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The Economics of Single Market Regulation

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The Economics of Single Market Regulation

BEEP n° 25

Jacques Pelkmans

Abstract

In the vast domain of the internal market, 'regulation' is EU's core business. Therefore, a good appreciation of European economic integration requires a sound analytical economic perspective of EU regulation. Since the Single European Act, economists have gradually improved the economic analysis of EU regulation. EU policy-makers began to accept cost/benefit analysis with the Maastricht treaty and nowadays the rigorous logic of Better Regulation and regulatory impact analysis has become routine in the EU circuit, although less with the EU legislator (EP and Council).

The present BEEP Briefing provides an accessible survey of the state of the art of the evidence-based, economic approach to EU Single Market regulation. This approach puts the subsidiarity test, proportionality and necessity on a firmer analytical footing and offers a healthy discipline of the precautionary principle. The acceptance of economic, evidence-based regulatory logic has caused a change of mind-sets in the European Commission: EU regulation is now routinely discussed in terms of incentives, asymmetries of information, multiple policy options (instead of going for a single one only), market-based instruments, quantification of benefits and costs, red-tape alerts and cost-effectiveness. Last but not least, this also matters for national regulation. Given an ever deeper and wider internal market than two decades ago, not to speak of the Eurozone, the regulatory autonomy of Member States has to be balanced against the possible consequences of undermining or preventing the 'proper functioning' of the internal market. The key words here are pro-competitive reforms and 'diversity'', based on distinct national preferences, yet minimizing costly 'regulatory heterogeneity' arising from decentralized decision-making but without being rooted in genuine differences in preferences.

Keywords: EU internal market, EU regulation, risk regulation, subsidiarity, proportionality, cost-benefit analysis, precautionary principle, regulatory acquis

JEL-codes: F 15 ; L51 ; 052

1. Introduction

Establishing the European Union (EU) internal market and making it 'function properly' requires both *EU* regulation and changes in *national* regulation (whether adaptation, conditioning or removal). Together with the five economic freedoms, 'regulation' is the core business of the internal market. From the perspective of economic analysis, it is therefore desirable to place *the economics of EU regulation at the centre of European economic integration studies*.

The purpose of this paper is to 'map' the economic analysis of two-tier EU regulation in the context of the internal market. The aim is to survey the essentials of the literature, without trying to be exhaustive. The structure of the chapter is as follows.

Section 2 will make the case for a sound economic perspective of EU regulation in the context of the EU internal market under the heading 'Why regulate the internal market?'.

Section 3 will summarize a functional (i.e. economic) subsidiarity test for answering the question 'at what level of government' regulation ought to be issued, once the case for regulation has been correctly made. This is supplemented by the proportionality test, minimizing the cost of centralization while maintaining its benefits. Subsequently, two special issues are discussed: EU risk regulation (a very large part of EU regulation) and the precautionary principle.

Section 4 will show that an analytical 'mapping' of the EU regulatory internal market acquis can easily be derived from the economics of EU regulation. It provides an economic underpinning of the notion that the internal market acquis communautaire broadly makes economic sense.

Section 5 takes a closer look at the quality of EU regulation. 'Good' regulation at the right level is likely to serve general economic welfare by providing correct incentives, overcoming market failure (but no more than that) and avoiding unnecessary regulatory burdens or red tape. The key words in this perspective include not only proper impact assessment and less 'red tape', but also variations of EU regulation such as mutual recognition and co-regulation.

Section 6 discusses the vexed issue of the regulatory autonomy of the EU member states in an ever 'deeper' internal market, which is also widening in scope more and more. Two key words here are (national) market reforms and heterogeneity. Section 7 concludes.

2. Why regulate the internal market?

The internal market of the EU combines negative and positive integration. Insofar as markets can fail, appropriate regulation or subsidies or some other policy intervention (like EU common policies) will have to overcome or remove the market failure at the common level of government. Of course, this assumes that the EU level of government (with all its complex decision-making) can act benevolently in the EU public interest. This contribution will not deal with EU public choice or 'positive' theories of regulation, or, for that matter, various political economy analyses.[1] It will solely elaborate the 'public interest approach' to EU regulation. In the first instance, it is based on the proper functioning of markets, that is, it is in the EU public economic interest to ensure the 'proper functioning' of the internal market (in turn, instrumental to pursuing the economic goals in the treaty) by overcoming or removing market failures.

[1] The public choice approach as applied to the EU has been elaborated in particular with respect to the Common Agricultural Policy (CAP) and the EU budget. See the contributions in Pelkmans, (ed.) 1986 and e.g. Vaubel, 1994a and 1994b. A rare example about the Single Market is Teutemann, 1990. The positive theory of regulation based on Stigler and Peltzman has been applied to the EU only occasionally. See e.g. Buchwitz, 1998. Political economy of EU regulation enjoys a huge literature e.g. Baldwin & Cave, 1999. A landmark study on the internal market is Egan, 2001. Principal-agent theories and their empirical verifications with respect to regulation, especially for (EU) autonomous Agencies, are also left out due to space constraints. Incentive structures and institutional design for (EU) regulation do matter. See e.g. Pollack, 2003, Majone, 2001 and Nicolaides, 2004.

Traditionally, economic theory distinguishes four broad market failures, with numerous differentiated manifestations. Guided by the authoritative survey of Spulber (1989), these four are: externalities and internalities, imperfections of competition and (EU) public goods. Definitions and basic examples are found in Table 1.

Table 1: Market Failures: Definitions/Examples

Kinds of market failure	Definition	Notes	Examples
1. Externalities	Costs or benefits transmitted between economic agents, without an agreed transaction between them	lack of compensations; missing markets; can be positive or negative	environment, some health (contamination), some safety)
2. Internalities	Unexpected costs or benefits of transaction, not accounted for in contracts	not a missing market,; rather imperfect competition due e.g. to asymmetry of info to consumers or to insurers; also, unobservable conduct	relevant to many services and the (min.) quality of professionals; some labour; some health & safety
3. Imperfections of competition	deviations of effective competition due to market power or distortions		classic anti-trust + network industries; state aid controls, discrimination & non-equivalence; market access; harmful tax competition
4. Public goods	characterized by non-appropriability (of adequate revenues) and non-excludability (in consumption)	if private, would be undersupplied or not supplied	mainly, at member states' level; at EU uniform system of EU law

In actual practice, it is far from easy to recognize a market failure from other market distortions, let alone, to identify the precise boundaries of the market failure. In most cases of market failures, however, government has to intervene. Yet, due to the imprecise nature and extent of market failures, regulatory intervention may well turn out to be too weak, too strong or otherwise not fully appropriate. Therefore, even if one strictly adheres to the EU public interest approach, there is nevertheless a risk, when regulating, of getting it wrong. The EU public interest will be badly served when market failures would be replaced by 'regulatory' or 'government failures'.[2] Moreover, in the EU internal market, a considerable complication is formed by its two or three tier governmental structure. The single market is governed by powerful EU treaty principles and EU secondary legislation but also by the tier of Member States' governments, responsible for implementation in national laws, for enforcement and for pre-empting or removing regulatory provisions which conflict with free movement or harmonized laws. For federal EU countries, a third layer may be relevant in case regions or provinces have regulatory power in areas which matter for the single market. Since centralization is costly (see Section 3), regulation should only be shifted to the EU level when alternative methods to address the market failure fall short of solving the problem. Another difficulty of multi-tier government is that some policy instruments remain exclusively reserved for national governments, in other words, the EU level is unlikely to dispose of all the instruments. In the light of these difficulties, it is essential to assess the benefits and costs of proposed EU regulation or, ideally, even of established regulation in the EU acquis. Box 1 summarizes the proper economic framework for EU regulation in five consecutive steps. The case for 'proportionally' regulating the internal market is only helpful if one has an economically sound concept of the (EU) internal market itself. Economists tend to think in terms of market integration, a behavioural notion indicating that the activities of market participants in different regions or member states are geared to supply-and-demand conditions in all participating countries together.

[2] There are different degrees of such 'failures' but the idea is that a regulation or intervention would be more costly (when all repercussions are taken into account) than the costs of the market failure itself. See for example Labory & Malgarini, 2000 for extensive discussion.

Box 1: Proper economic framework for EU regulation.
Why intervene?

- identify market failures and the benefits of their removal
- if beneficial effects are non-trivial and
- if market-based incentives or cooperative solutions are impossible

At what level?

- subsidiarity test
- explicitly consider cooperative (but credible) solution among member states
- consider two-levels solutions, if appropriate

What instruments are available?

- constraints at EU level
- national or EU subsidies sometimes; or taxes at national level
- usually regulation, including economic instruments

Least-cost regulation

- minimize costs of centralization
- minimize degree of binding, where possible
- consider different types of regulatory solutions

Maximize net benefits

- assess options as to effectiveness
- use appropriate analytical tool (e.g. models, cost-benefit analysis, etc..)

This ambitious definition implies that, ideally, local and national markets can only exist if transport or other 'trade costs' (including language and culture, but mostly fragmenting national regulation, distortions of competition, exchange rates, etc.) render it rational for economic agents not to extend their search for better price / quality. Otherwise, the relevant market would cover neighbouring markets as well or indeed the entire EU. This concept serves as a benchmark for long-standing attempts to measure the degree of price convergence over time.

There are numerous empirical problems surrounding such a measurement (Commission of the European Communities, 1988; Engel & Rogers, 2004; Ilzkovitz, Dierx, Kovacs and Sousa, 2007), not least that of measuring prices of services, but at least in goods and capital there seems little doubt that the EU internal market has prompted long-run trends of price convergence over time. There is another empirical tool that reflects the economic concept of market integration, namely, 'home bias'. In the words of Delgado (2006), greater market integration has to show up in the extent to which '… economic decisions have become less domestic and more European', in other words, a single market in the pure economic sense should have no 'home bias' at all. This paper will not survey the 'home bias' literature (Head and Mayer, 2000; Nitsch, 2000; Chen, 2004; Delgado, 2006; Balta & Delgado, 2009) but the two central conclusions so far would seem to be: (1) home bias is found to be 'high' in the EU (there is still a strong national bias in the economic transactions of agents), (2) but it is clearly declining over time – deepening reduces 'home bias'.

Nevertheless, being successful in the EU internal market is tough. This could be due to local incumbents having market power, to local regulations and other forms of (tacit?) discrimination, to 'missing links' in EU infrastructure (especially, cross-border), to subsidies, other transaction costs like languages and local habits and/or to significant asymmetries of information between market players.[3] A powerful (though indirect) confirmation of this fundamental problem is given in Mayer & Ottaviano, 2007, showing that a very large majority of firms in the EU does not actively participate in the internal market.[4]

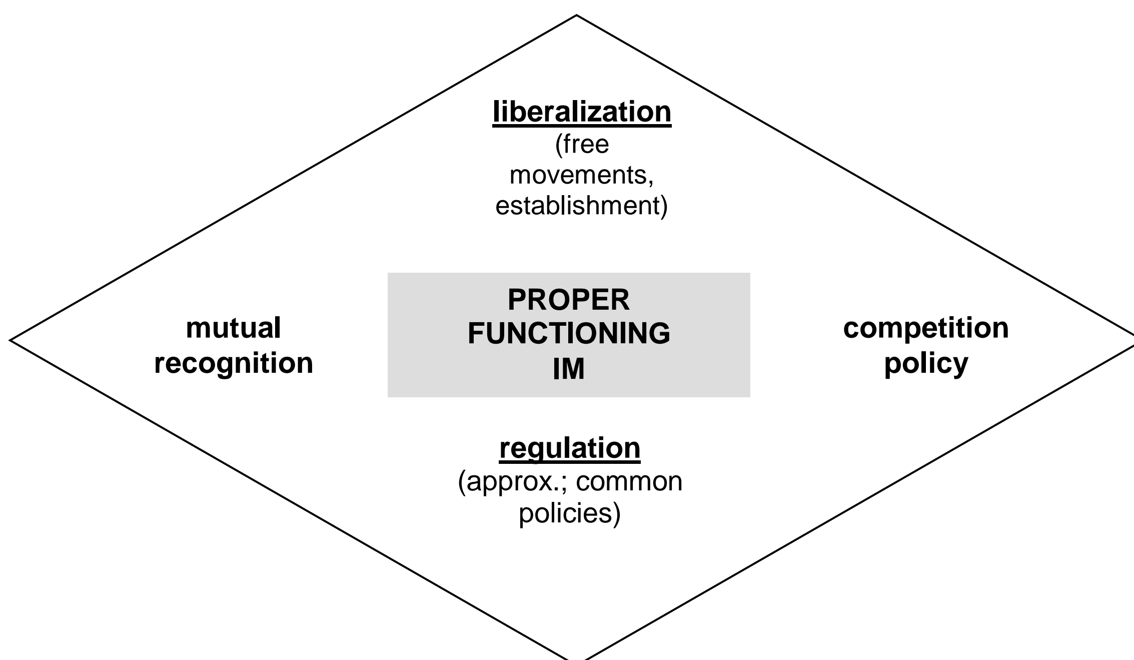
All this empirical economic research therefore goes to show that EU market integration is still far below (the economist's) standard.

[3] Combes, Lafourcade & Mayer, 2005, show empirically that trade and business networks can harden preferences to deal with selected (national) partners, due to trust, knowledge and lower transaction costs.

[4] Note that, of course, these 'local ' firms do experience the internal market via import competition and establishment by companies from other EU countries and this may well induce pro-competitive behaviour on their part as well. See also Barba Navaretti, Bugamelli, Schivardi, Horgos and Maggioni, 2011, for a more detailed follow-up.

Consider Figure 1, the internal market diamond. This 'diamond' is of conceptual help when developing a generic approach to (EU) regulation for the five types of 'markets' at stake (that is, goods, services, capital, labour and codified technology). A properly functioning internal market requires both negative and positive integration. Negative integration is called here (cross-border intra-EU) 'liberalization'.

Figure 1: A Properly Functioning Internal Market
Regulation as one of the determinants.



Positive integration primarily consists of 'regulation' based on the key approximation article (now art. 114, Treaty on the Functioning of the European Union (TFEU)) and competition policy in the wide sense (anti-trust, state aid regime and an appropriate network industries' regime).

A clever combination of regulation and liberalization is formed by 'mutual recognition', ensuring free movement whilst leaving (constrained) national regulation in place, without imposing EU regulation. The diamond shows that regulation is paramount for the proper functioning of the internal market, but it is not the only determinant.

There is a lot left implicit in the diamond, such as the great variety of regulatory tools at EU level,[5] the implications for national regulation under art. 114, TFEU, the institutions for EU regulation including autonomous (but not independent) EU regulatory Agencies and the regulatory influence of common or quasi-common EU policies.

Finally, when applying the analytical fundamentals, there is the danger of aligning internal market regulation with the factual organization of 'the internal market' in EU institutions. The latter fail hopelessly in their single market work to organize themselves on the basis of a sound overall economic and strategic concept of the EU internal market. Some 15 Directorate-Generals (DGs) of the Commission deal with 'the' internal market, without a lead Commissioner, and/or without a thorough compatibility test with such a sound conceptual design which every DG should have to make at all times.[6]

3. Regulation, subsidiarity and proportionality

3.1. Subsidiarity and proportionality: why and how to centralize regulation?

The bottom-up development of European integration (starting from low stages of economic integration) naturally leads to the question: 'what 'integration deficits' the internal market still suffers from and what EU regulation (or other intervention) would be needed to remedy this?'. In contrast, the economics of federalism assumes a single country from the beginning, prompting the opposite question: 'what public economic functions can be decentralized in the pursuit of higher welfare for the federation?'

[5] From EU 'regulations' by Council & European Parliament (EP), to directives, decisions, comitology regulations, co- and self regulation, links to private law (e.g. product liability; counterfeiting) or to penal law (e.g. counterfeiting; environmental infringements; anti-trust) and various instances of 'soft law'.
[6] The Monti Report (Monti, 2010) rightly observes this anomaly, too, and rightly underlines that it is little better in Council and EP, but fails to propose meaningful solutions.

These two contrasting perspectives have to be reconciled in the process of European integration, once the aspiration is changing to the attainment of stages much higher than a customs union or a customs-union-plus.

Although the economics of federalism deal primarily with the assignment of the three basic public economic functions (allocation, or, market functioning; redistribution; macro-economic stabilization) to the two levels of government, or of the provision of public goods (Bureau & Champsaur, 1992; Oates, 1999), for present purposes, it is narrowed down to the assignment of *regulatory* powers. What the subsidiarity principle essentially reflects is the acceptance of 'centralization' of (here) regulation if, and only if, welfare in the EU would be lower (ceterus paribus) when keeping a *de*centralized assignment of that type of regulation. If welfare would not decrease, decentralization is preferred. Thus, it links the assignment of regulatory powers to the EU level directly to the economic welfare potential (cet. par.) of the internal market. Therefore, this approach accords well with the economic framework for (EU) regulation as set out in Box 1.

The juxtaposition of the case for decentralization and that for centralization has now become well-established in the literature (CEPR, 1993; Oates, 1999; Pelkmans, 2005; Ederveen, Gelauff & Pelkmans, 2006; Gelauff, Grilo & Lejour, 2008). The economic case for *decentralization* begins with the finding that all-out centralization is clearly sub-optimal, unless extreme assumptions would be met: all preference sets of voters would have to be congruent and information at the central level about regional needs and constraints would have to be 'complete'. This is of course totally unrealistic. Although this is indeed unrealistic, it does not necessarily follow that decentralisation is superior. Preferences at local level need not be homogeneous. The locality may be as heterogeneous as the nation. In addition, you need to assume that politicians at the local level are not more easily "captured". Decentralization will tend to increase the welfare of voters for two reasons: (a) local governments 'read' local preferences better than in the centre, (b) local governments respond more effectively to locally revealed preferences.

Again, this assumes that the only relevant factor is that there is better info at the local level. But effectiveness also presupposes existence of the requisite capacity at local level. Voters will appreciate their politicians being close(r) to them and better satisfy their preferences. Thus, in federations or in the EU, there will often be costs to centralization.

The economic case for *centralization* is about overriding reasons to centralize. Again, the case rests on the promotion of economic welfare. It starts with the finding that regions / countries are economically interdependent (indeed, even more so due to integration) and that various policies have very different, at times very high, costs. The interdependencies tend to cause positive and negative cross-border (intra-EU) externalities, which can only be properly internalized at a higher level of government. When desirable policies have extremely high costs, the average costs can fall considerably when going for joint policy making in a larger group. The classical case is a defence alliance like NATO or large scale EU infrastructure projects like GEANT and GALILEO or nuclear research in Euratom.

The subsidiarity principle brings the two perspectives together: respecting national preferences where possible as well as the national capacity to respond effectively to nationally revealed preferences, on the one hand, and the need to internalize cross-border spill-overs and to decrease the average costs of agreed policies. Subsidiarity is thus fundamentally a *two-way principle*: applying the principle can lead to (more) centralization or to (more) decentralization. What the (functional) subsidiarity test does is to centralize only if a stepwise *economic justification* is provided. Table 2 provides the test. For shared powers, first, a need-to-act-in-common has to be provided, based on spill-overs and/or scale. Even if this 'need' is convincingly demonstrated, step 3 consists of a search for an inter-member states cooperative solution, as long as it is credible and durable.

Table 2: EU Subsidarity Test

Step 1: verify whether the issue at stake falls under shared or (EU) exclusive powers	If exclusive, the treaty rule cannot be undone by the test. If shared, the test can be applied.
Step 2: the 'need-to-act' in common; is regulation at national level ineffective or too costly because of scale or externalities (the two criteria)?	If one criterion (or both) applies (apply); there is a 'need-to-act' in common
Step 3: can the common action avoid centralization at EU level? For example, by cooperative action among some or all member states, or by coordination, or by jointly accepting constraints on national regulation.	Non-centralized common action retains some national powers, hence is preferred, provided it is • feasible • adequate • durable. If not, non-centralization is not credible to market players and will not solve the issue, while inducing costs (e.g. uncertainty)
Step 4: centralization at EU level is justified if step 3 is not credible.	

It is therefore up to the member states to come up with credible arrangements which can overcome market failures (including too costly regulatory fragmentation), via (say) joint (national) model laws or cooperative 'compacts' (a US mode of solving spill-overs without federalization) or otherwise. If not credible, step 4 will imply EU 'centralization'. Nevertheless, when assigning to the EU level, the idea of subsidiarity is to centralize 'not more than necessary' for achieving the objective(s): the EU 'proportionality test'. Proportionality in EU law is always about regulating 'no more than necessary'. Once the subsidiarity test yields the conclusion that regulation should be assigned to the EU level given the benefits, proportionality is applied so as to

minimize the costs of this centralization. A classical illustration is the shift from the Old to the New Approach of technical harmonization. In the old, heavy-handed EU goods regulation of the 1970s and 1980s, proportionality could mean partial or optional harmonization, although this menu fails to truly integrate the internal market. Yet, regulating everything under heavy-handed regulation (Old Approach) is very costly.[7] The better (New) approach is to opt for a different regulatory strategy – focused on common objectives (which overcome the market failures) - and ensure a co-regulatory system with the European standard bodies under strict guarantees, certification (under quality obligations) and EU accreditation of the certification bodies. This regime is far more flexible, more market driven and nevertheless attains the objectives set in EU directives; it expresses the idea of proportionality well. All in all, the subsidiarity principle together with proportionality boils down to nothing else than carefully juxtaposing the costs and benefits of (de)centralization.

3.2. EU Risk Regulation and Proportionality

Risk regulation has moved more and more to the EU level and its proportionality is critical to the proper functioning of the internal market, especially of goods and services. Most of the EU internal market regulatory acquis consists nowadays of risk regulation. A convenient shorthand for risk regulation is SHEC: (EU) regulation about safety, health, environment and consumer protection goals.[8] SHEC regulation concerns mostly goods and services markets, with occasional excursions to labour and capital markets too. In goods it covers the vast domain of health and safety regulation (from cars and tractors, to chemicals, pharmaceuticals (including pesticides and fertilizers), electronic products (with many standards 'behind' relatively few directives), plant health and animal health/welfare rules, food law, machines (with many standards behind relatively few directives), etc. In services, all safety rules and inspections in six modes of transport, the complex area of financial market regulation and supervision

[7] Examples include the 55-plus car directives and 23 tractor directives, which require continuous updating (as they are so specific and detailed) and entail static and dynamic implementation costs.
[8] More precisely, SHEIC, if one wants to identify separately investor protection regulation (and supervision). The text will employ 'SHEC'; the 'I' of investor regulation in SHEC is subsumed in the 'C' of consumers, widely defined. Also 'savers' can be subsumed in this 'I'.

(which extends to financial capital and corporate governance), professional services regulation (including entry, hence, mutual recognition of diploma's), network industry aspects (incl. externalities, access issues, market power vertically, etc.) in e.g. gas & electricity, rail, telecoms and broadcasting and regulation of many other services. More horizontally, it includes the enormous 'acquis' of environmental regulation from water, soil pollution, air pollution to climate related rules (and the ETS) and packaging as well as e.g. end-of-life of car (and electronic goods) rules. Finally, it includes horizontal consumer protection and consumer rights (e.g. across borders in e-commerce). In labour markets, occupational health and safety laws (largely at EU level as well so as to avoid distortions in the goods and services markets for which labour costs is an input) is relevant.

It is crucial to see why such a huge regulatory terrain can endanger the good working of the internal market. The menace is overregulation, regulatory failures by too intrusive, rigid or otherwise costly regulation and by covering an unjustifiably wide spectrum of goods markets (that is, where few if any societal benefits can be expected). This danger has to be weighed against the benefits of overcoming possible failures of the internal market when sticking to national, diverse rules and, following the subsidiarity test, opt for common regulation. Most of the rules – and, by definition, the standards behind them – boil down to technical regulation, with all the asymmetries of information that it implies. SHEC regulation entails almost unlimited opportunities to bend the rules towards certain players. It might incorporate high requirements (always in the name of 'safety' or 'health', etc.), in business strategies known as "raising rivals' costs" (thereby raising barriers to entry and enlarging the scope for higher profits (Church & Ware, 2000, 625-42). It risks – erroneously - to merely accumulate at the EU level all the prior requirements at member states' level (as the Old Approach typically did, due to vetoes) and to engage in prescribing specific technical solutions as 'safe', thereby (re)creating regulatory barriers for third countries and neither allowing a cost/benefit analysis nor flexible options.

Ensuring proportionate EU regulation in overcoming market failures (including excessive fragmentation of the internal market) is a function of the risks involved. When risks are moderate but do justify regulation, the New Approach has demonstrated how to combine EU SHEC objectives (and it is regulatory objectives, not technical details, which are critical to overcome SHEC-type market failures) with a highly flexible, cost-minimizing regime of EU co-regulation. This regime consists of relatively 'light' directives (primarily about these common objectives, complemented by some common principles, the layers of conformity assessment when using European standards and some administrative arrangements plus a safeguard clause). The approach hinges on free movement and mutual recognition (where applicable) and the mandated European standards fully aligned with the directives' SHEC objectives (Pelkmans, 2007 and Pelkmans, 2009). In writing European standards, private players have strong incentives to bring their knowledge and capabilities to the table, and so obtain access to a huge internal market, but they are bound by the objectives, the strong preference for 'performance' (rather than restrictive 'design') standards, a set of principles (compatible with the World Trade Organization (WTO)) in a Memorandum of Understanding with the EU and the quality requirements of EU conformity assessment.[9]

When risks are higher, command-and-control (though costly) may well be justified since the benefits of strict regulation consist in pre-empting severe damage to consumers, workers or animals. Effects may often show up in indirect and complex ways (e.g. in the food chain or in complicated products, etc.). In high risk goods, one needs to be much more certain that hazards are drastically reduced to a level tolerable for society. The Old Approach in goods and for transport (equipment) assumes a more interventionist slant, with less or no scope for voluntary standards and often with a major role for public controlling authorities. Meanwhile, the Old Approach has been made less rigid and more coherent, thereby reducing unnecessary costs without giving up SHEC objectives. Examples include the regulatory acquis in cars and trucks (now

[9] Certification bodies have to be accredited with the EA (= European system for Accreditation). See Reg. 765/2008, OJEU L 218/30.

aligned with the world regulatory regime run by the United Nations Economic Commission for Europe) and Registration, Evaluation, Authorisation & Restriction of Chemicals (REACH) and its EU Agency (ECHA) for chemicals, as well as the EU Agencies for air transport safety (EASA), maritime safety (EMSA) and railways (ERA) together with their underlining rules. Similarly, enormous progress has been made in areas like EU food regulation (with a mixture of the Old and New approaches, and an EU Agency [EFSA, primarily for risk assessment]) and that for medicines (with EU Agency EMEA).

EU Environmental and consumer protection regulation are slightly different. The former has steadily moved away from its prior emphasis on command-and-control methods to ‘market-based’ instruments, with the most prominent example being the ETS, the EU emission trading system. The cost differential of the latter with rigid and prescriptive rules is large, whilst the same benefits are ensured a priori because emission caps (reflecting the objectives) are pre-set, indeed, have to be pre-set as a prerequisite for trading and carbon pricing to work. Where environmental rules are at stake, or where environmental and health/safety regulation overlap like in REACH, a profound problem is posed by the treaty obligation to apply the precautionary principle, which will be dealt with in Section 3.3. Consumer protection rules at EU level have often been hindered by the attachment of local consumer organizations to their local solutions and preferences (e.g. about what can be advertised and how, and what not), not least because much is covered by private law that remains national. The upshot is an unnecessarily costly fragmentation of consumer regulation, which reduces internal market gains, discourages Small and Medium Sized Enterprises (SMEs) to go ‘Europe’ and undermines e.g. cross-border e-commerce between firms and consumers (B2C) as well as between consumers directly (C2C). EU risk regulation is also the most important domain when it comes to regulatory impact assessment (RIAs) at EU level as elaborated in Section 5.

3.3. The precautionary principle and proportionality

Art. 191, 2 TFEU specifies four principles on which EU environmental policy and regulation ought to be based: the precautionary principle, that of prevention, environmental damage be rectified at source and 'the polluter pays'. The policy shall aim at 'a high level of protection'. Whereas the latter three principles do not present special problems for good EU regulation in an economic sense, the combination of the precautionary principle and 'a high level of protection' is very problematic indeed.

The precautionary principle (PP) in the EU is usually traced back to an operational approach engineered by the Commission: ' [PP should be applied in case]… scientific evidence …[about the] safety of a product or action is found insufficient, inconclusive or uncertain…[and when] … reasonable grounds for concern that …[effects on environment & health] may be inconsistent with the high level of protection chosen by the EU'.[10] There can be no doubt that in some rare instances PP might be justified, even if such 'justification' would be surrounded by unusually great uncertainty. The most critical issue in 'risk management' by authorities is presumably 'irreversibility'. Cases that come to mind might include climate change, BSE disease (in its early stages) and e.g. nuclear radiation. Nevertheless, the other three basic principles may go quite far in containing the hazards and the question then becomes how and how far PP ought to be applied in EU regulation. However, in the overwhelming majority of instances, one should be extremely prudent about the application of PP in EU regulation, for fear for huge regulatory failures lowering economic welfare in the Union. There are at least three reasons for this circumspect approach. First, PP ignores opportunity costs: could the resources directly or indirectly employed in living up to PP-based regulation not be better spent on other regulatory issues or on other priorities, especially for developing countries? Second, PP lacks operational clarity for setting targets unambiguously. This is problematic enough in and by itself but, given such ambiguity, it attracts interest groups eager to frame their positioning in terms of

[10] COM (2000) 1 of 2 February 2000, on the precautionary principle. The UN Rio Declaration of 1992 speaks about using PP where '… there are threats of serious and irreversible damage, lack of full scientific certainty shall not be used as a reason for postponing cost-effective measures to prevent environmental degradation…'.

PP and this can lead to curious coalitions imposing high costs on society (Vogel, 1995). Third, the vague operationalization of PP will cause different countries with different levels of development and/or preferences to opt for distinct levels of ambition, generating multiple 'standards' in the WTO and a threat to open world trade in the relevant goods or services.

In the risk assessments preceding RIAs, it is frequently the case that scientific evidence is 'insufficient, inconclusive or uncertain'; this is inherent to science and its application. There is no such thing as scientific certainty. The idea of being 'better safe than sorry' is not capable of discriminating 'how safe' one wishes to be or when exactly one feels 'sorry'. An essential notion in the economics of regulation is that, beyond a threshold of SHEC–type risk reductions, further risk reduction rapidly becomes extremely costly. What marginal costs for what marginal gain are justified when uncertainty is so extreme? Also the Court of Justice of the European Union (CJEU) Pfizer case[11] has shown that PP in the EU must be limited to 'real risk', proportionate with the goal and – despite all difficulties – accompanied by a RIA. In other words, an important idea behind the economics of regulation – 'evidence based' regulation – should not be sacrificed on the altar of PP.[12]

In the EU, genetically modified organisms (GMO) regulation and (e.g). REACH are based on PP. REACH has brought out what the dangers can mean in actual practice i.e. hazards rather risks becoming the basis for EU regulation. Basing regulation on hazards rather than risks is usually tantamount to a regulatory failure. A hazard is the potential for a substance, activity or process to cause harm or adverse effect whereas a risk combines the probability and the severity of a substance, severity or process to cause harm (Lofstedt, 2011). Thus, a chemical substance might have a potential to cause cancer (a hazard) and nuclear radiation might inflict deadly harm or cause diseases or

[11] Case T-13/99 Pfizer Animal Health, 2002 ECR II-3305.

[12] Majone (2002, pp. 96-7) gives a telling quote from CJEU Advocate General Lenz who saw a finding of a consumer anti-preference as sufficient justification (!) and scientific evidence was seen as unnecessary. In Gollier, 2001, it is shown that strongly pessimistic views on vaguely known risks could have led to a PP application in the UK to BSE with truly absurd costs. Rather than the actual 0.5 per cent of GDP that it has probably cost Britain to solve the BSE crisis, one might have 'consumed' far beyond 10 % of GDP.

failed pregnancies for more than one generation (idem). If one were to base regulation merely on such hazards, (EU) regulation would become unnecessarily restrictive. Unnecessarily, because the actual danger to persons (or animals) is determined by risk. Going from hazard to risk identification is done with the help of an accepted international standard: once the hazard is scientifically established, the dose/response relationship is found (the dose to f. i. a human body), the likely exposure or indeed tolerated exposure is identified, and these together determine the risk. Thus, when miniscule quantities of a potentially harmful chemical substance are found in human blood, far below volumes that might cause any harm, the risk is very low for the given harm. Exposure might be extremely low because chemical substances are trapped in solid rather than liquid or gaseous states as part of a product. Or, exposure might be very low because a chemical might only be used inside a controlled laboratory environment. Driven by a hazard-inspired approach of PP, at first the Commission early draft proposal was to subject all chemical substances to testing even when quantities used (hence, exposure risks) were minimal. Such a hazard-based approach is in conflict with principles of impact assessment where risks, not hazards, are related to SHEC-type objectives (and market failures) (Lofstedt, 2011). In the final proposal for REACH (in October 2003) the Commission significantly raised the quantity threshold (in other words, it shifted more to a risk-based approach) with the result that the estimated costs suddenly were reduced by more than 80 per cent! In the same proposal the benefits of REACH turned out to be hardly known – only a very simplistic back-of-the envelope calculation was presented – although the new REACH approach in chemicals regulation should have been considered if, and only if, benefits can be specified at least indicatively. Why otherwise regulate in the first place?

These experiences – and other ones (Wiener & Rogers, 2002 on the US experience) - have fortunately reduced the unquestioned employment of PP in Europe. PP should remain truly exceptional and, when used, the focus ought to be on research and evidence about benefits. Besides, one should make a serious attempt to apply RIAs.

4. An analytical approach of the EU regulatory acquis

4.1. Analytical mapping of the regulatory acquis

The economics of EU regulation simplify an analytical mapping of the regulatory acquis of the EU internal market. The acquis of the internal market is the collection of all EU regulation (including the underlying free movements, mutual recognition and EU competition policy as indicated in Figure 1) and related European standards as well as the relevant CJEU case law. Mapping the enormous internal market acquis in a conceptually understandable fashion is an interesting result in and by itself, since the 'regulatory acquis' is usually regarded as a giant mass of rules resistant to overall assessment. Understanding the EU regulatory acquis, in particular its logic, is crucial. This is illustrated best by an important incident during the pre-accession period of the Central and East European countries. Their obligation was to incorporate the acquis of the internal market[13] but no overview of that acquis, let alone, a genuine understanding of its logic, appeared to be available anywhere. When the Commission finally made a kind of inventory in the White Paper,[14] it became a helpful tool for ticking off the work programme of the national parliaments, but little if any systematic understanding of the internal market logic was gained.

The internal market regulatory acquis can be captured in a relatively simple matrix, derived from the public interest approach to regulation. The matrix consists, horizontally, of the five markets (goods, services, capital, labour, codified technology) and, vertically, of the four market failures (internalities, externalities, competition imperfections and public goods). One can fill the entries with examples of EU regulation that combine a market (say, services) and a market failure (say, internalities such as asymmetries of information).

[13] In the wide, conceptual sense. This was interpreted as incorporating 23 of the 30 negotiating chapters.

[14] European Commission, 1995, The White paper: Preparation for the associated countries of Central and Eastern Europe for integration into the internal market of the Union, COM (95) 163, May. It contains 23 chapters with lists totalling some 900 directives' without almost any explanation and without any clue how these chapters and clusters inside them hang together.

What the matrix does not capture is redistributive regulation but this is a rarity in single market rules.[15] The matrix shows the economic logic of the regulatory acquis, be it at a high level of generality. It clarifies that, in principle, the regulatory acquis is a functional one and may well serve the European public interest. It is only when zooming in on the specifics of each and every directive or regulation, on the basis of a proper RIA, that these generalities can be subjected to a hard test (Section 5).

4.2. EU regulation, deepening and widening

There is no authoritative 'indicator' or analysis establishing 'gaps' or the 'incompleteness' of the EU internal market. The difficulty begins with the discrepancy between the economic internal market concept and the treaty concept. In three types of markets the treaty has always been weaker than for goods and capital: services, labour and intellectual property rights (linked to codified technology).

Intellectual Property Rights (IPRs) (like patents) are under unanimity and the relevant treaty article is and remains a huge drafting flaw.[16] The EU patent brings together two important results from the economic literature: it applies to the entire internal market - stimulating R & D and innovation beyond what otherwise would be undertaken (Friebel, Koch, Prady and Seabright, 2006; Guellec and van Pottelsberghe, 2007; van Pottelsberghe, 2009) - and it is far cheaper than today, both at the outset and in terms of annual fees (current patenting in the EU is about five times as expensive as in the US). Therefore, the EU patent 'gap' severely hinders the internal market to serve effectively the attainment of (higher) growth and productivity trends, expressing central treaty objectives.

[15] There are two such exceptions. One works indirectly via 'host country control' in labour migration (and posted workers) – as it protects minimum wages in EU countries. The other is found in those agricultural rules not dealing with risk (like veterinary & phyto sanitary, or, fertilizers and pesticides) but with payments to farms.

[16] That systems of ownership are a national prerogative was almost certainly understood by the 1957 negotiators as referring solely to state ownership, not to IPRs like patents.

For labour, the treaty is also in the way but more subtly so. The crux of the matter is that the treaty speaks about the 'free movement of workers' but not in the list of free movements (where 'persons' are mentioned). The status of art. 45, TFEU (former art. 39, EC) on the free movement of workers is clearly lower than the former art. 3, EC. The strict conditionality of the 'free' movement of workers under a broad form of host-country control , essentially protecting (heavily regulated) national labour markets and their wage formation, cannot be a surprise . The TFEU defines the internal market (art. 26, sub 2) again with reference to 'persons'.

Unlike the economic (and indeed also federal) notion of an internal market, there is no obvious basis to expect an 'EU internal market for labour' given these severe constraints at national level . The free movement of workers is therefore 'residual' in the minds and practices of EU policy makers, and probably also for labour unions. For economists, this means that such migration flows might fill up shortages but do not, as a rule, exercise wage constraining or convergence effects or at most temporarily in specific segments of national labour markets.[17] One can push this argument further in noting that cross-border migration in the EU is relatively small, even when taking the brief East-West surge of 2004-08 into account. This observation is usually seen as a sign of socio-cultural and language differences 'naturally' reducing such intra-EU migration. To some extent this is undoubtedly true – the 'stay-put' incentives in Europe are much more powerful than e.g. inside the US. Nevertheless, one should not ignore other reasons for low migration and these are due to sheltering national regulations, the welfare state and the EU acceptance of host country control in migration and the posted workers directive.[18] In turn, these strong preferences for national labour market regulation (other than selected EU minimum requirements) and national redistributive arrangements render Europeanization of labour market regulation unlikely: it would not easily pass step 2 of the subsidiarity test (the need-to-act-in-common), as cross-border externalities cannot be large.

[17] For empirical confirmation, see Kahanec & Zimmermann, 2009, analysing the economics of migration generated by the two Eastern enlargements.
[18] See Pelkmans, 2006, 197-9, for a graphical proof that host country control can throttle or eliminate the demand for EU workers coming from low wage countries.

Also, the internal market diamond does not work like in other types of markets as neither competition policy nor mutual recognition is applied.[19] The recent turmoil about instances where free movement of workers and a very wide interpretation of host country control conflict,[20] illustrate explicitly what has long remained implicit in European integration. A partial and residual EU labour market is probably as far as one might expect to go both for reasons of a subsidiarity test and of socio-political legitimacy.

On services, the treaty postulates free movement and the right of establishment applies. Nevertheless, it has long been neglected. Not only does the internal services market fail to 'work properly', it is a sensitive and complex area, also ignored by economists for too long. The selective approach for six transport modes only began to work after the CJEU ruling of 1985 (when the CJEU sided with the EP, against the Council). Financial services currently undergo a fourth generation of regulation. It is said that the 3rd generation rules for bank supervision (which were anyway not tight enough) spawned some 150 exceptions, derogations and variations in EU countries, overseen by a total of more than 55 regulators/ supervisors.

The fourth generation of financial services regulation is seeking far better risk transparency, risk regulation (especially via higher capital requirements) and incentives to reconsider risk, together with novel bank resolution arrangements (see e.g. Lannoo, 2011). 'Good' EU financial services regulation should root out, where appropriate, national divergences and costly fragmentation, while focussing primarily on risk management and transparency, tough supervision (which has to be Europeanized for some 50 cross-border banks and certain services), investor and consumer protection as well as 'systemic' financial stability overall.

[19] See also Kostoris Padoa Schioppa, 2003, for mutual recognition. Competition policy would run the risk of undermining constitutional rights to strike or to make collective agreements.
[20] See the ECJ Laval (C-341-05, ruling December 2007) and Rueffert (C-346/06, ruling April 2008) cases.

The treaty can be in the way, however, in that the Meroni doctrine [21] prevents the proper solution for supervision: EU Agencies cannot be truly independent, like the ECB is (at least, not without treaty change). The same legal 'freeze' has shown up for services from network industries where the economic case for independent EU Agencies is strong in e.g. electricity & gas and air traffic control, for example. So far, unfortunately, the doctrine reduces the quality of EU solutions in financial markets and network industries, possibly other services too and undermines deeper market integration (Lavrijssen and Hancher, 2008; de Muyter, 2008; Chiti, 2009).

In the internal market for professional services, it has also proved very difficult to make progress despite widespread anti-competitive practices hidden in self-regulation at the national level (Delimatsis, 2010).[22] The CJEU Wouters case[23] gave restrictive Dutch regulation the benefit of the doubt and thereby, once again, discouraged the Commission's pursuit to open up these national markets.

These examples show that, in services, the emergence of a deep internal market with a wide coverage of types of services is hindered in complex and subtle ways which are partly due to the treaty, partly to case law, partly to aspects of unanimity and of course due to vested interests as well. When the horizontal service directive (2006/123) was finally adopted – easily three decades too late - services other than the ones discussed above were to be addressed in a single piece of regulation based mainly on CJEU case law. Years of sometimes hectic debate revealed the profound ambivalence in the EU about an internal market of services and labour. Main discussion points included (a) the labour aspects,[24] directly or indirectly, (b) the numerous derogations (even though the country-of-origin principle had been taken out!), (c) a few lingering

[21] The Meroni doctrine is in fact a doctrine of constitutional logic. Officially, it is based on an old case from the ECSC (Meroni , Case 9/56, Industrie Metallurgische vs, High Auhtority [1957 – 1958], ECR 133) but this case is a peculiar one and what matters in today's debate is the prohibition for the EU level of re-delegating the powers received from the Member States to (EU) bodies which could regulate independently, without first ensuring a legal basis in the treaty for such delegation.
[22] See COM(2004) 83 of 9 February 2004, Report on competition in professional services.
[23] Case C-399/99, ruling 19 February 2002. See Vossestein, 2002. Delimatsis, 2010, shows that the services directive 2006/123 may well induce progress in e.g. EU-wide codes of conduct.
[24] Note that Boeri, Nicoletti & Scarpetta, 2000 show empirically that restrictive labour market regulation is strongly correlated with restrictive services markets.

sensitivities[25] and (d) the vexed problems of consumer and labour contracts as well as cross-border access to health services for patients. Again, a truly 'deep' and 'wide' internal services market is bound to be intrusive and has profound effects on what are regarded by many as 'domestic' traditional arrangements (be they social, legal, financial or institutional). This raises formidable questions of socio-political legitimacy.

Besides these three broad domains, other 'gaps' in the internal market can be identified (as the Monti Report, op. cit., the 2007 Internal Market Review[26] and the 2011 Single Market Act[27] have all done in somewhat different ways) but they are in a different category. One can see them as 'unfinished business', perhaps hard at first and easier today, or, responding to novel issues or new technology and new markets. They emerge due to a combination of legal and economic (neo-functionalist?) pressures, combined with political judgement by the Commission and other EU bodies. There are also 'generation' effects as dossiers such as 'public procurement' and 'mutual recognition' of diplomas show, probably reflecting a tendency to move from a legalistic to a more economic, evidence-based (and 'deeper') approach.

[25] E.g. on services of general (economic or non-economic, even though the latter are not even part of the internal market) interest; on the posted workers directive 96/71, even though this directive remained explicitly untouched by the proposal.

[26] See COM (2007) 724 of 20 Nov. 2007 and a series of accompanying COM and SEC documents; see also Pelkmans, 2010.

[27] European Commission, Single Market Act, twelve levers to boost growth and strengthen confidence, COM(2011) 206 of 13 April 2011 and accompanying documents.

5. Better EU regulation: an evidence-based, economic approach

Starting from the framework indicated in Box 1, this section will provide the economic underpinning of the shift to systematic 'better EU regulation'. This culminates in the crucial tool of RIAs (regulatory impact assessment) for new EU regulation as well as for revisions of parts of the regulatory stock. Since their introduction in mid-2003, Commission RIAs have grown into a leading and fairly rigorous instrument to impose Better Regulation principles, logic and economic cost-benefit analysis on every legislative proposal to Council and EP. Over time EU RIAs have improved significantly in quality and the 2009 Guidelines have become a standard in the world.[28]

Good EU regulation maximizes the benefits while minimizing the (economic) costs of EU regulation in the single market. This is essentially done by transposing the economic logic of Box 1 into a sequential process of identification of EU (usually SHEC) objectives, policy options and a comparative cost-benefit analysis of those options. However, RIAs are not purely economic. What the EU calls 'integrated assessment', it combines long checklists of economic, environmental and social 'impacts'. The RIA logic goes through six steps: (i) what is the EU policy problem?; (ii) what are the EU objectives to be pursued?; (iii) what are the policy options?; (iv) what are the likely impacts of those options (with checklists totalling more than 130 aspects); (v) how do the options compare?; (vi) how to best monitor and evaluate later, once the regulation is in force for a few years? Of course, this chapter cannot go into the very detailed Guidelines and the rationale of each and every step. The underlying rationales are five, three of them economic and the other two possibly having economic effects as well. First the latter two. Since RIAs (if well done) create easy access to quality information about data and to economic (and other) impacts of a range of options, while adhering to a rigorous approach of policy analysis, it disciplines the 'regulatory state' and unaccountable agencies; it should also make biased lobbying and unreliable pleading much more difficult because RIAs set the minimum standard in the policy debate.

[28] See European Commission, 2009, Impact Assessment Guidelines, and its many Annexes, at http://ec.europa.eu/governance/impact/docs/key_docs/iag_2009_en.pdf; see Renda, 2008 and the detailed EU Court of Auditors Report, 2010.

It might also help controlling the sprawling bureaucracy in 'Brussels' whether perceived or actually present, in particular, with respect to unnecessary 'red tape' for business or consumers. The economic arguments for supporting RIAs include:
(a) competitiveness concerns of European business (avoiding 'bad' EU regulation);
(b) micro-economic benefits of avoiding 'bad' regulation throttling entrepreneurial initiatives or competitive entry or raising costs without overcoming market failures (or doing so with disproportionate means);
(c) macro-economic benefits: in moving from 'bad' to 'good' regulation, resources are freed for more productive application - if inappropriate regulation is widespread, one can empirically demonstrate that a shift to 'best regulatory practices' engenders a one-time increment to GDP and possibly a higher trend growth of the economy (see e.g. Cotis, de Serres & Duval, 2010).

The main problem with the EU RIAs is that the EU legislator (Council & EP) is not bound to adhere to RIA logic, although they have agreed to Better Regulation ideas in an Interinstitutional Agreement. The EU Court of Auditors Report (2010) shows clearly that RIAs plays some role in the EU legislator but a fairly modest one; drastic amendments are not subjected to a new RIA, the most painful example being the services directive 2006/123.

In RIAs there has been more attention, recently, for alternative forms of regulation such as co-regulation or voluntary agreements and this may sometimes amount to a superior solution. Also, the EU has developed the Standard Cost Model in order to quantify the red-tape costs of EU legislation. To the extent that such red tape is avoidable, direct costs (especially for SMEs) can be cut and a major irritant for European business is removed. The EU target for red-tape cost reduction is 25 per cent by 2012, based on a huge exercise of estimating red tape costs of the EU single market regulatory acquis in 2006/7. The EU is likely to reach this target, for a total cost saving of €40 billion.[29] Finally, inspired by Better Regulation programmes, the Commission has

[29] See the summary of all actions and their estimated cost savings in Commission Press Memo 10/654 of 7 December 2010. In November 2010, the adopted actions amounted to € 27 billion.

also initiated a programme of identifying 'market malfunctioning' of certain 'pockets' in the single market. Detailed proposals to improve market functioning in certain retail branches where market power and other problems were playing a role is one concrete result of this new approach called 'market monitoring'.[30] What matters is whether EU regulation better serves allocative and dynamic efficiencies in the internal market, thereby promoting the very socio-economic goals European economic integration has always been pursuing: growth and productivity increase in the long run.

6. Blurring boundaries of national regulatory autonomy

Insofar as internal market regulation and liberalization is goal-driven, an economic case can be made that *national* regulation – though autonomous - should be designed with the better functioning of the *EU economy* in mind. The internal market is seen as one of the principal means to achieve higher trend growth. *National* regulatory reform, in particular, in services and labour markets, is regarded as just as essential (Woelfl, Wanner, Kozluk and Nicoletti, 2009; Cotis et al, 2010; see also Kox & Lejour, 2005).

Domestic reforms in services and labour markets can of course be driven by enlightened self-interest. But what if domestic political reasons prevent such insights (from economic analysis in the Lisbon policy process or the OECD) to be put in practice? Can the EU exercise go beyond peer pressure or perhaps 'naming & shaming' lists? Can one not maintain that reforms in all EU countries, even when governed by national autonomy, support an overall higher growth rate and external competitiveness in the EU so that positive externalities and complementarities are enjoyed; with the corollary that a refusal to reform in some EU countries implies negative effects for all? Can one not go further still and observe that the desired reforms found especially in labour and services markets suggest a direct link between

[30] See Ilzkovitz, Dierx & Sousa, 2008 for methodology and first application, and COM (2010) 355 of 5 July 2010, Retail market monitoring report. See also COM(2009) 591 of 28 October 2009 on a better functioning food supply chain in the EU.

the lower potential of the internal market (due to gaps in precisely these areas) and the low reform record of some EU countries, exactly those with low records of productivity growth? It can be empirically shown as well that the euro area would function better if these domestic reforms would be undertaken (Pelkmans, Acedo & Maravalle, 2008).

Sapir (2007, 407 ff) supports this view forcefully. 'The case for coordinating product and capital market reforms on the one hand and labour market reforms on the other *within each EU country* increase the demand for labour and therefore facilitate reforms in the labour market. Equally, reforms of labour markets tend to facilitate the creation of new firms… Because countries share a common good, namely the single market,… better national labour markets operate, the easier it is to reform the single market and vice versa. Instead of a clear separation between the EU and the national remits, as was the case in the early days of the EC, there is an increasing overlap between the EU and national… domains'.

A similar phenomenon can be observed about regulatory heterogeneity in the EU. It is worthwhile distinguishing regulatory heterogeneity between Member States from the diversity of preferences between Member States. Although the internal market deals with access to markets and competitive conduct (and structures at times), numerous rules, forms of red tape and other constraining factors of the corporate environment still differ a lot between all 27 member states. These interventions fall under national regulatory autonomy. To some degree this is inevitable and probably legitimate as well. It occurs in federal countries between provinces, cantons or states, too. The relevant question is: when is '*diversity*' a sensible expression of different preferences and circumstances, and when is *heterogeneity* objectionable, as a costly fragmentation by autonomous rule making, *not* expressing diversity of preferences but merely technical or administrative differences? Diversity is underlying the subsidiarity principle, heterogeneity is not. It is important to appreciate the difference between the two. Given national regulatory autonomy and assuming for a moment that national objectives are equivalent (that is, there is no diversity of preferences), the

pure fact of decentralized decision-making will yield costly regulatory heterogeneity which has no economic purpose and is not rooted in diversity which ought to be respected under subsidiarity.

Heterogeneity can be a reason why services exports in the EU cannot reach sufficient scale since the fixed costs of entering one national market have to be incurred again in the next market. If these costs per market are high enough, small national markets will be less well integrated as fewer entrants try. In national competition policy, all member states have gradually come to follow the EU rules and this is helpful. Still, European business (probably rightly) complains that the mere rejection of a European one-stop-shop below the EU merger thresholds (that is, being subjected to three, four or five merger authorities, if not more) can be very costly. For numerous aspects in the corporate regulatory environment, heterogeneity rather than diversity can be costly, too. It might well be that the expected internal market effects are in effect throttled by the too low weight of the internal market benefits against the remaining heterogeneity in the day-to-day reality for business in the single market. When Kox, Lejour & Montizaan, 2004, employed a heterogeneity index for services regulation in order to simulate the economic impact of the Bolkestein draft – the first time this was ever done – it was the *reduction in regulatory heterogeneity* between the member states (in bilateral gravity equations) which led to 0.3 per cent extra Gross National Product (GNP) and 30 to 60 per cent extra services trade in the internal market. This should be food for thought. In fact, Kox & Lejour, 2005, conduct a pure heterogeneity analysis, *not* an economic analysis of the impact of the barriers, their nature, scope and height in services markets.

7. Conclusions

In the vast domain of the internal market, 'regulation' is EU's core business. Therefore, a good appreciation of European economic integration requires a sound analytical economic perspective of EU regulation. In the 25 years since the Single Act, the core questions of 'why regulate (in) the internal market', at 'what level', and 'how' have prompted much economic analysis of an ever more sophisticated nature. After quite some resistance, the rigorous logic of Better Regulation and even of cost-benefit analysis or other quantification has become routine in EU regulatory thinking, incorporated in RIAs and verified by a quasi-autonomous Impact Assessment Board (IAB) of the Commission.[31] This refers mainly to risk regulation that is preponderant in the total stock of EU rules. The high number of RIAs each year (around 100 or more) and the quality control by the IAB have spawned a new, rapidly growing industry of economic analysis of EU regulation, in analogy with the evidence-based, more economic approach meanwhile adopted in EU competition policy.

The increasing acceptance of economics and analytical rigour does not mean that there is no politics anymore in EU rule making. Nevertheless, it puts the subsidiarity test, proportionality and necessity (all basic requirements in EU law) on firmer analytical economic footing and offers a healthy discipline of the application of the precautionary principle. The acceptance of economic, evidence-based regulatory logic at EU level has caused a change of mindsets in the European Commission: regulation is now routinely discussed in terms of incentives, asymmetries of information, tight connection between instruments and objectives, various (and not merely one) policy options, quantification of benefits and costs, explicit red-tape alerts, market-based (instead of command-and-control) instruments and the notion of cost-effectiveness. This change of mindsets has not yet trickled down to the EU legislator to the same extent.

[31] See for instance SEC (2011) 126 of 24 January 2011, Impact assessment board report for 2010, on http://ec.europa.eu/governance/impact/docs.

Finally, the regulatory environment for business and consumers in the internal market is not solely determined by EU regulation, but by the blending of EU and national regulation. The regulatory autonomy of member states in an ever deeper and wider internal market has to be balanced against the possible consequence of worsening the sub-optimality of the functioning of the internal market. First, the key words here are (desirable) pro-competitive reforms and diversity, insofar as the segmentation is truly founded on diverse preferences between member states. Second, there is a lot of pure heterogeneity in the EU, not based on diverse preferences but, rather, an outcome of decentralized decision-making which is cumbersome to 'undo', but also costly when persisting.

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