, without consulting their commercial partners, enacted the Toxic Substances Control Act (TSCA). The new regulation represented a serious threat for European exports to the lucrative American market. A European response to TSCA was clearly needed, and the Community was the logical forum for fashioning such a response. An EC-wide system of testing new chemical substances could serve as a model for negotiating standardized requirements covering the major chemical markets. In fact, the 1979 Directive has enabled the Community to speak with one voice in discussions with the United States and other OECD countries, and has strengthened the position of the European chemical industry in ensuring that the new American regulation does not create obstacles to its exports. There is little doubt that the ability of the Commission to enter into discussions with the USA has been greatly enhanced by the Directive, and it is unlikely that each European country on its own could do so effectively (Brickman, Jasanoff and Ilgen, 1985: 277).

At the beginning of this section we stated that it is becoming increasingly difficult to understand the domestic policies of member states without taking Community policies into consideration. The most obvious impact of Community regulations on national policies is a transfer of legislative competence to the Community since the principle of supremacy of Community law bars member states from passing laws inconsistent with the relevant EC directive. Hence it is also becoming more and more difficult to explain the development of Community regulatory policy-making as if the only important political actors were the national governments represented in the Council. Models of this type have led, for example, to the incorrect prediction that

environmental process regulation would not occur in a system requiring unanimous consent of the member states, because states with relatively low standards would find it against their interest to agree to higher standards (Rehbinder and Stewart, 1985). As the example of the 1979 directive on toxic substances shows, such state-centered models overlook many important factors such as the variety of industrial interests within one country; the advantages of "preemptive federalism" for multinational or export-oriented firms, both for avoiding inconsistent national regulations and for shifting regulatory decision-making to a less political, more technocratic arena; the importance of speaking with one voice in negotiating international regulatory issues; and last but not least the ability of the Commission to regulate even without adequate legal and budgetary resources.

3. Competition among Regulators

In the White Paper on the completion of the internal market, the Commission has proposed a new approach to regulation which includes among its key elements the strategy of "mutual recognition". Recognition of the rules and standards of one EC country by the other member states gives greater scope to national regulation and hence seems to falsify the hypothesis that the EC Commission attempts to maximise the scope of its competences. In this section I shall try to show that this is not the case, and in doing so I shall have to examine to what extent the competition among regulators which is implicit in the principle of mutual recognition, is in fact possible or desirable in a supranational system like the European Community.

The immediate reason for introducing the new strategy was to reduce the burden on the Commission in harmonizing national rules. Despite the impressive growth of Community regulation in the 1960s and 1970s, by 1985 the Commission had to acknowledge that the amount of work that remained to be done was such that the goal of completing the internal market by 1993 could not be

achieved by relying exclusively on the traditional harmonization approach. In the words of the Commission (1985, 18) "experience has shown that the alternative of relying on a strategy based totally on harmonization would be over-regulatory, would take a long time to implement, would be inflexible and could stifle innovation".

Harmonization, rather than unification, of national regulations had been the main objective of the Community in its first 25 years. Harmonization is the adjustment of national rules to the requirements of a common market. Its characteristic instrument is the directive because this instrument only specifies the regulatory objectives to be achieved, leaving the choice of methods to the member states.

To overcome the limitations of the traditional approach, the Commission's White Paper introduced a new strategy with the following key elements: mutual recognition of national regulations and standards; legislative harmonization to be restricted by laying down essential health and safety requirements which will be obligatory on all member states; gradual replacement of national product specifications by European standards issued by the Comité Européen de Normalisation (CEN) or by sectoral European organizations such as CENELEC in the electrical sector and CEPT in the telecommunications sector.

In essence, the White Paper proposes a conceptual distinction between matters where harmonization is essential and those where it is sufficient that there be mutual recognition of the equivalence of the various basic requirements laid down under national law. This line of reasoning was first introduced by the European Court of Justice in the famous Cassis de Dijon judgment of 1979. The Court had stated that a member state may not in principle prohibit the sale in its territory of a product lawfully produced and marketed in another member state even if this product is produced according to technical or quality

requirements which differ from those imposed on its domestic products -- except when the prohibition is justified by the need to ensure effective fiscal supervision, to protect public health or the environment, or to ensure the fairness of financial transactions.

Given the cumbersome nature of the Community decision-making process, the new approach has considerable advantages, at least in theory. Unlike harmonization, mutual recognition does not involve the transfer of powers to the Community but, at most, restricts the freedom of action of member states. Moreover, the emphasis on mutual recognition avoids all the difficulties linked to the necessity of drafting directives so as to suit the substantive concerns of twelve different actors or the particular requirements of their legal system. Finally, the new approach creates a competition among national regulators which, like competition among producers of goods and services, should provide an efficient way of assessing the costs and benefits of different methods of regulation and increase the range of choice available to consumers.

★ ↳ To some, the competition among national rules made possible by mutual recognition is the strongest argument in favour of the new approach. The advantages expected from this kind of competition are indeed likely to be realised when regulation deals with information asymmetries (Kay and Vickers, 1990) or in the case of undifferentiated products which consumers are competent to evaluate. For example, if German TV standards are less costly than French standards but consumers regard German TV sets as essentially equivalent to the more expensive French sets, French producers will lose business to their German competitors. Hence they will bring pressures on their government to modify national standards. If other countries find themselves in a similar situation, competition among rules will eventually lead to convergence to the most cost-effective standard (ex-post harmonization).↳

competition bet
legal orders.

But there are many products for which mutual recognition is far from being optimal. First, as already noted, the consumer must be able to evaluate the relevant cost-quality tradeoffs. For many products and services this is not a realistic assumption. In such cases, not the consumers but public authorities will decide whether certain price-quality or price-risk combinations are acceptable. However, national regulators tend to raise objections against each other almost routinely, as shown by the experience with the mutual recognition of new medical drugs discussed below. This and similar examples suggest a general problem with mutual recognition: when decisions are made by a handful of national authorities rather than by millions of consumers, strategic (oligopolistic) behaviour replaces free market competition -- a phenomenon discussed in more detail in the next section.

Second, mutual recognition of technical standards may be least satisfactory in precisely those areas where the potential gains from the Single Market are highest (Gatsios and Seabright, 1989). This is because it is often convenient to have uniform technical standards in order to enable interconnection of specialized equipment, as in the case of telecommunications. The problem is particularly acute when several standards (like the PAL and SECAM standards for colour TV) are equally satisfactory from a technical viewpoint so that there is no obvious reason why one standard should be given preference. The essential equivalence of many technical standards explains why in the telecom sector, for example, the industry's regulators -- usually the national PPTTs -- have traditionally been able to sustain their restrictive procurement practices by demanding observance of national standards reinforced by discriminatory certification procedures.

Recent developments in the field of high definition TV show how difficult agreement about technical standards continues to be. The D2 MAC interim standard imposed by a 1986 EC Directive has been opposed by some satellite operators such as B SKY B in

Britain who opted for the older, more common PAL standard. A compromise seems now to have emerged, but only because the Commission has promised to pay some of the costs of "simulcasting" in both standards at once. It is not yet clear whether broadcasting in D2MAC will be made mandatory after a certain date, or perhaps only after a certain proportion of satellite dishes and televisions can receive it.

The time dimension, although seldom considered, is essential in evaluating the efficiency of competitive processes. Assume a situation where it is reasonable to think that competition among national rules will eventually eliminate the less efficient forms of regulation, leading to ex-post, rather than ex-ante, harmonization. Unfortunately, it will be usually impossible to estimate the speed of convergence toward the superior method. If convergence to the most efficient type of regulation is slow, producers in different countries may become committed to a particular system of standards which it would be extremely costly to change at a later stage -- a kind of "first-mover disadvantage" (Williamson, 1975).

Another source of potential difficulties, related to the strategic behaviour mentioned above, has been noted by Gatsios and Seabright. Even assuming that mutual recognition of existing standards is nearly optimal, national authorities may bias their decisions on future standards toward low level of quality or protection. Because approved products may be sold throughout the Community, national authorities know that much of the harm due to low standards will fall on consumers in other member states, while the cost savings will accrue to their own producers (Gatsios and Seabright, 1989: 43).

It is important to realize that the same danger can arise even in areas, like the regulation of financial and professional services, where mutual recognition seems to be most appropriate. Thus, under the Second Banking Directive banks licensed in one member state can operate in another. The Solvency Ratio Directive

and Own Funds Directive attempt to ensure that bank licensing is conducted on a reasonably common basis. However, the application of the home country principle to the approval and supervision of banking services, coupled with the application of the host country principle for deposit insurance schemes, creates opportunities for strategic regulation by national authorities. As in the case of product standards, national regulators have incentives to set weak standards since foreign tax payers will pay the bill in case of bank failure. A process of "competitive deregulation" may set in as each country attempts to give competitive advantages to its domestically licensed institutions (Vives, 1990).

< It is clear that the principle of mutual recognition cannot be relied upon to manage negative externalities with international effects such as air or water pollution crossing national boundaries. There is also fairly general agreement among the experts that the competitive structure of the integrated European market will have to be protected by central institutions of the Community against national interests in anti-competitive regulations. This implies that the competition policy of the internal market should be monopolised by the Community. Only for products with a national distribution is a national competition policy conceivable. >

Finally, let us come back to the instructive example of medical drugs. For more than two decades, the Commission has attempted to harmonise national regulations for the approval of new medical drugs. The present system includes a set of harmonised criteria for testing new products, and the mutual recognition of toxicological and clinical trials -- provided they are conducted according to EC rules. In order to speed up the process of mutual recognition, a "multi-state drug application procedure" (MSAP) was introduced in 1975. Under the MSAP, a company that has received a marketing authorisation from the regulatory agency of a member state may ask for mutual

recognition of that approval by at least five other countries. The agencies of the countries nominated by the company must approve or raise objections within 120 days. In case of objections, the Committee for Proprietary Medicinal Products (CPMP) -- a group which includes experts from member states and Commission representatives -- has to be notified. The CPMP must express its opinion within 60 days; within another 30 days it may be overruled by the national agency that has raised objections.

The procedure has not worked well. Actual decision times are much longer than those prescribed by the 1975 Directive, and national regulators do not appear to be bound either by decisions of other regulatory bodies, or by the opinions of the CPMP. Because of these disappointing results, the procedure has been revised in 1983. Now only two countries have to be nominated in order to be able to apply for a multi-state approval. But even the new procedure has not succeeded in streamlining the approval process, since national regulators raise objections against each other almost routinely. In sum, mutual recognition of national drug approvals has proved to be extremely difficult. The problem is that differences among national schools of medicine, different national attitudes in the evaluation of risks and benefits, and differently perceived needs for new drugs lead to divergent interpretations of drug approvals despite the fact that they have been prepared according to a standardised European format (Kaufer, 1990).

These difficulties have finally convinced the European Commission to propose the establishment of a European Agency for the Evaluation of Medicinal Products and the creation of a new centralized Community procedure, compulsory for biotechnology products and certain types of veterinary medicines, and available on an optional basis for other products, leading to a Community authorization (Commission of the European Communities, 1990).

The above discussion is not meant to deny that mutual recognition may play a useful role in the integrated European

market, especially in connection with market failures due to insufficient information. However the principle can be effective, not in place of, but in conjunction with, European regulation. If it were possible to avoid centralization by inducing the member states to accept the principle, we should observe a more extensive use of mutual recognition in mature federal systems like the United States. In fact, mutual recognition presupposes a higher degree of cooperation among member states than the commerce clause of the U.S. Constitution requires among individual states. The commerce clause has been interpreted by the U.S. Supreme Court to allow each state to insist on its own product quality standards -- unless the subject has been preempted by federal regulation, or unless the state standards would unduly burden interstate commerce (Hufbauer, 1990). Is it realistic to assume that the members of a community as varied in language, history, political culture and legal traditions as the EC, are willing and able to cooperate more closely than the members of the American federation? >

It is hard to imagine that the authors of the White Paper had not anticipated at least some of the difficulties discussed here. It cannot have escaped policy-makers in Brussels that mutual recognition is too dependent on the good will and altruism of national actors to be more than an auxiliary solution to the various kinds of market failure that can be expected to arise in an integrated European market. Supporters and advocates of the Community's "new approach" to regulation like to present it as an application of the subsidiarity principle of federalism: the higher level of government should intervene only to provide public goods that lower levels cannot supply. But this is disingenuous; concepts like public good, externality, public interest have no generally accepted meaning in a system which is at best pre-federal and where the sovereignty of the member states is still largely intact.

The practical conclusion can only be that the "new approach" is less a new and promising strategy than an attempt to reduce the burden on the Commission in harmonizing national rules; a tactical move meant to take advantage of the political appeal of deregulation, and to rally all available forces around the banner of 1992. In launching a new, ambitious programme of economic integration it was both wise and politically expedient not to emphasise that while the completion of the Internal Market calls for massive deregulation at the national level, this would have to be followed, in many cases, by re-regulation at Community level.

Logically speaking, however, re-regulation at Community level is not the only possibility. In theory, it would be possible for the member states to avoid an expansion of Community competences by coordinating their regulatory policies so as to take into account (explicitly or tacitly) one another's interests. Mutual recognition is a weak, largely passive form of cooperation; policy coordination is considerably stronger and hence could conceivably provide an adequate regulatory regime for the Internal Market. We explore this possibility in the next section.

4. Coase Theorem, Prisoners'Dilemma and Regulatory Failure

The rationale for supra-national regulation is regulatory failure rather than market failure. As Ronald Coase (1960) argued in a famous article, the presence of externalities alone does not necessarily prevent effective coordination among independent actors. If national regulators were willing and able to take into account the international repercussions of their policy choices; if they had perfect information of one another's intentions; and if the costs of organising and monitoring policy coordination were negligible, market failures could be managed in a cooperative fashion without the necessity of delegating regulatory powers to a supra-national level.

International regulatory failure occurs when one or more of these conditions are not satisfied, and it is important to observe that this can happen even in the case of purely local market failures. For example, problems of safety regulation for construction of local buildings create no inter-country externalities and thus, according to the traditional view of the matter expressed by the principle of subsidiarity, should be left to the local authorities. However, if safety regulation specifies a particular material only produced in that locality, it may amount to a trade barrier and thus have negative external effects. In this case, local regulation of a local market failure creates an international regulatory failure. In general, strategic behaviour, imperfect information, and positive transaction costs are the main obstacles to successful coordination of national (or sub-national) regulatory policies.

Within the context of EC institutions, "coordination" means joint and interdependent actions without legal force: renegotiations cannot be taken to the European Court of Justice (Emerson, 1989). The most important example is the European Monetary System (EMS) in which participants behave according to rules which are not enforceable in European law.

The relative success of the EMS shows that supra-national policy coordination is not impossible. At the same time it must be noted that even after the European Single Act, monetary policy cooperation has not yet crossed the threshold of stronger institutionalisation. The delay until today of the transition of the EMS into its second stage -- characterised by an advanced degree of pooling of the official international reserves of the participants and by the consolidation and extension of the credit mechanisms through a European Monetary Fund -- is probably due to the fact that the EMS cannot impose any convergence constraints which fall into the sphere of responsibility of general economic policy.

At any rate, the EMS is a special case of doubtful relevance to the problems of regulatory policy coordination discussed in this paper. The theory of hegemonic stability (Kindleberger, 1973; Gilpin, 1987) is quite sufficient to explain the emergence and stability of the system. According to this theory, the formation of international regimes normally depends on hegemony ("leadership" or "responsibility" in the terminology of Kindleberger) of one country, and their maintenance requires continued hegemony. In fact, the initiative for the establishment of the EMS came from the German, and to a lesser extent the French, government -- rather than from a collective choice of all the member states of the EC -- and the viability of the system depends crucially on its asymmetry. It is well known that while the EMS has only had a minor influence on German monetary policy, the other participants often had to adjust their monetary policy in order to defend their DM exchange rate. It has been argued that the EMS, as a European institution, should be as symmetric as possible in order to reflect the interests of all its members. However, the demand for symmetry clashes with the basic proposition that in a fixed-exchange rate regime only one country can, in the long run, determine its own monetary policy, which then constitutes the anchor that ties down the price level and money supply in the other countries (Gros and Thygesen, 1988). Hence, the EMS must be an asymmetric system anchored by German monetary policy if the exchange rates are to be really fixed -- as both economic theory and the theory of hegemonic stability demand.

It seems highly unlikely that Germany, or any other member of the EC, would be willing to provide leadership in regulatory matters -- or that leadership would be accepted by the other member states. There are many reasons why one cannot count on the initiative of a "lead country" to achieve cooperation in regulatory policy. Of special importance to environmental regulation, for example, is the case of one-directional hazards.

A hazard is said to be one-directional when the risk creator(s) are in one country and the victim(s) of pollution in one or more other countries, for example when pollution travels by river downstream into one country from a site upstream in another.

The most straightforward case of a one-directional hazard is when only two countries are involved, the effects are acknowledged to be one-directional by all parties, ownership of the transmitting medium is not in question, and damage and control costs are easily measured and relatively insignificant for both countries. These were the characteristics when, in 1935, the Trail Smelter metal refinery in British Columbia, Canada, was found to have discharged sulphurous gases that damaged farm crops across the border in the state of Washington, USA. Despite the relative simplicity of this case, it took many years before the International Court of Justice in the Hague resolved it by finding the Canadian government liable for \$350,000.

Pollution of the Rhine River is an illustration of more complex factors that can come into play in one-directional hazards. In this case, several countries are involved, damage and control costs are difficult to estimate and are relatively large, and economic aspects cannot be separated from environmental considerations. This complexity is reflected in the variety of institutional arrangements that have evolved. In 1815, the Congress of Vienna established the Commission of the Rhine River, primarily to handle problems of navigation. In 1956, the Convention of the Canalization of the Moselle, a tributary of the Rhine, set the precedent of environment-related agreements among the nations sharing the Rhine River basin. In 1963, after 17 years of negotiations, a five-nation International Commission for the Protection of the Rhine was formed, followed by a tripartite commission set up in 1975 by France, the FRG, and Switzerland. These arrangements have failed to produce a satisfactory result as yet. At the Dutch-German border, for example, the Rhine

carried 360 kilos of chlorides per second in the early 1980s, a six-fold increase from the levels measured at the beginning of the century (Caldwell, 1984).

As these examples suggest, even when international actors agree to cooperate, they have incentives not to enforce the agreement too strictly. The well-known Prisoner's Dilemma captures the essence of the problem. In this game, each player has two strategies: to cooperate or to defect from the agreement. The payoff matrix is as follows:

		Player 2	
		Cooperate	Defect
Player 1	Cooperate	R,R	S,T
	Defect	T,S	P,P

Payoff ordering: $T > R > P > S$, with $2R > S + T > 2P$.

The latter condition is added so that the game is a standard Prisoner's Dilemma in which (Cooperate, Cooperate) and (Defect, Defect) are the best and worst possible outcomes in terms of the sum of payoffs. Each player has a dominant strategy, namely to defect, but the equilibrium payoff (P,P) is worse than (R,R) -- the payoff they could achieve by cooperating -- and indeed collectively worse than any other payoff. Moreover, because the equilibrium is a dominant strategy equilibrium, the information structure of the game does not matter. If Player 1 is allowed to know the move of the other player before making his own, the equilibrium is unchanged. Player 2 still chooses Defect, knowing that Player 1 will surely choose Defect afterwards (Rasmusen, 1989).

The conclusion that defecting is a dominant strategy depends on the assumption that the game is played only once, or at most a

small number of times. The theory of infinitely repeated games proves that cooperation between several players can be sustained by the threat that if one player breaks the agreement, the others will retaliate by reverting to the non-cooperative situation. However, as Rasmusen (1989:96) observes, this is a purely mathematical result and hence the strategies that generate particular patterns of behaviour may be unreasonable. Two problems reduce the practical significance of the theoretical conclusion: discounting and incomplete information. Given a positive discount rate, the present gain from defecting is weighted more heavily and future gains from cooperation more lightly. If the discount rate is very high the iterated game almost returns to the single-play Prisoner's Dilemma. Democratic governments usually have short-time horizons and therefore strong incentives to breach agreements for short-term advantages. This is because a democratic government cannot trade present votes for future votes the way a voter can trade present income for future income. Hence, in Anthony Downs' words, "no government aims at maximizing a stream of incomes composed of separate incomes for each of many periods ... government has no discount rate of its own to apply to its own income -- an income measured in votes" (Downs, 1957: 174-75).

Lack of information is an even more serious problem in enforcing supranational cooperative agreements about regulatory issues. There are at least three reasons why it is difficult to observe whether agreements are being properly kept or not. First, regulation is a highly complex type of policy-making in which technical, economic, and political elements are closely intertwined. Hence the reasons for particular regulatory decisions can seldom be made fully explicit and thus objectively verifiable (Majone, 1982). Second, measurement problems are extremely serious in some areas of regulation like pollution control. Because of quickly changing atmospheric conditions, for example, it may be quite difficult to know whether a given

threshold value has been exceeded, and for how long. The difficulties are compounded if ambient quality standards rather than effluent standards are used as regulatory instruments.

The third and most important reason why it is difficult to observe whether or not agreements are being properly kept, is that much economic and social regulation is discretionary -- in practice if not in theory. Because regulators lack information that only regulated firms have and because governments are reluctant, for political reasons, to impose excessive costs on industry, bargaining is an essential feature of the process of regulatory enforcement. Regardless of what the law says, the process of regulation is not simply one where the regulators command and the regulated obey. A "market" is created, so to speak, in which bureaucrats and those subject to regulation bargain over the precise obligations of the latter (Peacock, 1984:3). Because bargaining is so pervasive, it may be extremely difficult for an outside observer to determine whether the spirit, or only the letter, of an international regulation has been violated.

When it is difficult to observe whether member states are making an honest effort to enforce a cooperative agreement, the agreement is not credible. The issue of credibility plays a large role in discussions on coordination of macroeconomic policies. For the reasons just given, credibility is probably even more important for the success of regulatory policy coordination. Sometimes member states have problems of credibility, not just in the eyes of each other as in the Prisoners'Dilemma situation, but in the eyes of third parties, such as regulated firms or governments outside the Community. For example, where pollution has international effects and fines impose significant competitive disadvantages on firms that compete internationally, firms are likely to believe that national regulators will be unwilling to prosecute them as rigorously if they determine the level of enforcement unilaterally rather than under supranational

supervision. Hence the transfer of regulatory powers to a supranational authority like the EC Commission, by making more stringent regulation credible, may improve the behaviour of regulated firms (Gatsios and Seabright, 1989: 49).

The issue of credibility of national regulators is closely linked to the problem of "regulatory capture". Following a seminal paper by Stigler (1971), many economists have argued that regulatory agencies, sooner or later, become captured by the very interests they are supposed to regulate. It is true that the phenomenon is not as general as Stigler and others seem to suggest; for example, there is little evidence of regulatory capture in the areas of environmental protection, consumer protection, and occupational health and safety (Majone, 1989). Nevertheless, the danger of regulatory capture is a real one in the case of economic regulation and thus poses a serious threat to the credibility of international agreements.

Partly for this reason, it was suggested above that competition policy should be set and enforced by the Community. In fact, the EC Commission has consistently taken a stricter competition stance than national authorities like the British Monopolies and Mergers Commission and the German Bundeskartellamt. EC authorities are less vulnerable to lobbying by firms and trade unions; this is a considerable advantage in cases involving merger authorisations and state aids to industry. Another advantage has been noted by Gatsios and Seabright (1989:50). Because the EC is involved in the regulation of a large number of firms throughout the Community, it has much more to gain by being tough in any individual case than a national regulator; weak enforcement would destroy its credibility in the eyes of more firms. Thus it may be more willing to enforce sanctions than a member state would be, even if its direct costs and benefits of doing so are no different.

Credibility is not uniformly distributed among member states or across different areas of regulation. Some countries enjoy low

credibility because they lack, or are perceived as lacking, the scientific knowledge, technical expertise and administrative skills to regulate effectively in certain areas. This credibility problem explains, at least in part, the disappointing results of the multi-state procedure for the approval of new medical drugs, see above. To take another example, until recently most countries of the EC lacked the legal and administrative instruments to regulate monopolies and mergers. In such cases, delegation of regulatory powers to the EC can achieve economies of scale in research and administration, and improve the quality of regulation in the Community, even when no international prisoners' dilemmas are involved.

5. Institutional and Policy Implications

We conclude this paper by drawing some practical implications from the arguments developed in the preceding pages. Our analysis of regulatory failures strongly suggests that, despite the theoretical and political appeal of decentralisation in a community of nations as varied as the EC, many regulatory powers will have to be surrendered by the national governments after 1992. Even in areas like the regulation of financial and professional services and (more problematically) product standards regulation, where the "new approach" has good chances of succeeding, European regulation will still be necessary to curb excessive or counter-productive regulation by national authorities.

Although the potential gains from a transfer of regulatory powers to the Community could be considerable, there are also serious risks. In this paper the concept of regulatory failure has been applied to the national level, but various types of failure are clearly possible also at the European level, with even more serious consequences. Present methods of regulatory decision making in Brussels suffer from a number of defects. Among the shortcomings identified by analysts in various policy

fields are the absence of central coordination, leading to serious inconsistencies across and within regulatory programmes, lack of rational procedures for selecting priorities, insufficient attention paid to the cost-effectiveness of individual rules; inadequate staffing and insufficient research capabilities.

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The Community regulatory process also suffers from a lack of political oversight, not only by the European Parliament but also by the President of the Commission and by the Council. The lack of political guidance and control will become increasingly serious, since the growing complexity of regulation requires greater reliance on standing committees of experts and eventually, the creation of specialized agencies. We mentioned above the Commission's proposal for the establishment of a European Agency for the Evaluation of Medicinal Products. The Council has recently approved the establishment of a European Environmental Agency, although this is more concerned with coordinating research and monitoring environmental conditions than with actual regulation. An independent European agency to regulate monopolistic concentrations, mergers, and state aid in industry has frequently been suggested. The proposed agency should be independent not only of national governments but also of the EC Commission since the latter can be influenced by national interests through the Council.

◀ Regulatory commissions are the logical consequence of the adoption of a regulatory mode of policy-making. Regulation is not achieved simply by passing a law, but requires detailed knowledge of, and intimate involvement with, the regulated activities. Thus, a commitment to regulation implies, sooner or later, the creation of specialised agencies capable of fact-finding, rule-making, and enforcement. At the present stage of development of the Community, however, the idea of European agencies still faces the strong opposition of the member states. Therefore, other

means must be found to improve the quality of regulatory policy-making.

When regulatory policies require a substantial amount of local knowledge for effective enforcement, decentralisation is, in principle, advisable. However, decentralised administration of centrally determined policies often provides only a partial answer since it involves all the problems of monitoring and control mentioned above in connection with Prisoners'Dilemma situations. Instead of a simple delegation of implementing authority to the member states, it would be necessary to devise institutional arrangements allowing constrained implementation of Community policies by the member states. For example, it may be possible to introduce some weak version of the American "State Implementation Plans" and "State Capacity Assurance Plans", whereby states have to demonstrate that they have the technical and administrative capacity to implement federal regulation -- or to develop their own regulation. >

It is also important to keep in mind that the optimal assignment of policies and responsibilities between different levels of government does not have to coincide with existing national boundaries. For example, there may be significant externalities and a need for coordination between some, but not all, regions within a country or group of countries. A model which deserves particular attention in this context is that of consortia or "compacts" among several states (or regions within different states) sharing similar problems; for example, in areas like transboundary water and air pollution, waste management, and so on. By pooling their financial, technical, and administrative resources, these states or regions are in a better position to deal satisfactorily with their regulatory problems than either by acting alone or by relying exclusively on centralized regulation which cannot be closely tailored to their specific needs. In this way it might be possible to achieve a nearly optimal combination

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of flexibility in regulation and economies of scale in policy formation and implementation.

Adoption of the "regional compact" model would have far-reaching consequences. Instead of the traditional dichotomy of Community or national regulation, with its artificial separation of fact-finding and rule-making from enforcement, we would have a system of different, but compatible, regulatory regimes coordinated and monitored by a small regulatory body at Community level. Among the tasks of this body would be improving the fit between the different subsystems, providing technical and administrative assistance, facilitating the diffusion of experiences and policy innovations and, last but not least, acting as "regulator of last resort". The American experience shows that the emergence of regional compacts is greatly facilitated by the existence of a regulator of last resort; again, a conclusion wholly consistent with the analysis developed in the preceding pages.

Something could also be done within the present institutional framework in order to ensure a correct choice of priorities and overall consistency of Community regulation. As noted above, the regulatory process in the EC suffers from a lack of political oversight. To correct this defect, it would be necessary to set up a "regulatory clearing house" at the highest level. Directorates-General (DGs) would be asked to submit annually draft regulatory programmes to the clearing house for review. When disagreements or serious inconsistencies arise, the President of the Commission or a "Working Committee on Regulation" would be asked to intervene. By extending centralised control over the regulatory agenda of the DGs, this review process would help the Commission shape a consistent set of regulatory measures to submit to the Council and the European Parliament. The usefulness of the procedure as a tool of managerial and policy control could be enhanced by coordinating the regulatory review with the normal budgetary review, thus

linking the level of budgetary appropriations to the cost-effectiveness of the different regulatory programmes.

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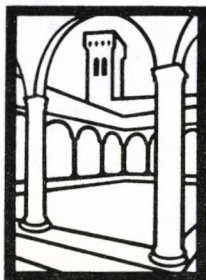
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