



The End of Market Power Europe?

The EU's Failure to Include Aviation Fully into its Emissions Trading Scheme

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Introduction

This article deals with aviation, conflict between the European Union (EU) and (amongst others) Russia and the question of the power of the EU in the 21st century, still it has nothing to do with the downing of Malaysia Airlines Flight 17 and the EU's response to this tragedy. This article analyses a conflict belonging more to the sphere of 'low politics', and where not Russia stands opposite to the rest of the world, but the EU found itself isolated: the EU's attempt to tax all flights landing or departing within the EU² for their carbon emissions during the whole of that flight.

The European Union decided in October 2008 to include the aviation sector in its emissions trading scheme (ETS) from 1 January 2012 onwards. Originally, also foreign airlines were supposed to buy emission permits for all emissions during a flight landing or departing within the EU. However, under fierce international pressure, the EU decided in November 2012 to exempt

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² In fact, it concerns the airspace of the European Economic Area (EEA), but for reasons of simplicity, I will here mostly refer to the EU.

international flights entering or leaving EU airspace, in order to give the opportunity to multilateral negotiations within the International Civil Aviation Organisation (ICAO) to find a global solution to limit aviation emissions. While only a shallow deal within the ICAO had been reached in September 2013, the EU decided in Spring 2014 to exempt completely all international flights leaving EU airspace, thereby significantly watering down the inclusion of aviation in the ETS.

This article will study the decision-making process of this eventually diluted attempt by the EU to limit the contribution of the aviation sector to climate change. This is not only done because the case is intrinsically interesting, but especially because it is instructive for assessing the EU's much-proclaimed 'market power' (Damro, 2012). Whereas the limited abilities, power and influence of the EU in traditional foreign policy areas has been widely recognized within academia and policy circles, and has been lamented again with the crisis in Ukraine (and elsewhere in the world in this crisis-ridden era), it is often argued that this grim conclusion is somewhat compensated by the EU's ability to use the power it derives from the size of its market to assert influence in the rest of the world. The case under scrutiny in this article seems to qualify this assessment, and we will try to find out why this is and what it means. Finally, this conflict is an interesting example of the intertwinement of the fields of energy, environmental and trade policies, a feature that is becoming only more important and relevant today, not least in the EU's trade negotiations with the US on the so-called Transatlantic Trade and Investment Partnership (TTIP).

The remainder of this article is structured as follows. In the following section, the decision-making process on the inclusion of aviation in the ETS is analysed from the first proposal in 2005 to the eventual watered-down decision of 2014, highlighting the importance of foreign pressure and the interaction with the international level. Subsequently, different views in the literature on the EU's market power and its ability to shape global policies are discussed and applied to the specific case of this article. Finally, we conclude by contemplating what this case shows for the EU's future ability to export its policies and norms to the rest of the world.

The Decision-making History of the Inclusion of Aviation in the ETS

Why did the EU want to include aviation in its emissions trading system, the Union's most important instrument to reduce carbon emissions and fight climate change? The contribution of aviation to climate change through different aircraft emissions has been growing rapidly. CO₂ emissions from aviation, directly resulting from fuel consumption, account for around 3% of global greenhouse gas emissions, having doubled since 1990, to a large degree because of the growth of the sector. The Intergovernmental Panel on Climate Change (IPCC) estimated that this share will grow to 5% by the middle of this century, thus, without policy change, risking to jeopardize climate change mitigation efforts in other industries. However, the aviation sector had been excluded from the Kyoto Protocol, which referred work towards reducing its emissions to the International Civil Aviation Organisation. As progress within the ICAO had been slow, the European Commission decided to take up unilateral leadership. In its 2005 Communication on the subject, it declared its intention to bring aviation into the EU's ETS that had been launched that year (European Commission, 2005).³

In December 2006, the European Commission presented draft legislation on including aviation in the ETS (European Commission 2006). In June 2008, the European Parliament (EP) and the Council reached a compromise deal on the legislation, after which the EP and the Council approved the compromise, in July and October 2008 respectively (European Union, 2008). In March 2011, the Commission decided on the basis to calculate the number of emission permits granted to the aviation sector.

Concretely, the EU foresaw to create and distribute aviation emission allowances in 2012 amounting to 97% of average annual aviation emissions by the covered carriers for the reference period 2004-2006. The number of allowances to be created yearly from 2013 onwards would be 95% of historic aviation emissions. Eighty-two percent of these allowances are distributed for free per aircraft operator based on the activity of each operator in 2010. Fifteen percent of the CO₂ allowances are allocated by auctioning, while the remaining 3% are reserved for fast-growing airlines and new entrants into the market. Revenues from the auctioning shall be used to tackle climate change, including

³ The first paper by the Commission on aviation emissions and global warming dates back to 1999 (Stanilan 2012: 1012).

in the transport sector. The inclusion of aviation in the EU-ETS was supposed to concern any international flight to, from or between EU airports ('the routes-based approach'). It would cover any aircraft operator servicing such flights, whether EU- or foreign based, thus embracing over 4.000 operators.

The inclusion of the aviation sector by the EU in its ETS has been criticized early on from different sides. Predictably, the Association of European Airlines (AEA) lamented that the measure would bring great cost to European airlines, and it was especially anxious that this had been decided in the wake of a (prolonged) financial and economic crisis (EurActiv, 2008). However, the greatest tide of criticism came from outside the EU, and was directed at the fact that also non-EU operators were covered by the directive and that emission allowances would have to be acquired also for those parts of flights between EU and foreign airports outside the Union's airspace. In several countries, national air industry associations joined hands with their governments to put pressure on the EU. The American industry group brought a case before the United Kingdom's High Court of Justice, which referred it to the Court of Justice of the European Union (CJEU) in Luxembourg. However, the CJEU ruled completely in favour of the EU law, arguing that it did not violate other states' sovereignty and was compatible with the EU's international commitments (EurActiv, 2011a). This did not stop the international opposition against the measure. In the United States, India, Russia and China there were attempts by the government to obstruct or even prohibit their airlines from complying with the EU directive. The countries combating the EU's unilateral aviation carbon emission policy have even held meetings to coordinate their opposition. They came together several times as 'the coalition of the unwilling'⁴ and issued joint declarations condemning the EU's decision and threatening to retaliate and start a trade war. The temperature raised most in the conflict between the EU and China on the matter. State-owned Chinese airlines have been reported to refuse to finalise orders for Airbus long-haul jets worth up to €9.6 billion (Parker et al 2012).

This threat (and reported first manifestations) of a trade war increased caution among member states (especially Germany and France, see EurActiv, 2011b) and criticism among aviation constructors and operators within the EU. However, EU Climate Action Commissioner Connie Hedegaard thought it

⁴ They are: Argentina, Brazil, Burkina Faso, Cameroon, Chile, China, Colombia, Cuba, Egypt, India, Japan, South Korea, Malaysia, Mexico, Nigeria, Paraguay, Peru, Qatar, Russia, Saudi Arabia, Singapore, South Africa, Swaziland, Uganda, the United States and the United Arab Emirates.

unwise to bow to foreign blackmail: ‘If nations and regions do not defend their legitimate right to legislate, it would send an extremely unfortunate signal and create problems not just for the global climate but also for European companies and businesses’ (EurActiv, 2011b). To no avail: the international protest and fear among member states for a trade war eventually led the EU in November 2012 to freeze enforcement of ETS obligations for foreign airlines for one year to give opportunity for a multilateral solution in the ICAO until Autumn 2013.⁵ Following a deal within the ICAO⁶ in October 2013, that has been assessed an inadequate, vague promise by observers and stakeholders (such as the European Low Fares Airlines Association and green transport group Transport & Environment) going against long-standing EU positions, the European Commission proposed two weeks later to exclude emissions occurring outside the EU airspace, thereby responding to the criticism of ‘extraterritoriality’ on the previous measure. Foreign airlines would still have to submit carbon permits for those emissions made within EU airspace. In January 2014 the European Parliament voted in favour of this ‘airspace approach’ instead of the earlier routes-based one. However, three months later, after heavy pressure by third country governments on especially the Member States, the European Parliament and the Council of the European Union decided to water down the measure even further and amend the legislation for the period 2013-2016 so that all flights that enter or leave the European Economic Area are exempted from the ETS (thereby *de facto* fully exempting non-EU airlines while also reducing the burden on EU operators for their transcontinental flights). This effectively reduces the amount of CO₂ emissions covered by three quarters as compared with the original scheme, and still by a third as compared to the Commission airspace approach, according to Transport & Environment (Keating, 2014).

⁵ To be precise, the EU decided to “stop the clock” on enforcing the inclusion of aviations into ETS for non-European flights for one year, to allow for a global deal within the ICAO. Otherwise, all carriers would have had to buy and surrender their emission permits on 30 April 2013.

⁶ The 38th session of the Assembly of the ICAO decided ‘to develop a global MBM [market-based mechanism] scheme for international aviation’ (¶ 18), the modalities of which should be decided by the 39th session of the Assembly in 2016 with the goal of implementation of the scheme from 2020 onwards. Those states that design or implement their own MBMs for international aviation should ‘a) engage in constructive bilateral and/or multilateral consultations and negotiations with other States to reach an agreement, and b) grant exemptions for application of MBMs on routes to and from developing States whose share of international civil aviation activities is below the threshold of 1% of total revenue ton kilometres of international civil aviation activities, until the global scheme is implemented’ (¶ 16). Thus, while the EU had sought a clause that would have allowed member states to implement MBMs that also apply to foreign flights departing from or landing in their territory, this has been removed and replaced by the obligation to engage in dialogue and negotiations (something that the EU had been fighting for years).

This escalation of an environmental measure taken to combat climate change to the edge of a massive trade war is puzzling when one looks at the forecasted costs of the move. According to EU analyses and independent studies, the cost of joining the scheme for all airline operators combined would have been between €1 billion and €1.4 billion in 2012, which may rise to as much as €7 billion in 2020. This is marginal compared to rising fuel prices and aircraft lease payments, according to Standard & Poor's' analyst Stuart Clements (EurActiv, 2011c). Another peer-reviewed study in the *Journal of Air Transport Management* even claims that far from being hurt by inclusion in the EU-ETS, US airlines would have accrued €2 billion windfall profits (Malina et al., 2012). Could it be that third countries were more opposing the principle of the EU unilaterally imposing climate change measures to their airlines (for them an inconvenient 'signal', to use the words of then Climate Commissioner Hedegaard, see supra), rather than trying to avoid the limited economic costs involved?

Before turning to some general and future-oriented conclusions that can be drawn from this case, we have to say something about its specificities. As is well-known, the aviation sector is an internationalized sector *par excellence*. According to Eurostat, in the second quarter of 2013, of all flights that stay in, leave or enter the EU airspace, 17,9%⁷ are national, 44,2% are international within the EU and 37,9% are international with part of the flight occurring outside the EU airspace. Secondly, the passenger aviation market is characterized by high price elasticity, especially for individual carriers, meaning that a small increase in fare tickets (compared to competitors) may result in large losses of passengers (InterVistas, 2007). This is something we all know intuitively as most passengers nowadays buy their tickets via search engines that compare the ticket prices of all carriers that fly a certain route. This means that the inclusion of European airlines in the ETS for all their emissions but not their foreign competitors would seriously competitively disadvantage the former vis-à-vis the latter. This has urged the EU to include foreign airlines in its original proposal. As well as why in the end the decision was not to demand of EU airlines to surrender carbon permits for their entire flights that leave or enter the EU airspace, including the parts outside the EU (that would have been better from a purely environmental perspective), but to exempt all emissions made outside the EU airspace for EU and foreign carriers alike. On the

⁷ In terms of passengers, as is reported by Eurostat.

other hand, as Staniland (2012: 1009ff) has pointed out, commercial aviation as a service industry means that service provider (airline) and customer (passenger) need to be in close proximity, so that commercial aviation services cannot be ‘easily’ outsourced. In theory, this should have made it easier to apply strict (in casu environmental) obligations to the (domestic as well as foreign) industry.

It is also interesting to note that aviation would have been the first sector where the EU would have asked of foreign suppliers to surrender carbon emission permits to supply a service or good in the EU. Nonetheless, also many other EU sectors have been complaining, especially before the collapse of the carbon permit price, that their obligation under the EU-ETS to make their production less carbon-intensive and/or buy emission permits confront them with a competitive disadvantage vis-à-vis their competitors located outside the EU, in countries with no or less strict climate policies. There has been a debate around proposals to include in the ETS, or levy a carbon border tax on, imports from third countries to level the playing field between EU and third country firms. In parallel to the case discussed in this article, the EU decided not to ask third country suppliers to buy emission permits or levy a carbon border tax on their imports to give full opportunity to multilateral climate negotiations to find a global solution, and to review the situation later (in 2010, thus after the Copenhagen debacle). In the end, the EU decided not to go down this road for fear of losing a dispute before the WTO or, worse, inciting a trade war (see De Ville, 2012), and to compensate energy-intensive industries that meet certain criteria for potential competitiveness losses by allocating them emission allowances for free. As free distribution of allowances instead of auctioning then became the rule instead of the exception, this compromise significantly eroded the ETS, as the eventual compromise with regard to the inclusion of aviation did with regard to this sector specifically.

Now, what does this interesting case, where the EU first proposed to require carbon permits from foreign airlines that make use of EU airports for their flights, including for emissions made outside EU territory, only to bow in the end to international pressure and exempt emissions made on flights leaving EU airspace completely, teaches us about the EU’s ability to influence third countries’ policies?

The EU's Market Power? Declining, Internally and Externally Contested

While it has long been stated that the EU lacks state-like features to be a classic *power* in the realist sense (e.g. Hill, 1993), and after some disillusion with the extent to which the Union can be qualified as a 'normative power' (Manners, 2002), Chad Damro coined the EU in 2012 a Market Power Europe (MPE), after several authors had argued the same without conceptualizing it as clearly (e.g. Vogel, 1995; Bretherton & Vogler, 2006; Meunier & Nicolaïdis, 2006; Bach & Newman, 2007). Damro defines MPE as 'a powerful actor that actively engages in international affairs through the externalization of its economic and social market-related policies and regulatory measures' (2012: 696). This is built on three interrelated and mutually reinforcing characteristics (or independent variables): material existence, institutional capabilities and interest contestation (or domestic support for externalisation). Damro cites a number of cases where the Commission itself has claimed to have set international standards: product safety, food safety, environmental protection, public procurement, financial regulation, and accounting. But did Damro invent a concept at a time when its empirical validity was on the wane?

In the meantime, a number of other authors have argued that while the EU has succeeded in some, to be sure not unimportant, instances to export its norms internationally (a notable example being REACH, see e.g. De Ville, 2012; Heyvaert, 2009), such instances of policy exports are rather rare. For example, Müller et al. (2014) note that while most attention has gone to such limited number of cases of EU policy export, other modes of interaction between EU and international policy regimes are far more common: policy promotion (where the EU promotes international policy solutions that are not simply copy-paste from its own regulation or policy), policy protection (where the EU neglects global commitments or blocks the global development of policies to shield its domestic rules and preferences) and policy import (whereby the EU adapts to global standards, policies or simply pressure). Mitchell Smith concluded that 'regulatory accommodation [similar to Müller et al.'s policy import] may increasingly become the preferred mechanism for reconciling single market regulation with global economic competition' (2010: 950).

Without a doubt, it seems that most of the cases where authors lauding the EU's exports of ambitious regulatory standards and other policies refer to date

back to the period 1995-2005.⁸ This case shows that it might be getting more difficult for the EU to set ambitious standards and assume that the rest of the world will follow, so that it kills two birds with one stone: achieving its regulatory objective while avoiding competitive harm for its industry – to the contrary, even achieving a competitive gain through ‘first mover-advantages’, i.e. the fact that adaptation costs are lowest for European firms as they have implemented the measure earlier, might have set the norm and in that way occupy the new high-standard market. Bretherton and Vogler (2013), but for a wider range of EU foreign policy areas, arrive at a similar conclusion that the years since the mid-2000s have witnessed a decline in EU effectiveness, concluding that the EU might be a ‘global actor past its peak’.⁹ Also McGuire and Lindeque (2010) have questioned the EU’s continuing ability to use the threat to withhold access to its market as a way to influence trade partners’ policies. Young and Peterson (2014: 207) recently concluded that the ‘effectiveness of the EU’s use of trade policy as foreign policy has been oversold, at times dramatically so’ and that ‘the EU’s status as a trade power is probably a time-limited resource, which is arguably already beginning to depreciate (2014: 227). Of course, the EU’s relative success in achieving conclusion (1997) and ratification (2004, after Russia ratified under pressure of the EU) of the Kyoto Protocol versus its traumatic failure at the COP-15 in Copenhagen (2009) has been much commented (e.g. Parker & Karlsson, 2010).

Currently, the EU’s ability to act in this way – in other words: its market power – seems to be declining. The explanation for this is not hard to find: it is the inverse of the features mentioned by Damro in his ‘Market Power Europe’ article. The EU is gradually losing market share, and hence: power. This is quite logical (but see *infra*) as emerging economies, by definition, assume a larger share of the world market and (will) become less dependent on the EU as an export market. The economic crisis since 2008 that is much more protracted in the EU (especially in the euro area) than elsewhere only accelerates this process. As Damro noted, the factors driving market power are inter-related and mutually reinforcing. This is what we also note now that this

⁸ It is also interesting that a number of (more general) optimistic books on the EU’s capabilities to be a (super)power in the 21st century date back from the end of that period, most notably Leonard (2005), Reid (2005).

⁹ Their analytical framework consisting of presence (‘the international reputation of the EU and associated third-party expectations of EU action’), opportunity (‘the external environment or context that enables or constrains EU action’) and capability (‘internal factors affecting the EU’s ability to capitalise on presence and respond to opportunity’) resonates with Damro’s framework (Bretherton and Vogler 2013: 376).

power (after a relative brief period of reign) is waning. As the EU's relative market size is losing in importance, it is also becoming more and more contested, both within the EU (e.g. by the international-oriented aviation industry) as externally (by all the major economies in this case).

Conclusion

The eventual yielding of the European Union to international pressure not to include flights that partly take place outside the EU airspace in the inclusion of aviation in its emissions trading scheme might be seen as following a pattern that started in the middle of the previous decade whereby the EU is ever less able and/or willing to adopt ambitious unilateral regulations that have to be adopted by third countries to keep access to the EU market. The EU's share of world imports decreased from 19.5% in 1999¹⁰ to 16% in 2012, thereby also diminishing the EU's international leverage based on its material existence (Damro, 2012) or presence (Bretherton & Vogler, 2013).

Crucially, this structural change is mediated by perceptions, both of actors within the EU as well as (within) third states, of the consequences this has. The dominant perception currently seems to be that the EU does not have the luxury anymore of being in a position to export its ambitious internal policies. A similar idea first expressed by Merkel (Peel, 2012) but subsequently repeated by several key policy-makers in Europe is that 'Europe today accounts for just over 7 per cent of the world's population, produces around 25 per cent of global GDP and has to finance 50 per cent of global spending', and that this is a luxury the EU cannot afford anymore nowadays. In general, many policy-makers panic about the EU (or individual member states) losing market share (mostly referring to export shares in the world), and often putting the blame with too costly welfare and regulatory arrangements in Europe. However, no one would deny that emerging economies such as China are growing at a pace that is simply not attainable for Europe, which is a matured economy already at the vanguard of innovation, productivity and whose population is, at best, stabilizing, and few would deplore this catch-up by emerging and developing countries. Well, the loss of market share by the EU and member states is simply an accounting consequence of that catch-up.

¹⁰ For the EU-27, barring Croatia for which we do not have data.

An alternative response to the relative economic decline of the EU than abandoning the ambition to set global standards would be to protect simultaneously the EU's rather unique, ambitious social and environmental model and the (quality) competitiveness of its economy by applying its high standards also to imports from its trade partners, rather than fixating on *price* competitiveness as is the case today. For a brief period of time (mid 1990s-mid 2000s), this was part of the EU's ('harnessing globalization') strategy, although it was never supported by all political and societal actors. For a number of reasons already alluded to above, this has diminished significantly. Again, perception is crucial. An obsession with avoiding accusations of 'protectionism disguised as protection', the tackling of which has indeed been key to the revival of European integration in the 1980s, risks resulting in the inability to adopt legitimate policies to protect.

The EU is currently negotiating a free trade agreement with the United States (TTIP) with the proclaimed triple objective of boosting growth, setting global standards and protecting EU norms. The outcome of this will be instructive for the future direction of the European Union. It provides an opportunity for, together with the US, regulating the global economy to make it more economically, environmentally and socially sustainable. Now that the EU's global market share is indeed shrinking, providing it with ever less leverage to influence third countries policies, working together with the US (the transatlantic economy aggregately stands still for a third of world trade and half of global GDP) can be a smart strategy. If, on the other hand, TTIP would lead to a lowering of EU standards and reduction of policy space to adopt ambitious norms in the future for limited economic gains, the EU might definitely be a regulatory power past its peak.

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