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A New Phase of European Integration

Organized Capitalisms in Post-Ricardian Europe

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Abstract

In the past, economic integration in Europe was largely compatible with the persistence of different national varieties of capitalism. While product market integration intensified competition, member states could build on and foster their respective comparative advantage. To date, this no longer unequivocally holds true. We contend that a new, 'Post-Ricardian' phase of European integration has emerged in which the Commission's and the ECJ's attempts to further economic integration systematically challenge the institutions of organized capitalism. This quest for liberalization has reached a point at which its output legitimacy is increasingly uncertain. As a result, the de-politicization of EU decisions proves increasingly unsuccessful. In addition, liberalization measures rely on a very generous interpretations of the 'four freedoms' that exceeds the amount of liberalization the member states agreed upon in the European treaties and, therefore, lacks input legitimacy. We show this by discussing recent struggles over the Services Directive, the Takeover Directive, and company law. In the current phase of European integration, the Commission's and the ECJ's liberalization attempts either transform the institutional foundations on which some of the member states' economic systems rely or they create political resistance to an extent that calls into question the European project. The case studies reveal evidence for both of these possibilities.

Zusammenfassung

In der Vergangenheit war die europäische Wirtschaftsintegration mit der Fortexistenz unterschiedlicher Kapitalismusmodelle in Europa vereinbar. Angesichts verschärfter Konkurrenz auf den Produktmärkten konnten sich die europäischen Volkswirtschaften auf ihre komparativen Vorteile konzentrieren und diese im Rahmen ihrer jeweiligen Funktionslogiken fortentwickeln. Wir argumentieren, dass die europäische Integration in eine neue, „post-ricardianische" Phase eingetreten ist, in der diese Logik nicht mehr gilt: Die Integrationsversuche von Kommission und Europäischem Gerichtshof zielen nunmehr direkt auf die Transformation der Institutionen der organisierten Kapitalismen. Mit Output-bezogenen Argumenten lassen sich diese Liberalisierungsversuche immer weniger legitimieren; folglich erweist sich die Depolitisierung europäischer Entscheidungen als zunehmend erfolglos. Gleichzeitig beruhen die Liberalisierungsversuche auf extensiven Interpretationen der „vier Freiheiten" und gehen damit über das in den Verträgen vereinbarte Maß hinaus, sodass ihnen an Input-Legitimität mangelt. Dies zeigen wir anhand von Fallstudien über die Dienstleistungsrichtlinie, die Übernahmerichtlinie und die Neuinterpretation der Niederlassungsfreiheit. Es existieren zwei mögliche Folgen dieser Integrationslogik: Entweder erweisen sich die Integrationsversuche als erfolgreich, was fundamentale Veränderungen der Funktionslogiken der organisierten Kapitalismen zur Folge hat; oder sie rufen ein Maß an politischem Widerstand hervor, der den Fortgang des europäischen Projekts in Frage stellt. Wie wir zeigen, gibt es empirische Anzeichen für beide dieser Möglichkeiten.

Contents

1 Introduction: The problem

To anyone interested in an evaluation of the current state of Europeanization, we recommend the webpage <www.go-limited.de>. The advertising company, following the European Court of Justice's (ECJ) judgments on Centros (1999), Überseering (2002) and Inspire Art (2003), asks German businesses to take advantage of the guaranteed European freedom of establishment. Rather than suggesting the actual relocation of companies, the advertiser merely provides a vehicle for them to circumvent German company law. For 260 euros only, the advertiser offers a complete package for the establishment of a British 'limited liability company' (Ltd.). The advertising firm promises several advantages: among them, doing away with German bureaucracy; registration of the company in two weeks only; avoidance of strict German personal liabilities; free choice of authorized capital as long as it exceeds 1.40 euros (compared to a minimum of 25,000 euros in the case of a German GmbH[1]); no supervisory board codetermination if the company grows beyond 500 employees.

'The European legislator is less and less willing to be considerate of the German *Sonderweg* [special route]', argues lawyer Martin Henssler in a recent newspaper article.[2] He asks German politicians to restrict supervisory board codetermination to no more than one third of the supervisory board seats. This, he argues, is a necessary act of anticipatory obedience. In Germany, close-to-parity codetermination has always been seen as an expression of a distinguished 'social market economy'. Yet has the purpose of European integration ever been to put pressure on the organized elements of 'Rhenish' capitalism? Was not a 'social model', in contrast, part of the European promise? What has happened to European integration?

The last years have also been characterized by a series of failures of integration projects, by a so far unknown degree of politicization of European level developments and, ultimately, by a crisis of the European project. In July 2001, the European Parliament voted down a directive that aimed at creating a European market for corporate control by removing national barriers to hostile takeovers. Later, in December 2003, the European Parliament approved a compromise on the Takeover Directive that had been unanimously approved by the Council and that, according to Internal Market Commissioner Bolkestein, was 'not really worth the paper it was written on'.[3] Between 2004 and 2006, the Commission's Services Directive caused fierce protests, especially in organized economies[4] such as Austria, France and Germany. As with the takeover case, the Com-

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1 The 'Gesellschaft mit beschränkter Haftung' (GmbH) is the German version of a British 'Ltd'.
2 *Frankfurter Allgemeine Zeitung,* 1 February 2006, 23.
3 *Financial Times,* 18 October 2004, 6.
4 For the purpose of this paper, we distinguish two forms of capitalism in the European Union: liberal market economies and organized economies, the latter being distinguished by (a) non-

mission ended up with a compromise that lagged far behind its aim to effectively liberalize services in the European Union. In 2005 and 2006, the Commission's proposed 'Port Package II' directive, which aimed at imposing more competition on harbours, led to European-wide, sometimes violent, protests. The European Parliament rejected the proposal in January 2006 and, two months later, the Commission announced its intention to withdraw from it. What is more, failure and contestation were not limited to individual policy proposals but also affected the constitutional treaty of the European Union. In 2005, French and Dutch voters rejected the proposed draft in two referendums. In the French referendum on the European constitution, the people's 'non' was largely affected by resistance to the proposed Services Directive.[5] More generally, many French citizens thought that economic integration had got out of hand.[6]

In this paper, we contend that European economic integration has entered a new, post-Ricardian phase in which it systematically clashes with national varieties of capitalism. Rather than enhancing competition that builds on existing comparative (institutional) advantages, recent Commission initiatives and ECJ rulings propel convergence. Integration attempts affect market capitalism and organized capitalism differently: they asymmetrically target institutions of organized capitalism and, therefore, result in a 'clash of capitalisms'. Such proposals may lead to two different outcomes. The first is that they are successful and fundamentally change the way in which continental European economies operate. The second is that political resistance in the organized economies leads to a crisis of political integration. To us, a cross between both possibilities appears as the most realistic scenario for the future.

This paper proceeds as follows. In the next section, we will outline why we suggest the existence of a new phase of European integration and how this relates to the strategies of supranational actors. After linking these observations to a more theoretical account of 'delegation' and 'agency drift' in Section 3, the following fourth section offers three case studies of the Service Directive, the Takeover Directive, and the ECJ's rulings on company law. In all of these cases, EU actors did not attempt primarily to create a level playing field in the EU but instead tried to administer convergence between different varieties of capitalism. The final section concludes that a political economy perspective helps to better understand the crisis of political integration. In short, the EU lacks the legitimacy to alter national varieties of capitalism as much as national welfare states. If the Commission and the ECJ nonetheless overstress their mandate, they will provoke resistance not only to specific proposals but to the European Union in general.

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market coordination between stakeholders and (b) a high degree of institutionalization of economic action, i.e. a high degree of public interference in private decisions over finance, investment, and consumption.

5 See, for example, *Financial Times,* 20 April 2005, 6; *Financial Times,* 30 May 2005, 6.

6 For more details, see European Commission (2005a).

2 Three phases of European economic integration

The history of European economic integration can be divided roughly into three phases: Customs Union, Common Market, and Economic Union.[7] Obviously, these phases overlap and cannot always be neatly separated. Yet, arguably, they do differ in the dominant aim of economic integration. First, between the late 1950s and the mid-1970s the aspiration was to create a Customs Union, in which tariffs were removed and trade between largely autonomous member states was facilitated. In these early years, economic integration did not affect national varieties of capitalism. Member states were able to build national welfare states and to run their economies largely without outside interference. If there were converging trends, these were due to a common process of economic modernization (Shonfield 1965). The EU institutions at that time had the rather limited role of facilitating compromises and making sure that governments lived up to their commitments once they had reached an agreement. The High Authority and the Court were the 'guardians of the Treaty' but not vitally important for deepening integration (Moravcsik 1998: ch. 2). At this stage, economic integration was not at odds with domestic policy goals but was seen as a means of achieving these (Milward/Sørensen 1994: 20–21).

The second phase started with the *Dassonville* and *Cassis de Dijon* decisions of the European Court of Justice in the 1970s and acquired political clout with the Single European Act and, more specifically, with the introduction of the principle of 'mutual recognition' (see Alter/Meunier-Aitsahalia 1994). Under this provision, goods lawfully sold in one member state can also be sold in any other EU country. Mutual recognition is an alternative to either harmonization or to the host country principle (Schmidt 2007). In contrast to earlier attempts to create the Common Market, mutual recognition is less dependent on political agreement. Although exemptions are possible, the country-of-origin principle leads to an abdication of national sovereignty. Member states are no longer exclusively in a position to determine which products can be marketed domestically.

Another feature of the second phase of economic integration was that European actors were no longer sidelined but instead took centre stage. Making skillful use of legal and political authority to expand their own competencies, they became the 'engines of integration' (Pollack 2003). However, their room for manoeuvre was unevenly distributed. European integration has been characterized by the asymmetry between 'negative' (market-enforcing) and 'positive' (market-regulating) integration (Scharpf 1996, 1999: 43–83). Yet, the discrepancy between negative and positive integration is, in principle, compatible with the existence of different institutional varieties of capitalism. Product

7 Cf. Balassa (1961) for a theoretical account of different stages of economic integration. In contrast to his account, which assumes a balanced integration of economic, fiscal, monetary, social and tax policy, the actual process of European economic integration has been characterized by a highly asymmetrical process of delegating competencies to the EU across policy fields.

market liberalization increases competition between firms from different countries. As long as different institutional settings are associated with different comparative advantages (Franzese 2002: 184–190), transformative pressure on supply-side institutions does not necessarily occur. In fact, more competition can reinforce differences between countries (or regions) as these build on their respective strengths. If firms shift their activities to those countries that offer the best institutional support (for example, with respect to the availability of particular skills, flexible vs. stable employment patterns, etc.), market integration may make the different institutional settings even more stable; in their 'Introduction to Varieties of Capitalism', Hall and Soskice (2001: 57) have called this 'institutional arbitrage'. Hence, the impact of product market integration – including increased abilities to relocate production – on different forms of capitalism is an indirect one and its direction as yet indeterminate.

Our argument points to something different: European integration, after having largely completed product market integration, has entered a phase since the late 1990s in which the quest for liberalization directly targets the domestic institutions of organized capitalism. This implies Europeanization as transformation (Schmidt 2002: 901) in the strong sense. In this 'post-Ricardian' phase, European integration differs from Olsen's (2002: 934) observation that overall 'European-level developments do not dictate specific forms of institutional adaptation but leave considerable discretion to domestic actors and institutions'. The goal of a number of recent Commission initiatives is no longer to create a level playing field among EU countries, so that market success is the judge of different varieties of capitalism; instead the Commission consciously pushes for the 'modernization' of European economies along the lines of the Anglo-Saxon model.[8]

Of course, EU decisions sometimes had a transformative impact on national economies in the past, too, mainly during the second phase. For example, the European Commission and the ECJ used EU competition policy, where they were able to decide without the agreement of the Council of Ministers, to push for economic liberalization. In these cases, non-political, i.e. bureaucratic, decisions resulted in an assault on the mixed economies of many member states (Scharpf 2006: 853). EU actors used their competencies to redefine which economic activities were of public interest and, therefore, exempt from Common Market requirements. The difference to the third phase of European integration is, however, that these interventions still ran under the heading of 'non-discrimination'. The goal was to eliminate a disguised protectionism on the part of the member countries to allow for fair competition between companies of different origin. Lately, the Commission's understanding of a level playing field has been changed to mean that *institutional differences as such* are an obstacle to competition. Liberal market economies and organized economies are no longer equally valid production regimes but the institutions of the latter are seen as barriers to Economic Union. In promoting

8 This 'New Economic Policy' seeks to administer modernization from above. It is no longer committed to the Ricardian world of comparative advantage, and thus lasting differences, but strives instead for convergence.

further liberalization, EU actors are able to resort to practices – such as the country-of-origin principle – that were introduced during the second phase and successfully established in product market liberalization.

The case studies demonstrate that recent liberalization attempts have aimed at ultimately detaching democratic institutions from the economic units they intend to regulate. If they were to succeed, they would cause what we call 'de-institutionalization'. To us, institutions are the instruments with which society governs the (economic) behaviour of its constituencies (rather than being efficient solutions to coordination problems between firms). If national governments even collectively cannot control supranational agents, this raises fundamental questions as to the democratic legitimacy of current European integration. However, before turning to the case studies, we discuss the theoretical relevance of these changes.

3 The politics of delegation

Recently, much of the theoretical literature on EU politics has been cast in principal–agent language and has made use of the notion of 'delegation'. Yet, this literature cannot adequately account for the cases described in the next section. Either it denies the problem of agency drift altogether (rationalist perspective) or it falls short of a genuinely political understanding of EU actors (neo-functionalism). We do not claim that our theoretical perspective is entirely new; we stress, however, that the control of supranational actors is not just a question about the pace of economic integration, but that it is at the heart of the struggle over the future of European capitalism(s).

In general, the main reason for delegating decision-making competencies to the Commission and the ECJ has been the desire to curtail transaction costs. Negotiations among 27 member states can be extremely time-consuming and possibly inconclusive if the aim is consensus. Moreover, since it is the member states that usually implement EU legislation, there is ample room for opportunistic behaviour and non-compliance. More specifically, Pollack (2003: 21) identifies four functions of delegation: (1) monitoring compliance with the treaty obligations, (2) solving problems with incomplete contracting (interpreting the treaties), (3) expert information, and (4) agenda setting. Delegation should thus make negotiations more efficient and help to solve collective action problems.

The downside of transferring power to agents is that their preferences may differ from those of the principals, and effective control mechanisms can eat up the potential gains of delegation. Usually agents develop expert knowledge, and a growing information asymmetry emerges that renders control even more difficult (Kiewiet/McCubbins 1991: 25). In deciding whether to delegate, principals thus weigh the costs of agency drift against efficiency gains (McCubbins/Noll/Weingast 1987: 247). However, principals not only delegate powers to reduce decision-making costs but also to enhance the credibility of their commitments to certain policy goals. In the first case, controlling the agent is central; in the second, the principals' self-interests need to be kept in check. Recent neo-functionalist arguments have stressed the inability of national governments to control supranational actors who are, thus, able to push economic integration ahead. Intergovernmentalist accounts have, in contrast, questioned the scale of unwanted agency discretion and instead pointed to the need for credible commitments.

Over the last years, a number of authors have sought to revitalize neo-functionalism. For example, Stone Sweet, Sandholtz and Fligstein have offered a transaction-based account of European integration (Stone Sweet/Sandholtz 1997; Fligstein/Stone Sweet 2002). They contend that integration is a response to societal demands for supranational rules. As cross-border transactions mount, societal actors (mainly, but not only, producers) call for common rules. In due course, governments agree to delegate competencies to the European level. Supranational actors help to bring about and enforce uniform market rules. Their actions, in turn, facilitate cross-border transactions that amplify demand for further supranational rules and centralized decision-making – thus generating a self-reinforcing process. In a related argument, Burley and Mattli (1993) suggest that the European Court of Justice safeguards member state compliance with prior agreements. As the legal system of the European Union is complex and provides plenty of opportunities to defect, an independent agent is best suited to monitor compliance. However, due to the doctrines of 'direct effect' and 'supremacy' the European Court of Justice has greatly expanded its competencies beyond what was initially intended (Weiler 1991; Alter 1998). Thus, the ECJ has become one of the 'engines of European integration' (Pollack 2003: ch. 3).

National governments are never fully able to collectively control supranational agents because of shorter time horizons and potential disagreements among them. While delegation necessarily results in gaps of control, member states are often unable to close those gaps (Pierson 1996). There are a number of strategies available for the Commission and the European Court of Justice to circumvent deadlock in the Council and to push integrationist legislation ahead (Héritier 1999; Schmidt 2000). In sum, these arguments rest on the idea that supranational actors propel integration behind the back of national governments that have neither anticipated the accretion of EU competencies nor been able to effectively confine them.

In the light of our empirical findings, we argue that this rejuvenated neo-functionalism focuses too little on the *political and economic consequences* of supranational activism. Economic integration trumps efforts to promote political integration or to build 'Social Europe'. Therefore, integration more often than not means strengthening market forces at the expense of political concerns in the member states. As we will show in Section 4, if the Commission had its way, a notable liberalization of organized economies would result. The case studies also show, however, that the European Court of Justice might be more effective in bringing about change.

The neo-functionalist interpretation of EU politics has not remained unchallenged. Rational institutionalist accounts emphasize that member governments not only know the preferences of the agents but also take the consequences into account. Member states delegate tasks to realize otherwise unattainable benefits of cooperation (Tsebelis/Garrett 2001: 363). Moravcsik's (1998: 36) intergovernmental theory champions the view that international cooperation is an attempt to arrange mutually beneficial policy coordination in the face of the negative external effects of unilateral actions. Delegation binds parties to negotiation outcomes over time. In principle, precise rules could credibly commit them, too, but uncertainty about the future makes contracts necessarily incomplete. Since governments cannot specify all possible contingencies in advance, they put supranational actors in charge of monitoring and enforcing their agreement. Hence, Moravcsik stresses credible commitment as the rationale for delegating powers.

More strictly rational-choice approaches point out that member states delegate competencies to supranational actors if there is little conflict between their own views and those of the agent or among the principals themselves. For example, Epstein and O'Halloran (1999: 51) find that the US Congress delegates decisions if informational concerns, i.e. the need for expert knowledge, outweigh distributional issues. Applying the same logic to the EU, Franchino (2004) shows that variation in the Commission's discretion across policy areas depends on the level of policy disagreement in the Council and the complexity of an issue area. The general argument runs that the Council anticipates agency drift and devises ex ante controls such as the comitology procedures or different rules for implementing EU legislation.[9]

Authors who see efficiency and credible commitments as the main effects of delegation also tend to question that the EU suffers from a democratic deficit (Majone 2000; Moravcsik 2002). If the principals fully control the agents and the agents' preferences are more prudent than those of politicians, there is little to worry about in democratic terms, and if the Commission were but the guardian of the treaties or a regulatory agency, democratic control would be of lesser importance. Delegating powers to the EU, in this view, promises welfare gains that the member states individually cannot realize. Yet the Commission has become highly politicized and is – much as the ECJ – no longer limited to its initial tasks (Majone 2005: 81). The liberalization attempts that we discuss below would not be possible either as outcomes of the *political processes inside member states* or as *outcomes of negotiations* between them. Applying a wide interpretation of the 'four freedoms', Commission and ECJ expand liberalization to an extent that member

9 If that logic were entirely true, we should not have observed the politicization of recent policy initiatives. Yet the Takeover Directive and the Service Directive caused considerable conflict among the member states.

states would not agree to – or, in other words, to an extent that intergovernmentalism does not predict.

While opposing purely intergovernmentalist perspectives, we emphasize that our argument must not be confused with a (neo-)functionalist one. The current state – and crisis – of integration can only be understood by looking beyond intergovernmental bargains. At the same time, neo-functionalist arguments are too narrowly focused on the question of more or less integration. Yet EU politics also involves a struggle between 'neo-liberal' and 'regulated capitalism' (Hooghe/Marks 1999). Accordingly, we perceive European integration as a power game between actors at the national and European level, in which supranational actors systematically use liberalization to expand their own scope of responsibility. Therefore, we suppose that the clash between European integration and organized capitalisms will not vanish in the foreseeable future. We reject any foregone conclusion as to which EU policies promote desirable outcomes such as economic growth and social justice best. Our only claim in this direction is that certainty over efficiency gains that may postulate output legitimacy cannot exist. Politics in the EU has become politicized because of the transformative character of liberalization and its lack of legitimacy. In a recent paper, Hooghe and Marks (2006) proposed a 'postfunctionlist' perspective; we agree, while stressing the prefix 'post'.

4 The quest for liberalization: Three case studies

The Services Directive

Our first example demonstrates how both the Commission and the Court aim at liberalizing more than the member states ever explicitly asked for in the treaties. In fact, the Commission's proposed Services Directive was an example of a de-institutionalization attempt in the strong sense. It led to the as yet most far-reaching clash between the Commission and the public in several member states and, actually, to a crisis of integration.

The aim to integrate European services markets is part of the internal market programme and the Lisbon strategy in particular (European Commission 2005b). Naturally, services markets are harder to integrate than product markets. While products can be exported, services are often attached to a certain place. Frequently they only take place when supply and demand come together at the same location. In Article 50 of the European Treaty,[10] member states agreed upon the principle that services suppliers from other member states must not be juristically discriminated against. Article 50 states:

10 In this paper, all cited paragraphs of the European Treaty refer to the new numbering (introduced after the Amsterdam Treaty from 1997).

> Without prejudice to the provisions of the Chapter relating to the right of establishment, the person providing a service may, in order to do so, temporarily pursue his activity in the State where the service is provided, *under the same conditions as are imposed by that State on its own nationals.* (our emphasis)

Compare this to the decisive Article 16 of the Services Directive that the Commission proposed in January 2004. The first two paragraphs of Article 16 state:

> (1) Member States shall ensure that *providers are subject only to the national provisions of their Member State of origin* which fall within the coordinated field. Paragraph 1 shall cover national provisions relating to access to and the exercise of a service activity, in particular those requirements governing the behaviour of the provider, the quality or content of the service, advertising, contracts and the provider's liability. (2) The *Member State of origin* shall be *responsible for supervising the provider and the services provided by him, including services provided by him in another Member State.* (Directive Com[2004]0002; our emphasis)

Obviously, the proposed directive turns the basic idea of Article 50 of the treaty upside down. Whereas the wordings of the treaty imply that suppliers shall rely on the regulations of the state in which the services take place, the Commission asks the member states to agree on the so-called country-of-origin principle (Kowalsky 2004: 237–238). The European Court rather than the Commission actually invented this principle. In contrast to its judgments until the early 1990s (compare Lorenz/Wannöffel 2005: 25), the Court later announced that Article 50 of the European Treaty does *not* necessarily allow member states to impose their internal regulations on service suppliers from other member states:

> [T]he application of the host Member State's national rules to providers of services is liable to prohibit, impede or render less attractive the provision of services to the extent that it involves expense and additional administrative and economic burdens.
> (Paragraph 30 of the judgment of 25 October 2001, C-49/98)

Therefore, but only partially, the country-of-origin principle is already associated with the European freedom of services (for a critical discussion of which, see Schmidt/Blauberger/van den Nouland 2007).

Modern economies are institutionalized economies in the sense that economic action relies on regulation and supervision of the local authorities in which the economic action takes place. However, the country-of-origin principle aimed at forbidding member states to supervise and govern economic actions within their own territory. According to the proposed directive, the state of Latvia would be responsible for the supervision of a Latvian plumber that – temporarily – offers its services in Germany. Yet, obviously, the interest of the Latvian state in actually supervising such transactions effectively would be weak, no matter whether the firm had Latvian roots in practice or only in theory (about which, i.e. the problem of so-called letterbox companies, see our third example).

In fact, the outcome of the liberalization measure would have been an effective de-institutionalization of economic action. Not surprisingly, the proposal caused fierce protests, especially in highly regulated countries such as Austria, Belgium, France, Germany and Sweden. The longer the discussion lasted, the more unrealistic became an adoption of the country-of-origin principle. However, Internal Market Commissioner McCreevy (the successor of Bolkestein, who had initiated the directive) refused to withdraw the proposed directive although he explicitly said that it was politically non-enforceable.[11] He was also quoted as saying, 'I am aware of the political consequences in the member states, and how difficult it is for governments to achieve things'.[12] Protests against the Services Directive were exceptionally prominent in France and, in the very context of this discussion, the French public rejected the European constitutional treaty in the May 2005 referendum. However, only weeks later, the Commission emphasized that the French referendum would not affect further liberalization. 'Of course, the Commission will pull through its reform programme',[13] announced a speaker for Commission President Barroso.

Yet this did not quite happen. The directive was watered down in two steps. First, in November 2005, the European Parliament's Internal Market Committee proposed a version in which it maintained the country-of-origin principle but explicitly excluded several areas such as labour law and social protection. Second, in February 2006, an EP majority went beyond the suggestions of the internal market committee and proposed a version in which the country-of-origin principle was abolished. 394 EP members voted for the proposal, and 215 EP members voted against it. Comparable to the Takeover Directive, a mixture of a left–right divide and a 'clash of capitalisms' occurred. Although the adopted proposal relied on a compromise between the Socialist and the (conservative) EVP faction, majorities of conservative EP members (in addition to some others) from Great Britain, Spain, Poland, Hungary, the Czech Republic and the Netherlands favoured more liberalization – though not necessarily in the radical manner initially proposed by the Commission – and voted against the proposal.

It was only then that the Commission announced its intention to revise its proposal. In a letter to the Commission, the six countries referred to above protested against the Parliament's extensive watering down of the directive. In April 2006, the Commission presented a revised directive that included the changes the Parliament had asked for. Resistance to the directive was not strong enough in the Council to establish a blocking majority (which – but this is speculation – the Commission might have suspected). In May 2006, after eight hours of negotiations in Brussels, the economic ministers of the member states unanimously agreed on the directive. The French 'non' to the constitution, however, caused a disruption of the ratification process with, as yet, unforeseeable consequences.

11 *Tageszeitung,* 4 March 2005, 2.

12 *International Herald Tribune,* 4 March 2005, 1.

13 *Die Presse,* 1 June 2005 (our translation).

The Takeover Directive

In the next example, the Takeover Directive, the Commission strategically used its power as master of the 'rules of the game'. In order to find majorities for liberalization measures that superseded national preferences, the Commission sought to buy several member states out of opposition to liberalization. For this purpose, it intentionally set agendas that asymmetrically hurt the member states. Contrary to its rhetoric, the Commission tried to achieve liberalization by *avoiding* the so-called 'level playing field'. This strategy runs parallel to what Schmidt (1998: 325–329, 2000: 46–50) has called the 'divide and conquer' strategy.[14]

From a comparative political economy perspective, takeover regulation is a decisive characteristic of production regimes. In liberal market economies (in the sense of Hall and Soskice 2001), takeover regulation aims at activating markets for corporate control in order to force managers to act in a shareholder-oriented way. In contrast, organized economies are characterized by stakeholder-oriented corporate governance spheres. Managers are supervised by company networks, creditors, insiders and large shareholders rather than takeover markets. The absence of hostile takeovers, in other words, is a characteristic feature of the 'Rhenish' (Albert 1993) form of capitalism. The emergence of markets for corporate control constitutes a major threat to this form of capitalism.

Of course, member states have explicitly obliged the Commission to promote a free European capital market. Paragraph 1 of Article 56 of the European Treaty states that 'all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited'. Every investor shall be free to invest anywhere in Europe. But forbidding restrictions on the free capital flow is different from forbidding restrictions on hostile takeovers. The member states neither agreed on harmonizing takeover regulation in order to actively promote hostile takeovers nor consented – which is the logical consequence – to providing shareholders with primacy over stakeholders. Internal Market Commissioner Frits Bolkestein, however, made no secret of the fact that exactly this was intended by the Takeover Directive: 'If Europe really wants to become the most competitive and most modern economic area, it must leave the comfortable setting of the Rhenish model and subject itself to the harsher conditions of the Anglo-Saxon form of capitalism.'[15]

The Commission presented a draft directive in 1989. It was changed several times until, in June 2001, the European Parliament voted down a (still relatively liberal) conciliation

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14 Schmidt uses the term 'divide and conquer' to describe the Commission's strategic use of infringement procedures in order to change member states' preferences on liberalization measures. In both cases, the Commission tries to play opposing member states off against each other by manipulating their pre-strategic interests. We thank Susanne Schmidt for her suggestion that in both cases, in principle, the Commission's strategy would be unsuccessful if the liberalization-opposing member states committed themselves to 'solidaristic' behaviour.

15 *Neue Züricher Zeitung,* 9 November 2002, 83 (our translation).

compromise by the narrowest possible margin: 273 EP members voted for the proposed directive, 273 voted against, and 22 abstained. The proposed directive had aimed at strictly implementing the so-called neutrality rule, i.e. obliging managements not to start any defensive measures against hostile takeovers unless the shareholders' meeting explicitly authorized the management board to do so. Hix, Noury and Roland (2006: 265) accordingly call the Takeover Directive 'one of the most high profile pieces of legislation ever to pass through the European parliament'. The battle over the Takeover Directive witnessed an amount of politicization that, until then, had been unknown.

The European Parliament's vote has been analysed in several articles (Callaghan/Höpner 2005; Ringe 2005; Hix/Noury/Roland 2006: ch. 11). While a left–right divide occurred among the small parties, members of the large conservative and social democratic EP factions voted with respect to their national origin ('clash of capitalisms' constellation). The less shareholder-oriented national corporate governance regimes were, the more likely it was that both factions uniformly opposed the proposed directive. Conversely, when the corporate governance system of the country of origin was relatively shareholder-oriented, social democratic EP members joined their conservative counterparts in supporting the directive.

In what follows, we will focus on the Commission's strategy after the rejection of the 2001 compromise. Although a group of experts proposed a version of the directive in 2002 that aimed at liberalizing even more than the 2001 version (see below), the Commission finally ended up standing alone against a front of member states which agreed to a solution that was rather ineffective from the perspective of the initially intended systems change.

In order to find ways out of its blocked liberalization attempt, the Commission appointed a High-Level Group of Company Law Experts, led by Jaap Winter, which presented its report in January 2002. The main problem was the relationship between takeover law and other areas of national company law: as long as most member states allowed companies to introduce several forms of unequal voting rights, *de facto* defensive measures against hostile takeovers exceeded those measures the Takeover Directive intended to remove. The Winter group suggested temporarily abandoning all forms of unequal voting rights during takeover contests. Strikingly, the revised directive proposal upon which the Commission decided in October 2002 differed from the Winter report in an important manner. Besides introducing the strict neutrality rule, it aimed at inhibiting all regulations that restrict the voting rights of single shareholders to defined amounts (such as, for example, twenty per cent of the overall vote). However, the proposed directive did not affect multiple voting rights. Multiple voting rights imply, for example, that the shares of certain shareholders are weighted twice as high as those of others.

The Commission made the rationale behind the revised blueprint very clear. 'The Internal Market Commissioner perceives it as important to secure majorities for his projects', explained Bolkestein's speaker Jonathan Todd.[16] Germany had already abolished unequal voting rights in its 1998 Corporate Sector Supervision and Transparency Act.[17] In contrast, multiple voting rights – widespread especially in Sweden and France, but also present in countries like Belgium, Great Britain, Finland and Denmark – were permitted to remain intact. The Commission knew it lacked a majority for its liberalization measures, but it assumed it would find support for its project if it asymmetrically hurt Europe's largest economy to the benefit of other countries' firms. A majority of Commissioners hoped to successfully prevent member countries from joining Germany in an opposition front against the Takeover Directive.[18] Liberalization, in other words, only seemed achievable by *not* constructing a level playing field. Interestingly, in the early summer of 2002, when the Commission's plans first became generally known, Bolkestein announced that multiple voting rights cannot impede takeovers – which is obviously absurd – and that the Commission might address multiple voting rights at a later point in time if they turned out to be systematically used to hamper the market for corporate control.[19] If the Commission had succeeded with its asymmetrical proposal, abolishing multiple voting rights at a second stage might have become a possible future option. This could have happened but did not.

In February 2003, the Greek Council Presidency tried to formulate a middle way between the Winter report and the Commission's proposal that also targeted the Scandinavian-style multiple voting rights. However, the French double voting rights remained untouched. This caused fierce resistance from Sweden, Finland and Denmark, in which the Wallenberg group especially – by far the most important family-owned investor group in Sweden – figured prominently. France insisted that its model of double voting rights did not cause any restrictions to hostile takeovers. In contrast, the German government insisted that a fair solution would also have to forbid the French double voting rights, thereby being quite aware of the fact that, if it succeeded, the outcome would be a blocking minority with France and the Scandinavian countries at its core. More and more, the member countries began to agree upon a 'harmless', non-transformative solution. As a consequence, the Commission's strategy to split the member states ran aground. In October 2003, Commissioner Bolkestein announced his intention not to support a solution 'without any value added to the current situation'.[20] The Commission's veto implied the necessity of unanimity among the member states, i.e. resistance of a single country could have prevented a Council compromise. But this strategy also failed. In the end, the Commission achieved the opposite of what it had intended: rather than having isolated Germany, it stood alone in the face of a united front against its liberalization plans. The European Parliament accepted the compromise in December 2003.

16 *Financial Times Deutschland,* 4 October 2002, 29 (our translation).
17 Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG).
18 Protest against the asymmetric proposal also occurred inside the Commission; see *Financial Times Deutschland,* 25 September 2002, 14.
19 See *Börsen-Zeitung,* 22 June 2002, 6.
20 *Börsen-Zeitung,* 14 October 2003, 7 (our translation).

Company law and the European Court of Justice

Our third example demonstrates that the European Court of Justice is an independent factor of European liberalization. Though the practical effects of its judgments on the member states' capacity to monitor and regulate their economies do not lag behind those of the Commission, the Court's rulings are widely seen as technical, rather than political, matters (Burley/Mattli 1993: 44). Therefore, the Court's liberalization measures are not affected by the wave of politicization of European affairs that occurred after Maastricht. We focus on a series of company law decisions that ruled that the so-called seat-of-management principle violates European law. The consequence is a de-institutionalization comparable to the liberalization attempt witnessed in the first case study.

In the past, the German Federal Court of Justice – just like the courts of Austria, Belgium, France, Luxemburg, Portugal and Spain – judged in line with the seat-of-management (or seat-of-administration) rule. This principle implies that the company law of the nation in which a firm is domiciled, rather than the law of the nation in which it is incorporated, must be applied to the firm. In other words, if a firm's administrative seat was in Germany, it could only retain corporate status if it had been incorporated in accordance with German law. This held until the ECJ decisions on Centros, Überseering and Inspire Art in 1999, 2002 and 2003 respectively. According to the European Court of Justice, the seat-of-management principle is inconsistent with the freedom of establishment under the EU Treaty even if so-called letterbox firms are involved. Therefore, the seat-of-management rule has had to be replaced by the origin-of-incorporation rule.

One of the 'four freedoms' guaranteed by the Treaties is the freedom of establishment:

> Restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State. (Article 43 of the European Treaty)

Article 48 adds:

> Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States.

Accordingly, until 1999, only few would have insisted that the treaty also guaranteed the right to freely choose among the national company laws provided by the member states.

The Centros decision raised doubts about the seat-of-management rule without clearly replacing it. Centros Ltd., a wine company, was established by two Danes under British law. In terms of its business, however, the firm was exclusively engaged in Denmark.

The incorporators announced that the only reason for the foreign incorporation was to avoid the minimum capitalization requirement for Danish companies. The Danish commercial registry argued that this approach was an unlawful circumvention of Danish minimum requirements and therefore refused to register the company's branch office. The entrepreneurs went to the ECJ. In its statement to the Court, the Commission argued that the complainants were right and that the Danish state was not allowed to apply its own standards on Centros. The Court decided for the firm's and Commission's position (decision of 9 March 1999, C-212/97).

The Court argued that the use of foreign letterbox companies to explicitly circumvent Danish minimum requirements was a legitimate measure that must not be objected to by the state the firm operates in:

> [T]he fact that a national of a Member State who wishes to set up a company chooses to form it in the Member State whose rules of company law seem to him the least restrictive and to set up branches in other Member States cannot, in itself, constitute an abuse of the right of establishment. … [T]he fact that a company does not conduct any business in the Member State in which it has its registered office and pursues its activities only in the Member State where its branch is established is not sufficient to prove the existence of abuse or fraudulent conduct which would entitle the latter Member State to deny that company the benefit of the provisions of Community law relating to the right of establishment. (Paragraphs 27 and 29)

In what followed, lawyers discussed controversially whether the Court had generally forbidden member states to apply the seat-of-management rule. It was the German Federal Court of Justice that called for a leading decision. In the case at hand, Überseering BV, a Dutch construction firm, employed a German contractor, a limited liability company (GmbH). The BV sued the GmbH for damages by reason of alleged defects in the work performed. Just prior to the filing of suit, however, the BV was purchased by two Germans, who then managed the BV from Germany. The lower German courts dismissed the BV's complaints against the German contractor as long as the owners refused to form a GmbH out of the BV; in its current form, the German court argued, the BV had no legal capacity in Germany. In its decision, the European Court – in accordance with the Commission's statement on the case – judged that the BV was right (decision from 5 November 2002, C-208/00). With this decision, the seat-of-management rule was toppled. But Überseering was not a letterbox firm in the classical sense.

A third decision combined the generality of the Überseering decision with a Centros-style circumvention matter. A Dutchman established Inspire Art Ltd. under British law and requested the registration of the company's Dutch branch office. The Dutch registry refused and argued that specific Dutch minimum rules for foreign companies – above all, a certain minimum capitalization – applied. Again, the European Court sided with the company and with the Commission (decision from 30 September 2003, C-167/01). The Dutch state, the Court argued, was not allowed to impose its corporate law minimum standards on Inspire Art although it operated nowhere else than in the Netherlands.

These juridical innovations have far-reaching consequences (compare, from a German law perspective, Maul/Schmidt 2003; Binge/Thölke 2004; Sandrock 2004a).[21] They imply an effective deregulation of European company laws. Most notably, this deregulation applies to situations in which, from the perspective of the member states, no foreigners are involved. The decisions effectively hollow out national company law.[22] Therefore, the protests against the Court's decisions have nothing in common with protectionist reflexes. The decisions actually apply the American situation to Europe: in the US, most firms are founded in the state of Delaware because of its lax requirements (see, for example, Roe 2005). Whoever dislikes his national company law is now free to pick one of the other members' company laws (Kirchner/Painter/Kaal 2004). As a consequence, the decisions put company laws, not production locations, into direct competition with each other and impose pressure to deregulate. Tony Blair has already declared his aim to let the British Ltd. become the European Delaware firm.[23] In fact, the decisions have caused a boom of Ltd.-type foundations in Germany. The advertiser mentioned in the introduction is the market leader for Ltd.-type foundations in Germany. It claims to have already founded around 28,000 limited liability companies in Germany.

So far, perhaps the most explosive – and from a political economy viewpoint most relevant – matter has not been juristically clarified: the impact of the Court's decisions on supervisory board codetermination in countries such as Germany (Kamp 2004; Sandrock 2004b). The current situation is that no supervisory board codetermination would be applied to a purely German Ltd. that grows beyond the amount of 500 employees – and, to us, it seems a remarkable fact that such a situation could arise out of the European Treaties in which no restriction on national codetermination laws were *ever*, implicitly or explicitly, intended. In its statement on the Centros case, the German government argued that, regardless of other reasons, the seat-of-management principle was necessary in order to secure appliance of employees' codetermination rights (see paragraphs 87–89 of the Centros decision). The European Court did not uphold this objection. However, in the Überseering decision, the Court declared in a very cautious and reluctant wording:

> It is not inconceivable that overriding requirements relating to the general interest, such as the protection of the interests of creditors, minority shareholders, employees and even the taxation authorities, may, in certain circumstances and subject to certain conditions, justify restrictions on freedom of establishment. (Paragraph 92)

21 Until now, the rejection of the seat-of-management-rule has been confirmed in two other ECJ decisions of general principle: in the decisions on Sevic Systems (from 13 December 2005, C-411/03) and on Cadbury Schweppes (from 12 September 2006, C-196/04).

22 Compare the striking title of Binge/Thölke (2004): 'Everything goes – The German international company law after Inspire Art' (our translation).

23 See *Börsen-Zeitung,* 15 September 2004, 2.

So far, it is unclear whether this may authorize the German state to impose supervisory board codetermination on foreign legal forms that operate in Germany.[24, 25]

In fact, the Centros, Überseering and Inspire Art decisions are not the only European threats to the member states' codetermination laws. The European Company Statute and the Merger Directive also create the possibility of 'codetermination-free zones'. Legal possibilities do not necessarily imply that actors choose them. So far, German companies with foreign legal forms rarely have more than 500 employees. However, our benchmark is a situation in which the state – in the strong sense of an institution – could *govern* the codetermination behaviour of the companies inside its national territory. European liberalization has led to a situation in which this ability diminishes. The realistic scenario is certainly not that companies will escape from supervisory board codetermination as soon as they are juristically allowed to. Rather, we anticipate a smooth but ongoing evolution of heterogeneity of codetermination practices in Germany that, in the medium term, will put pressure on the government to generally cutback codetermination rights.

5 Conclusion: Mechanisms of liberalization and the lack of legitimacy

After having largely completed the Internal Market for products, European economic integration has entered a post-Ricardian phase. Attempts to liberalize services, takeover practices and company law differ in their potential consequences from product market integration. Now the Court and the Commission directly target member states' institutions and aim at transforming them, even in situations in which no other country's economic activities are involved at all. We have argued that European-level actors have extended the interpretations of the 'four freedoms' to an extent that it becomes increasingly questionable whether the wordings and spirit of the treaties provide (input) legitimacy for the respective liberalization measures. However, one might object, it is so obvious that the member states are deadlocked with immobility and overregulation that the 'neo-liberal bias of the EU, if it exists, is justified by the social welfarist bias of current national policies' (Moravcsik 2002: 618).

We argue that this objection fails to provide (output) legitimacy. The impact of EU legislation differs across member states since Europe consists of various forms of capitalism (Fioretos 2001). Some may benefit from deregulation. For others, however, liber-

24 See, for example, Marcus Creutz in *Handelsblatt,* 9 November 2005, 37; Martin Henssler in *Frankfurter Allgemeine Zeitung,* 1 February 2006, 23.

25 Unsurprisingly, German employers claim that such an act would be inconsistent with the freedom of establishment. See the employers' comments to the report of the German Codetermination Commission (Kommission zur Modernisierung der deutschen Unternehmensmitbestimmung 2006: 56–58).

alization could result in a decomposition of the internal logic their production regimes rely on. What has already been shown for the different European welfare regimes holds true (Sánchez-Cuenca 2000: 159: Brinegar/Jolly 2005: 176; Menz 2005): Europeanization has quite different meanings for different member states. Yet if Europe really wants to become the most competitive economic area worldwide, and if the different institutional forms of capitalism differ in their comparative advantages, should not European integration secure the free flow of products, services and capital, but protect the respective internal logics of the member states' economic systems? Would this not imply, in particular, sheltering member states from de-institutionalization?

We may, or may not, be right here. But we suggest that the efficiency gains are too uncertain (to say the least) to provide output legitimacy. Deregulating the economy is a genuinely *political* decision that cannot be left to independent agents. Therefore, it requires *input* legitimacy. Whether the member states need a 'neo-liberal' corrective is not for the observer to choose but must be the result of public deliberation and parliamentary decisions – otherwise, the price to pay is a serious democratic deficit. However, instead of a strengthening of input-oriented legitimacy, we witness ongoing – yet increasingly unsuccessful – attempts to de-politicize EU politics. European-level actors transform essentially political matters into apparently technical ones. An extensive interpretation of the 'four freedoms' of the European Treaty allows Commission and Court to enforce liberalization measures juridically. The law shields these attempts from political resistance especially in organized economies (cf. Burley/Mattli 1993).

Our discussion of the three empirical cases has also identified some of the sources of the Commission's ability to extend its liberalization attempts beyond the level member states ever agreed upon. The first, and perhaps most important, is its freedom of interpreting the treaties, combined with a substantial freedom of choice between modes of integration, such as coordination or harmonization.[26] Second, the Commission sets the agenda for the Council and the European Parliament. It can start with a politically non-enforceable, maximally transformative liberalization attempt in order to evaluate member states' reactions. Third, it strategically uses the threat of non-decisions. Fourth, the Commission intentionally proposes asymmetrical measures in order to establish

26 This includes not only extensive interpretation of some goals but also the downplaying of others. Compare, for example, two quotes of Internal Market Commissioner McCreevy on different areas of economic integration. The first is about forbidding member states to tolerate firms' unequal voting rights. He says, 'my goal is that the "one share, one vote" principle must be accepted in every member state' (*Neue Züricher Zeitung,* 18 October 2005, 27; our translation). The second quote relates to integration in the field of tax policy, a field that is explicitly mentioned in Article 93 of the European Treaty. The Austrian economic magazine Wirtschaftsblatt asks McCreevy, 'The finance ministers are currently debating the introduction of a uniform taxable base for corporate income tax. Do you oppose this?' McCreevy answers, 'Without doubt I oppose this'. 'Why?' asks Wirtschaftsblatt; McCreevy responds, 'Because this opens up a backdoor to tax harmonization. I want competition' (*Wirtschaftsblatt,* 8 April 2006, 11; our translation). This nicely illustrates the eminently *political* character by which the Commission uses its freedom of interpretation to set itself its own goals.

and destroy coalitions (adopting a 'divide and conquer' strategy in the terminology of Schmidt).[27] It is free to add redistributive zero-sum games between member states to its proposals until an attainable majority of supporters emerges. Fifth, the Commission uses its veto power in order to weaken defensive majorities among member states. In the situation of a Commission's veto, buying a single member state out of the opposition to liberalization implies that non-transformative directives cannot be passed.[28]

Relying on principal–agent theory, much of the recent literature has focused on the efficiency gains of delegating powers. Autonomous decisions of non-elected actors are frequently welcomed because they are meant to creatively 'fill in gaps in the legal framework' and 'ensure the achievement of the Treaties' objectives notwithstanding legislative inertia on the part of the Council' (Arnull 2003: 180). However, inertia might be a safeguard against transformative decisions that lack legitimacy. Frequently, the literature on the Commission and the ECJ assumes that activist behaviour on the part of European agents is normatively desirable because it produces better results than political negotiations (Pollack 2003: 408). Yet, contested decisions and transformative measures fail the test of output legitimacy. The EU has moved beyond the stage of technical harmonization or purely regulatory policies. Boundary redrawing deeply affects the member states' ability to govern the economy, and governments are unable to control further integration: '… free circulation and competition policies are the kernel of the atomic engine of the integration process, an engine that is quite difficult, even for the Council, to switch off or even to cool down' (Bartolini 2005: 185). If this is the case, the indirect legitimation of European institutions seems an insufficient democratic basis for economic liberalization.

We have suggested that the liberalization attempts of the post-Ricardian phase are either successful or they bring about crises of integration. Failed referendums on the constitutional treaty and considerable Euro-scepticism throughout the Union indicate that the 'permissive consensus' of European integration is dissolving. 'Integration by stealth' (Majone 2005) has reached its limit because European decisions are in conflict with national welfare traditions or, as we have shown, with European varieties of capitalism. Paradoxically, for the Commission the appropriate answer to the recent crises seems to be to push integration further. After the French and Dutch rejection of the con-

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27 Compare footnote 15.

28 We perceive it as an open question whether or not these mechanisms are so well rehearsed that the selection of Commissioners hardly makes any difference any more. However, it is a fact that, in the period we observe, the Internal Market Commissioners (Bolkestein, McCreevy) have been distinguished by their commitments to the primacy of the free market. A similar point can be made with respect to the Commissioners for Competition (Monti, Croes). Since 2004, the Presidency has shared the same beliefs. Hyman (2006: 248) calls Barroso a 'born-again neoliberal'. Hooghe (2003: 284–286) shows how Commissioners' preferences on European integration differ decisively from those of both national elites and the European public. Therefore, good reasons exist for integration research to engage in a 'sociology of Commissioners' (Smith 2003).

stitutional treaty, Internal Market Commissioner McCreevy explicitly refused to take the proposed Services Directive off the table, and Commission President Barroso announced that the Commission would 'of course'[29] push through its reform programme. The modified Lisbon process concentrates on the completion of the Internal Market, mainly in finances and services. Given the degree of political opposition, this might further disaffect a Euro-sceptic public.

29 Compare footnote 13.

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