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### **EU Competition Law in Times of Crisis**

Between Present Challenges and a Largely Unwritten Future

**Citation for published version:**

Andreangeli, A 2012, 'EU Competition Law in Times of Crisis: Between Present Challenges and a Largely Unwritten Future', Paper presented at Scotland debates EU Economic Governance, Edinburgh, United Kingdom, 31/05/12 - 1/06/12 pp. 8-44.  
<[http://www.pol.ed.ac.uk/\\_\\_data/assets/pdf\\_file/0019/86203/conference\\_proceedings.pdf](http://www.pol.ed.ac.uk/__data/assets/pdf_file/0019/86203/conference_proceedings.pdf)>

**Link:**

[Link to publication record in Edinburgh Research Explorer](#)

**Document Version:**

Publisher's PDF, also known as Version of record

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The European Commission Representation in the UK;  
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### **Adriaan Dierx, European Commission, DG Competition**

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### **Henrik Enderlein, Hertie School of Government, Berlin**

Henrik Enderlein is Associate Dean, Professor of Political Economy and Economics, and Program Director of the Master of Public Policy at the Hertie School of Governance. He holds degrees in economics and political science from Sciences Po, Paris, and Columbia University, New York. He obtained his PhD at the Max Planck Institute for the Study of Societies in Cologne. Before entering the academic world, he worked as an economist in the Directorate International and European Relations of the European Central Bank in Frankfurt. His research is concentrated on the Financial Market Crises, Sovereign Debt Crises as well as Multi Level Governance, in particular Economic Governance

### **Lieve Fransen, EU Commission, Director in DG EMPL**

Since mid-November 2011, Dr. Lieve Fransen is the Director responsible for Europe 2020: Social Policies in Directorate-General Employment, Social Affairs and Inclusion of the European Commission. Dr. Fransen has devoted herself to promoting social justice and the values of solidarity. During a distinguished career in international public health, Dr. Fransen has worked as Public Health Advisor to the Ministry of Health, Mozambique, Kenya, Rwanda and Cape Verde Islands; as Task Manager of a research programme on pregnant women and new-borns in Rwanda; and as Director of a research programme on sexual and reproductive health in Kenya and in the Tropical Institute in Antwerpen, Belgium. Dr. Fransen is Medical Doctor with a PhD on Social Policies.

### **Gabriel Glöckler, EU Institutions Division, European Central Bank**

Gabriel Glöckler is currently Deputy Head of the EU Institutions Division at the European Central Bank. During his 13 year career at the Bank, he previously also served five years as Chief of Staff/ Counsellor to the ECB's Vice-President Lucas Papademos and as (Senior) Economist. Gabriel studied Philosophy, Politics and Economics at Oxford and also holds a Master's degree in European Studies from the College of Europe in Bruges. He regularly delivers guest lectures on European monetary, economic and political integration in academic and public settings and in the financial markets across Europe and beyond.

### **Iain Hardie, University of Edinburgh**

Iain completed his first degree in 1985 in History at Gonville and Caius College, Cambridge, before beginning an investment banking career in London and Hong Kong, specialising in emerging bond markets. He came to Edinburgh in 2001 to complete a part-time MSc in International and European Politics, before completing a PhD in 2003-07 and starting as a lecturer. His publications include 'Financialization and Government Borrowing Capacity in Emerging Markets' (Palgrave, 2012).

**David Howarth, University of Edinburgh**

David Howarth (Conference organiser) is a Senior Lecturer and a Jean Monnet Chair in the School of Social and Political Studies at the University of Edinburgh. He has written widely on European political economy topics, specifically EMU, central banking and, more recently national banking systems. For more information see [http://www.pol.ed.ac.uk/staff\\_profiles/howarth\\_david](http://www.pol.ed.ac.uk/staff_profiles/howarth_david)

**Bill Jamieson, Scotsman Newspaper**

Bill Jamieson has specialised in financial journalism and economics over a 40 year career. He has recently stepped down as Executive Editor of *The Scotsman* after 12 years but is retained by the paper in a freelance and consulting capacity.

**Owen Kelly, Head of Scottish Financial Enterprise**

Owen Kelly was appointed as Chief Executive of Scottish Financial Enterprise (SFE) in January 2008. SFE is the representative body for the financial services industry in Scotland and promotes the industry and Scotland as an international financial centre. SFE's membership is diverse and it includes some of the world's largest banks, insurers and asset managers, as well as companies providing specialist support services, universities and government agencies. Before joining SFE in January 2008, Owen worked for 20 years as a government official, in UK and Scottish Governments. His key policy specialisms in government were EU and international relations; and communications.

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Sylvia Maxfield is Professor of Management at the Simmons College School of Management. In August 2012 she will officially take over as Dean of the School of Business at Providence College. Experience in academia and business worlds underpins Dr. Maxfield's expertise in global economics, financial crises and corporate social responsibility. She was previously Vice President at Lehman Brothers and Associate Professor at Yale University.

**Philippe Pochet, General Director of the European Trade Union Institute, Brussels**

Philippe Pochet, political scientist, is currently General Director of the European Trade Union Institute (ETUI). He is temporary professor at the Catholic University of Louvain (Belgium) and invited lecturer at the Faculté Saint Louis. His main research fields are: social impacts of the monetary union, social dimension of the European Union and social dialogue at sectoral and cross-sectoral levels, the open method of coordination and the new modes of governance, the social challenges of the globalisation process and of climate change.

**Lucia Quaglia, University of York**

Lucia Quaglia is Professor of political science at the University of York. Her most recent research monographs are: *Governing Financial Services in the European Union* (2010) and *Central Banking Governance in the EU: A Comparative Analysis* (2008), both published by Routledge. Together with Kenneth Dyson she published two volumes: *European Economic Governance and Policies* (2010), OUP. Together Dermot Hodson, she was the guest co-editor of the 2009 special issue of the *Journal of Common Market Studies* on 'The Global Financial Turmoil: European Perspectives and Lessons'.

**Claudio Radaelli, University of Exeter**

Claudio Radaelli is professor of political science at the University of Exeter, where he directs the Centre for European Governance, a Jean Monnet Centre of Excellence. He is co-editor of *European Journal of Political Research* and Chair of the ECPR Standing Group on Regulation & Governance. His research interests lie in the theory of Europeanization, regulatory reform, and learning in public policy.

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Sebastián Royo is Associate Dean and Professor of Government at Suffolk University in Boston. He is an affiliate and co-chair of the Iberian Study Group at the Minda de Gunzburg Center for European Studies- Harvard University. He has written widely on Spain and Portugal's political economic issues. For more information see <http://web.cas.suffolk.edu/faculty/royo/>

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Waltraud Schelkle is a Senior Lecturer of Political Economy at the European Institute of the London School of Economics and an Adjunct Professor of Economics at the Free University of Berlin. She has written on the economic governance of EMU and the effect of European integration on welfare state reforms; her more recent interests concern the relationship between financial markets and social policy. For more information see <http://www2.lse.ac.uk/researchAndExpertise/Experts/profile.aspx?KeyValue=w.schelkle@lse.ac.uk>

**Alyn Smith, Scottish National Party, MEP, Scotland**

Alyn Smith is an SNP MEP who was first elected in 2004 and then again in 2009. Alyn is a full member of the European Parliament's Agriculture and Rural Development Committee and a substitute member of the Industry, Energy and Research Committee. Alyn was also a member of the temporary Committee on the Financial, Economic and Social Crisis, a committee set up to explore the failures that led to the current economic recession and to examine ways in which we can avoid similar crises in the future. This committee finished its work at the end of 2010.

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Amy Verdun is Jean Monnet Chair Ad Personam, Professor of Political Science, and Chair of the Department at the University of Victoria (UVic) in Canada. She is author or editor of sixteen books, a recent one being *Ruling Europe: The Politics of the Stability and Growth Pact* with Martin Heipertz (Cambridge University Press 2010). She co-editor of the *Journal of Common Market Studies*.



# **Arianna Andreangeli: 'EU Competition law in times of crisis: between present challenges and a largely unwritten future...'**

**DRAFT—NOT FOR CITATION**

## 1. Introduction

Since late 2007 and to this day, a broad ranging crisis has swept through a growing number of economic sectors; starting from the banking and financial sector, the crisis has invested numerous manufacturing industries and has triggered sometimes “convulsive” reactions by the public authorities, the economic operators and many of the stakeholders. According to the EU Commission the effective application of the competition rules is an essential tool to rebuild a fragile economy: as Neelie Kroes argued in 2009, competition law is a vital part of the solution to the crisis. Thus, despite an initial impasse, the Commission endeavoured to adopt measures designed to “cope” with the impact of the crisis on the single market and to pave the way out of this predicament in several segment of the economy, first and foremost, in the financial and banking industry. However, it is clear that overcapacity threatens a number of economic segments, calling for prompt and effective responses: the shockwaves of the US subprime mortgage crisis, which have been felt in Europe since 2007, have led to the nationalisation of several banks and to the restructuring of others, thus changing significantly the face of this market.

Against this background, it is legitimate to ask what this all has meant for the current approaches and the future prospect of competition enforcement in the EU. Have the merger rules and the principles governing the supervision over state aids provided effective tools to tackle the challenges presented by the crisis, without threatening the integrity of the single market? And has the Commission lived up to its reputation of “tough cop” when it comes to upholding the Union interest in the field of competition policy? This paper will attempt to address some of these questions. It will touch upon three main themes: first of all, it will consider which tools the Commission has deployed to tackle the challenges of the crisis. In this context, it will be argued that reliance upon Article 101(3) TFEU, as a means to providing a “safe harbour” to forms of coordination designed to ease restructuring has largely been replaced by other forms of intervention, such as the application of the merger control regulation and the supervision of state intervention in the economy. It will be suggested that this shift seems largely consistent with the outright, almost total condemnation of cartel behaviour and more generally with the mistrust of forms of collusion, shown not just by the Commission, but also by the Court of Justice.

Second, the paper will examine the role of state aids’ rules as a tool to “bust” the adverse impact of the crisis. It will be argued that the same desire to uphold the integrity of the single market and to apply these principles coherently with the overarching design of a competitive and open economy pushed the Commission to exercise hitherto rarely invoked powers for the oversight of state intervention aimed at preventing threats to economic stability: in this context, the 2008 ECOFIN guidelines will be especially discussed.

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Thereafter, the paper will examine the approach to merger control adopted by the Commission to deal with the restructuring of key industrial areas in response to the credit squeeze: it will illustrate that, after an initial impasse, which de fact allowed Member States to adopt unilateral decisions concerning mergers and acquisitions in key sectors of their economy, the Commission was able to devise and implement a convincing strategy in this area. In particular, it will be shown that, out of a concern for maintaining the integrity and the competitiveness of the single market against protectionist pushes, the Commission relied on the substantial and procedural rules contained in the Merger regulation to provide timely and effective responses to the competition concerns arising from these transactions. However, at the same time, it will be argued that the consequences of these mergers are still likely to present a number of challenges for ex post control, thus calling for a careful vigilance over “financially significant” entities.

Finally, the paper will discuss some general issues concerning the current status of both competition law and of the Commission as competition watchdog. The paper will illustrate that the desire to maintain the integrity of the single market was especially apparent in the supervision of state aids and in the flexible, realistic application of the merger rules in specific cases, with a view to securing timely and principled clearance to key proposed concentrations. However, it will also show that so far no overall response has been adopted with a view to dealing with the aftermath of the impact of the crisis as well as with the consequences of the Member States’ and EU intervention designed to respond to it. It will be argued that, although the Commission endeavoured to use existing tools flexibly and thereby maintain continuity with its long-standing policies and consistency with key principles, the concentration arising from the restructuring operations occurred in a number of sectors represents a challenge for future competitiveness. It will be added that state intervention, despite having played a central role in salvaging key undertakings, could have significant and potentially irreversible effects on market access especially by discouraging new rivals from attempting to enter certain economic segments.

The paper will conclude that competition policy remains an important component of the Commission’s agenda and especially of its response to the economic crisis. However, the need to deal with its aftershocks not just in the financial and banking markets, but also in “real economy” segments and especially the demands posed by the integrity of the single market have thrown in question a number of “established ideas” and tools that had hitherto been part of “traditional” EU approaches. While it is still unclear whether this shift is permanent, it is undeniable that the legacy of the economic crisis for the competitiveness and openness of the single market is both wide-ranging and liable to create further challenges for the years to come.

## 2. Competition law responses to times of crisis: leaving “obsolete” tools behind?

### *2.1. The EU Commission and the financial and economic crisis: a short summary...*

The historical development of the financial crisis which unfolded from the US subprime mortgages’ crack and swept large swathes of the financial and banking sectors throughout not just the Americas but also here in Europe has been addressed far more competently in other sessions of this conference and it is not the purpose of this contribution to do so. It is however interesting to identify roughly two phases characterising the Commission’s response to the crisis: the “watershed” moment can be identified with 2008, a year in which the Economic and Financial Ministers’

Committee ECOFIN openly recognised the “systemic” nature of the crisis, thereby paving the way for greater and deeper involvement of the EU institutions.<sup>1</sup> In the first phase, i.e. the years 2007/2008, started by the run on the British bank Northern Rock and culminating with the crash of Lehmann Brothers, the Commission was regarded by many as being very much a “witness” of unilateral measures adopted by the Member States individually in order to tackle the dramatic unfolding of the crisis:<sup>2</sup> the Commission was either prepared to avoid interfering with the domestic authorities or was ready to examine and authorise mergers and other “packages” of national measures designed to deal with the consequences of the crisis on an “as and when” basis.<sup>3</sup>

It may be suggested that this “wait and see” approach was particularly evident in relation to the UK Government’s intervention relating to the *Lloyds TSB/HBoS* merger, which in turns was triggered by the near downfall of HBoS: the Commission de facto accepted the British Government’s decision to “go it alone” and to allow the merger to go ahead, on the ground that “in light of the extraordinary circumstances of the financial markets (...) [it] would benefit financial stability and (...) be in the public interest.”<sup>4</sup> At the same time, the British Parliament, upon a proposal of the Chancellor of the Exchequer, amended the applicable legislation in order to exclude that a “relevant merger situation”, capable of triggering a referral to the Competition Commission, could arise in similar “public interest” circumstances that may occur in the future.<sup>5</sup>

The type of approach adopted in respect to *Lloyds/HBoS* was seen as perhaps the “only way forward” to avoid the financial collapse of a major financial player in a timely fashion. However, it highlighted the risk that a targeted action could de facto become a “dangerous precedent” allowing the Member States to privilege “national champions” to the detriment of non-domestic players which may find themselves in equally choppy waters. It also raised concerns as to the “aftermath” of the concentration, given the sheer size of the resulting merged entity and the resulting increased concentration within the market.<sup>6</sup> It is undeniable that in 2007/2008 all authorities, whether at EU or at national level, were navigating uncharted waters as far as the demands of dealing with the consequences of the crisis were concerned. Nonetheless, the lack of any precise guidelines as to how national “salvaging” operations should be conducted and overseen, together with the uncertainty as to the “aftermath” of the state-led restructuring and to the impact on the accessibility of individual geographic markets of “targeted” financial state intervention prompted the EU

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<sup>1</sup> See e.g. Gerard, “Managing the financial crisis in Europe: why competition law is part of the solution, not of the problem”, (2008) *Global Competition Policy*, available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1330326](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1330326), pp. 2-4; also Mateus, “The current financial crisis and state aid in Europe”, (2009) 5 *Eur. Comp. J.*, available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1500532](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1500532), pp. 1-2..

<sup>2</sup> Gerard, cit. (fn. 1), pp. 7-8.

<sup>3</sup> *Ibid.*

<sup>4</sup> See OFT report, 31 October 2008, available at: <http://www.of.gov.uk/OFTwork/mergers/decisions/2008/LloydsTSB>, para. 19; see also para. 4 ff.

<sup>5</sup> See Commission Press release of 13 October 2008, available at: <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1496&format=HTML&aged=0&language=EN&guiLanguage=en>; see also OFT report, 31 October 2008, available at: <http://www.of.gov.uk/OFTwork/mergers/decisions/2008/LloydsTSB>, and Conclusions of the Secretary of State for Business, Innovation and Skills, available at: <http://www.bis.gov.uk/policies/business-law/competition/mergers/mergers-with-a-public-interest/maintaining-the-stability-of-the-uk-financial-system>; for commentary see e.g. Gerard, cit. (fn. 1), pp. 5-7.

<sup>6</sup> See Gerard, cit. (fn. 1), pp. 11-12.

institutions and especially the Commission, in its capacity as competition watchdog, to jump in the driver seat.<sup>7</sup>

2008 was a rather momentous year, since it saw the ECOFIN ministers setting out the guidelines concerning emergency state intervention by Member States in the banking and financial sectors.<sup>8</sup> Perhaps more importantly, in 2008 there was a widespread recognition of the “systemic” nature of the crisis, namely of the circumstance that what started as a financial phenomenon, impacting on banks and other financial institutions, was now having ripple effects on the “real economy”. This watershed moment led to the Commission taking a far more “structured” and active role in responding to the crisis: in 2008, Neelie Kroes announced that competition law and policy would be “part of the solution” to the crisis, starting a season of greater and closer involvement on the part of her Office.<sup>9</sup> The powers of state aid supervision were exercised flexibly and pragmatically, often in close cooperation with other Commissioners, and decisions were usually adopted rapidly to cope with the “timetable” of the financial markets.<sup>10</sup> Importantly, as will be explored in more detail below, the Commission relied on a hitherto infrequently used (if at all) clause, namely Article 107(3) TFEU, allowing the authorisation of aid designed to cope with serious economic disturbances.<sup>11</sup>

Merger control rules were also applied in a more “creative” and flexible manner: the Competition Commissioner endeavoured to grant Phase I clearances rapidly, sometimes within 24 or 48 hours of official notification and to speed up the implementation of specific transactions by waiving the suspension effect following notification via a decision adopted according to Article 7 of the Merger Regulation.<sup>12</sup> At the heart of the Commission’s renewed resolve was however a desire to maintain the integrity of single market principles, an objective which was increasingly under threat and would have been even more so if the Member States had been allowed to continue “going it alone”: for this reason, Commissioner Kroes not only ensured swift responses to notifications motivated by restructuring; she also declared that her Office would use existing legal and economic tools to their fullest extent.<sup>13</sup> For instance, the “failing firm defence”, flexible merger negotiations, both in procedural and in substantive terms, and the exhaustive abut at the same time speedy testing of merger remedies emerged as effective instruments to deal with the crisis’ shockwaves.<sup>14</sup>

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<sup>7</sup> For commentary see Mateus, cit. (fn.1), pp. 4-5; see also Weitbrecht, “Mergers in an economic crisis”, (2010) 31(7) ECLR 276 at 278; see also p. 284.

<sup>8</sup> See Conclusions of the ECOFIN Council held in Luxembourg on 7 October 2008 (Doc. No 13784/08); also Declaration on a concerted action plan of the Euro area countries, 10 October 2008, European Council of 15/16 October 2008, Presidency Conclusions, available at: [http://www.consilium.europa.eu/ueDocs/cms\\_Data/docs/pressData/en/misc/103202.pdf](http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/misc/103202.pdf).

<sup>9</sup> See Commissioner Kroes’s briefing to the ECOFIN Ministers on the financial crisis, 2 December 2008, available at: <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/08/757&format=HTML&aged=1&language=EN&guiLanguage=en>.

<sup>10</sup> See e.g. Kapsis, “The impact of the recent financial crisis for EU competition policy in the banking sector”, (2010) 9(3) Int’l J for Trade Law and Policy 256 at 263-265.

<sup>11</sup> *Id.*, pp. 264-265; see also Zimmer and Blackschoch, “The role of competition in state aid control during the financial market crisis”, (2011) 32(1) ECLR 9 at 10-11.

<sup>12</sup> See e.g. Weitbrecht, cit. (fn. 6) at 282-283.

<sup>13</sup> Kapsis, cit. (fn. 9), pp. 261-262.

<sup>14</sup> *Ibid*; see also Zimmer et al., cit. (fn. 10), p. 14.

In light of the above, it is argued that the Commission's role, from this "second season" of the crisis and onward, evolved from that of a spectator and occasional participant to one of major protagonist: out of a concern for avoiding protectionist "torpedoes" on the part of individual Member States and, more generally, for maintaining the integrity of a competitive and open single market, the Commissioner for Competition engaged more frequently and more directly with dealing with the crisis and its challenges.<sup>15</sup> In doing so, the Office was also backed by the renewed resolve of the Member States, apparent in the 2008 ECOFIN Guidelines on state aid, to move from unilateral, occasionally coordinated crisis management to a more principled approach to this task, which would rely on the EU institutional architecture.<sup>16</sup> This marked change also led the Commission to become more closely involved not just in the overall response to these dramatic, choppy times; it could be argued that it also encouraged it to "micro-manage" the economic government of individual Member States, raising concerns for the democratic legitimacy (or lack thereof) of specific measures' packages.<sup>17</sup>

What the forgoing has meant, and is still likely to mean, for the role of the Commission itself and for the EU institutions as a whole will be examined briefly at the end of this contribution. At this junction, it can be concluded that the financial crisis of 2007/2008, which continues to haunt Europe and whose effects have now become systemic and entrenched in the "real" economy, posed great challenges for competition policy as well as for the whole European project of a single, open and competitive market. Despite initially sitting on the sidelines, the Commission became and continues to be closely involved in dealing with the challenges of the current economic predicament in which the EU Members find themselves: it could be argued that its increasing activism was both a reaction to the dangers posed by unilateral state actions to the integrity of the Common Market and the outcome of a realisation of the need to reassert its leadership in a scenario in which multilateralism was "creeping" to the detriment of the efficacy of the EU's supranational decision-making and implementation dynamics.<sup>18</sup>

However, what became increasingly clear was that the Commission carefully selected the competition tools with which it endeavoured to structure its response: merger control and state aid supervision emerged as core instruments in this task. By contrast other hitherto relatively "traditional" tools for assisting restructuring, such as the application of Article 101(3) TFEU to "crisis cartels" were not on the agenda. The next section will attempt to analyse, albeit briefly, the rationale for the choice of tools made by the Commission and will concentrate especially on the question of whether "crisis cartels" may have become increasingly obsolete, in the face of the almost total condemnation of cartel behaviour and of other forms of collusion.

## *2.2. Applying Article 101(3) TFEU to restructuring deals: are crisis cartels just "museum material"?*

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<sup>15</sup> Inter alia, see Gerard, cit. (fn. 1), pp. 8-9.

<sup>16</sup> Napolitano, "The two ways of global governance after the financial crisis", (2011) 9(2) Int'l J Const'l Law 310 at 314; see also 320-321.

<sup>17</sup> See e.g. Kapsis, cit. (fn. 9), pp. 269-270.

<sup>18</sup> For commentary, see Mateus, cit. (fn. 1), pp. 4-5; also Napolitano, cit. (fn. 15), pp. 319-320.

The previous section sought to provide a short sketch of the “phases” (such as they can be identified) in which the financial and later “systemic” crisis unfolded and to highlight the main traits characterising the response of the Commission to the challenges posed by it. It was argued that, despite initially being “reactive” to the unfolding of these rather dramatic circumstances, the Commission soon adopted a far more involved, purposeful stance to addressing the consequences of the financial crisis: it sought to respond to the demands of industrial restructuring in an industry whose instability could have potentially dangerous aftershocks for the real economy, while at the same time trying to reconcile this task with its responsibility for upholding single market principles. However, what became clear was that the Commission took on this task by relying mainly on two of its policy tools, namely state aid supervision and the exercise of its merger control powers. Other “traditional” crisis-busting tools, such as crisis cartels, did not feature in its tool box, thereby prompting the question of whether the application of the legal exception to forms of coordination designed to bring about industrial restructuring that had hitherto been employed in many economic sectors, may have become “relics” of the past.

The limited purvey of this contribution does not allow for any in-depth analysis of the issues arising from the practice of the Commission, mainly developed in the 1980s and 1990s, to “exempt” prima facie anti-competitive agreements destined to deal with the consequences of systemic overcapacity (namely over capacity owed to the consequences of demand downturn and not to, e.g., inefficiencies inherent to the conduct of individual undertakings) from the sanction of nullity provided by Article 101(2) TFEU.<sup>19</sup> As is well known, there have been cases in which rivals were allowed to jointly agree cuts of production if the dynamics of demand and supply cannot restore “normal” market conditions.<sup>20</sup> However, in similar cases, since they result in concerted output reductions,<sup>21</sup> the arrangements in question have been regarded as incompatible with the guiding principle of Article 101, namely that each undertaking must be able to determine independently its conduct on the market.<sup>22</sup> Accordingly, the Commission’s practice developed in the sense of allowing restructuring deals to benefit from the legal exception of Article 101(3) TFEU only in limited circumstances.<sup>23</sup>

Paramount to this approach was the objective finding of the existence of industrial downturn; in addition, these arrangements were only allowed to be stipulated for a transient period.<sup>24</sup> It must be shown that no lasting improvement can be forecast in the medium term in “normal” market conditions and that the cooperation entailed by the arrangement does not unduly restrain the freedom of the parties beyond what is strictly necessary to shed the overcapacity.<sup>25</sup> In relation to

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<sup>19</sup> See, *inter alia*, JONES and SUFRIN, *EC Competition Law: text, cases and materials*, 2<sup>nd</sup> Ed., 2008: OUP, p. 807.

<sup>20</sup> *Ibid.*; see also pp. 237-238.

<sup>21</sup> See e.g. Commission Decision 84/380/EEC, *Synthetic Fibres*, 4 July 1984, [1984] OJ L207/17, para. 25-27.

<sup>22</sup> See e.g. joined cases 40 to 48, 50, 54 to 56, 111, 113 and 114-73, *Suiker Unie and others v Commission*, [1975] ECR I-1663, para. 173-175.

<sup>23</sup> Commission Notice, Guidelines on the applicability of Article 81 EC Treaty to horizontal cooperation agreements, [2001] OJ C2, para. 25; see also para. 18-19.

<sup>24</sup> See e.g. Commission XII Report on Competition Policy, para. 38-41. For commentary, *inter alia*, WHISH, *Competition Law*, 6<sup>th</sup> Ed., 2007: OUP, p. 600.

<sup>25</sup> Commission XII Report on Competition Policy, para. 38-39. See also Commission XXIII Report on Competition Policy, para. 85.

the first condition of the legal exception,<sup>26</sup> it must be demonstrated that these practices are capable of eliminating excessive capacity and, consequently, of restoring efficiency and competitiveness in the industry.<sup>27</sup> As to the second condition that the arrangement afford consumers a “fair share” of their benefits, the parties must prove that any negative impact of the arrangements is at least offset by its positive outcomes and thus overall “neutral” for consumer welfare.<sup>28</sup>

To satisfy the third condition of “indispensability”, it must be established that the alleged benefits of the agreement cannot be secured through any less restrictive means: the arrangement must be limited in its duration and geographic scope and must not hamper the freedom of action of the parties beyond what is required to achieve its goals.<sup>29</sup> Finally, the agreement must not entail the elimination of substantial competition from the relevant market by weakening any existing rivalry to the point that the latter is no longer capable of restraining the parties’ freedom of action,<sup>30</sup> e.g. by conferring on them significant market power and/or foreclosing the market vis-à-vis actual or potential rivals.<sup>31</sup>

The legal exception clause was applied by the Commission in a handful of cases, mainly in the 1980s and early 1990s, in order to “exempt” from the sanction of nullity a number of agreements designed to attain a concerted reduction in production in industries characterised by “structural oversupply” (as opposed to overproduction owed to inefficient behaviour of the undertakings concerned), so that greater efficiency and more “normal” competition patterns could be restored within a reasonably short period of time. In cases such as *Synthetic Fibres* and *Dutch Bricks*, the Commission was prepared to accept that a number of rivals could agree on a plan of production cuts, despite these arrangements constituting a very serious infringement of Article 101(1) TFEU by reason of their object, provided that strict requirements were met: first of all, the market had to be in a situation of ongoing crisis caused by factors beyond the control of the concerned undertakings and which could therefore only be resolved by concerted output reductions.<sup>32</sup> Second, the arrangement must be limited in its duration and geographic scope<sup>33</sup> and should not have been capable of totally curtailing any remaining competition.<sup>34</sup> The Commission was especially concerned with ensuring that the arrangement preserved a certain degree of

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<sup>26</sup> Commission XII Report on Competition Policy, para. 39.

<sup>27</sup>*Ibid.* See also Commission XXIII Report on Competition Policy, para. 82 and 89; Commission Notice, Guidelines on the applicability of Article 81 EC Treaty to horizontal cooperation agreements, [2001] OJ C2, para. 73-75, 84.

<sup>28</sup> Commission Notice, Guidelines on the applicability of Article 81 EC Treaty to horizontal cooperation agreements, [2001] OJ C2, para. 84-85.

<sup>29</sup> *Ibid.*; see also Commission XXIII Report on Competition Policy, para. 89. For commentary, *inter alia*, FIEBIG, “European crisis cartels and the triumph of industrial policy over competition in Europe”, (1999) 25 *Brook. J Int’l L* 607 at 614-615.

<sup>30</sup> Commission Notice, Guidelines on the applicability of Article 81 EC Treaty to horizontal cooperation agreements, [2001] OJ C2, para. 105, 107-108.

<sup>31</sup> *Ibid.*; see also Commission XXIII Report on Competition Policy, para. 89.

<sup>32</sup> See e.g. Commission decision 84/380/EEC of 4 July 1984—*Synthetic Fibres* (IV/30.810), [1984] OJ L207/17, para. 28-29; see also para. 31-35.

<sup>33</sup> *Inter alia*, Commission decision 94/296/EC of 29 April 1994—*Stichting Baaksten* (IV/34.456), [1994] OJ L131/15, para. 32-34.

<sup>34</sup> *Id.*, para. 39-40. See also, *mutatis mutandis*, Commission decision 87/3/EEC of 4 December 1986—*ENI/Montedison* (IV/31.055), [1987] OJ L5/13, especially paras. 7-8, 21-22, 33-35.

“uncertainty” as to the parties’ future behaviour and did not prevent totally any residual competition originating from the conduct of other rivals.

Thus, it was held in *Synthetic Fibres*, for instance, that since the “market forces” had been unable to “achieve the capacity reductions necessary to re-establish and maintain” the long term competitiveness of the market, the agreed capacity reductions were likely to lead to the “needed structural adjustment”, thereby benefitting the industry’s performance in the long term.<sup>35</sup> The Commission emphasised that these reductions would not have impacted on existing supply patterns, since any remaining capacity could have been operated more intensively, without leaving “gaps” of unmet demand.<sup>36</sup> It also highlighted the circumstance that, by implementing the agreed cuts, each of the parties could have adopted more efficient industrial strategies, such as specialisation in specific types of supply, thus improving their performance in the long run.<sup>37</sup> It was added that this would have been likely to benefit consumers as well, especially in as much as it could have allowed suppliers to produce better products as a result.<sup>38</sup>

As to the other “negative” conditions, the decision highlighted the circumstance that the parties remained free to determine future output and deliveries and that the agreement, in any event, was of limited duration and geographical scope; thus, the “indispensability” requirement was regarded as being fulfilled.<sup>39</sup> As to the fourth condition, the Commission placed significant emphasis on the existence of other rivals vis-à-vis those affected by the agreement and on the relevant degree of product substitutability with other fibres, such as cotton and other natural materials, which in turn meant exposure to additional competitive pressure.<sup>40</sup> Similar remarks were also made in the later *Dutch Bricks* decision: the Commission took the view that due to the ongoing, permanent state of over-capacity, none of the parties to the agreement could have, without the agreement of the others, restored more efficient supply conditions within the Dutch brick industry.<sup>41</sup> In addition, and due to the same over-capacity, the agreed cuts could not have led to demand being unmet and, consequently, to appreciable price increases.<sup>42</sup>

The decision also found that the restrictions on the freedom of the parties were both indispensable and incapable of eliminating significant competition: in respect to the former condition, it was held that the arrangement was of limited duration and scope and did not prejudice the freedom of action of the parties beyond those obligations that were integral to it.<sup>43</sup> And, as regards the latter requirement, the arrangement was found not to hamper the competitive pressure originating from other rivals, especially those established in other Member States; the decision also

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<sup>35</sup> Commission decision 84/380/EEC of 4 July 1984—*Synthetic Fibres* (IV/30.810), [1984] OJ L207/17, para. 31-32.

<sup>36</sup> *Id.*, para. 34-35.

<sup>37</sup> *Ibid.*; see also para.36-37.

<sup>38</sup> *Id.*, para. 39.

<sup>39</sup> *Id.*, para. 43-44.

<sup>40</sup> *Id.*, para. 51-52.

<sup>41</sup> Commission decision 94/296/ECof 29 April 1994—*Stichting Baaksten* (IV/34.456), [1994] OJ L131/15, para. 19-28.

<sup>42</sup> *Id.*, para. 26-27.

<sup>43</sup> *Id.*, para. 33; see also para. 35-36.



emphasised that the arrangement affected only the element of supply, thus not affecting other elements of competitive importance.<sup>44</sup>

Although the application of Article 101(3) TFEU to mutually agreed output reductions was met with concern by some commentators, on the ground that it could have resulted in an excessively wide reading of the “efficiency gains” condition and in particular in incorporating “non-economic” elements in this analysis,<sup>45</sup> it has since been considered as an “acceptable” use of the legal exception.<sup>46</sup>

In light of the above, it could be argued that, with the advent of the financial crisis, Article 101(3) TFEU could have provided a flexible and overall effective instrument to cope with the aftershocks of the “credit squeeze”, especially when the latter started to adversely affect the “real economy”. However, it is apparent that no decisions such as the one in *Dutch Bricks* were adopted. How can this apparent “gap” be explained? It is suggested that it may have to do with factors that are specific to Article 101 TFEU as well as with reasons that are more related to general trends characterising the enforcement of competition law as a whole. In respect to the latter, it is unquestionable that over the past 20 years a clear condemnation of cartel behaviour has been inspiring the enforcement activity of the Commission, as well as justifying the closer and more active involvement of the national competition agencies: this is especially visible in the multiplication of leniency programmes across the Union, a phenomenon which in turn has resulted in a far more incisive detection activity, and also in the higher level of fines imposed on the undertakings found to have engaged in anticompetitive behaviour. Additional factors, such as the criminalisation of cartel behaviour in a number of jurisdictions, and the strengthening of the investigative powers conferred to the competition authorities within the EU, may be seen as contributing to an altogether more “sceptical” view that forms of coordination among competitors, however “benign” their objectives may be, may actually be seen as “acceptable” from a competition law standpoint.

It is submitted that this “mistrust” of prima facie “crisis cartel” arrangements was especially apparent in the Court of Justice of the EU’s preliminary ruling in the case of *Barry Brothers*.<sup>47</sup> The facts of this case are well known: a number of Irish beef producers sought to tackle a long standing and externally certified state of over-capacity, characterising the industry, by agreeing a timetable of plant closures and decommissioning; in addition, they undertook not to sell their plants to newcomers, to engage again in processing or production activities.<sup>48</sup> They also stipulated to pay those undertakings that had agreed to leave the industry altogether, in order to effect the production cuts, a certain amount of money per head cattle, thus, in substance, “buying out” the market share of the

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<sup>44</sup> *Id.*, para. 39-40.

<sup>45</sup> See e.g. FIEBIG, “European crisis cartels and the triumph of industrial policy over competition in Europe”, (1999) 25 *Brook. J Int'l L* 607 at 619; see also pp. 636-637; also HORNSBY, “Competition policy in the 80s: more policy less competition?”, (1987) 12(2) *ELRev* 79.

<sup>46</sup> Case T-17/93, *Matra Hachette v Commission*, [1994] ECR II-595, para. 85, 109-110; see also, *mutatis mutandis*, case 14/68, *Walt Wilhelm v Bundeskartellamt*, [1969] ECR I, para. 5; for commentary, see e.g. TOWNLEY, *Article 81 EC and public policy*, 2009: Oxford, Hart Publishing, p. 255.

<sup>47</sup> Case C-209/07, *Competition Authority v Beef Industry Development Society Ltd and Barry Brothers*, [2008] ECR I-8637 (hereinafter referred to also as *Barry Brothers*).

<sup>48</sup> For commentary, see *inter alia* Van der VIJVER, “The Irish beef case”, (2009) 30(4) *ECLR* 198; also SVETLICINII, “ECJ’s ruling in beef industry case: competition law must be observed at all times”, (2008) 12 *Eur. L. Reporter* 402.

“leavers”.<sup>49</sup> Following a decision of the Irish Competition Authority, which condemned the arrangement as a restriction of competition ‘by object’, proceedings were instituted before the Irish Courts, with the respondents, the Beef Industry Development Society (BIDS) being successful before the High Court: in his judgment, Mr Justice McKechnie opined that since the arrangement had been stipulated for a “good cause” and could not be “fitted” into any of the agreements identified by the Treaty as ‘by object’ violations, no such infringement could be found.<sup>50</sup>

However, on appeal a reference was made to the Court of Justice who rejected the “literal” approach to Article 101(1) suggested by McKechnie J and took the different view that each prima facie anti-competitive agreement should be examined in its own context and having regard to its object and purpose;<sup>51</sup> in this respect, the fact that the arrangement pursued, along with anti-competitive goals, other legitimate objectives, or that the parties had no intention to curb competition, would not be sufficient to exclude it from the scope of the prohibition.<sup>52</sup>

The Court of Justice examined the agreement and found that the latter allowed the parties, who together controlled 90% of the market, to ‘achieve their minimum efficient scale’ and boost profitability<sup>53</sup> via a ‘common policy’ designed to reduce the industry’s structural overcapacity by 25% and based on incentives aimed at encouraging some rivals to leave the market, with inevitable increases in its concentration.<sup>54</sup> It therefore took the view that the agreement permitted them to swap concerted action to the “fierce rivalry” that could have been expected of “normal” market dynamics, and therefore shielded them from the effects of normal competition, which overtime would have allowed them to “shed” the excess capacity by excluding less efficient rivals.<sup>55</sup> In the Court’s view, the anti-competitive nature of the content and purpose of this arrangement was further reinforced by the clauses concerning the limitations on the freedom of the parties as regards the utilisation and the sale of decommissioned plants and by the imposition of levies on the staying undertakings, designed to “compensate” the parties that had accepted to leave the market.<sup>56</sup> It was held that these clauses resulted in the Irish beef market being foreclosed to external pressure—by preventing new comers from entering it via the acquisition of existing plant—and in the market shares per each of the party being “frozen” artificially for the time stipulated in the agreement.<sup>57</sup>

It is suggested that *Barry Brothers* constitutes a “milestone” in the evolution of the Court of Justice’s approach to Article 101 TFEU since it confirmed that the analysis of each restriction of competition within the spectrum of the “prohibition clause” should take place having regard exclusively to its content and purpose and therefore without referring to the “intention of the

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<sup>49</sup> *Barry Brothers*, cit. (fn. 46), para. 16-17; see also para. 19-21.

<sup>50</sup> *Competition Authority v BIDS*, 27 July 2006, per Mr J McKechnie, [2006] IEHC 294.

<sup>51</sup> *Id.*, para. 16-17.

<sup>52</sup> *Id.*, para. 21.

<sup>53</sup> *Id.*, para. 32.

<sup>54</sup> *Id.*, para. 33.

<sup>55</sup> *Id.*, para. 33, 35.

<sup>56</sup> *Id.*, para. 36-37.

<sup>57</sup> *Id.*, para. 37-38.

parties” or indeed to any “external” considerations.<sup>58</sup> In this context, the Court emphasised that certain restraints, such as those resulting in output restrictions, should be regarded as unlawful by their object since they were contrary to the very goal of Article 101 (i.e. the protection of the freedom of action on the market, recognised to each undertaking) and affected a key aspect of competition, namely supply patterns.<sup>59</sup> Perhaps most importantly, it reiterated that any “non-economic” considerations, such as inter alia the need to pursue industrial restructuring, should only be relevant to the extent that they fitted the “paradigm” of the four conditions of Article 101(3) TFEU.<sup>60</sup>

Against this background it may be queried what significance, if any, *Barry Brothers* could have for the legal treatment of prima facie “crisis cartels” today. It is acknowledged that, due to the scope of the reference made by the Irish High Court, the Court of Justice did not deal with the question of whether the arrangement, despite featuring all the hallmarks of a “serious” infringement by reason of its object, could have benefitted from the application of the legal exception.<sup>61</sup> It may also be wondered whether, in this specific context, cases such as *Dutch Bricks* or *Synthetic Fibres* still constitute “good law” to that effect.<sup>62</sup> In respect to the question of whether the BIDS arrangement could in principle have been “redeemed” through the application of Article 101(3) TFEU, two considerations can be made: the first is that in principle implementing “successful” industrial restructuring could be regarded as constituting a form of technical or economic progress, within the spirit of the first of the four conditions, and could potentially also benefit consumers, since it may lead, over time, to more efficient processes and better products.<sup>63</sup>

The second point, however, is that whatever “benefits” of these kinds the arrangement could have led to, they would appear unlikely to fulfil also the two “negative” conditions of the legal exception, i.e. the requirements of “indispensability” and of “non-elimination of competition”: in respect to the former, it could be argued that the provision for “compensation fees”, provided to “leaving firms” as an incentive to stay away from the market, taken together with the scope of the agreement and the resulting increase in concentration, were clearly disproportionate to the aim (i.e. restructuring of the market into a more efficient structure) that the BIDS sought to achieve, a goal which could have been attained through less restrictive means, e.g. without a compensation mechanism.<sup>64</sup> As to the latter, it is clear from the ruling that the agreement resulted in the Irish beef market being de facto insulated from the rest of the single market for a significant period of time, due to the wide-ranging limitations placed on each of the parties as to their ability to dispose of the decommissioned factories.<sup>65</sup> Although it was argued that they remained free to determine their

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<sup>58</sup> *Id.*, para. 35. For commentary, see inter alia Andreangeli, “From mobile phones to cattle”, (2011) 34 W Comp 215 at 221.

<sup>59</sup> *Id.*, para. 38; for commentary see e.g. Van Vijver, *cit. (fn. 47)*, pp. 200-201.

<sup>60</sup> *Ibid.*; see also Balaguer, “Beef Industry development Society: warning on industrial restructuring”, (2012) 33(6) ECLR 296 at 299.

<sup>61</sup> See e.g. Andreangeli, *cit. (fn. 57)*, pp. 222-223.

<sup>62</sup> See inter alia Balaguer, *cit. (fn. 59)*, pp. 300-301.

<sup>63</sup> See e.g. Andreangeli, *cit. (fn. 57)*, pp. 222-223.

<sup>64</sup> *Id.*, p. 223.

<sup>65</sup> *Ibid.*

market strategies within the Irish market, and could also compete reciprocally as regards important aspects of their business,<sup>66</sup> it is undeniable that the BIDS members had succeeded in freezing their market shares and in “locking out” any external competitive pressure, thus shielding their position from any remaining actual or potential competition.<sup>67</sup>

In light of the above, it is argued that *Barry Brothers* represents a strong restatement of a rather “orthodox” view of Article 101(1) and especially of the notion of “restriction by object” contained in it, as encompassing all restraints that, by reason of their “content and purpose” and having regard especially to the underlying aim of Article 101 TFEU as a whole, are so serious as to merit being caught by the prohibition without any assessment of their impact on the market:<sup>68</sup> it is suggested that in *Barry Brothers* the Court of Justice was struck by the serious nature of the arrangement (i.e. one entailing a concerted restriction of output, coupled with clauses designed to protect a national market from outside pressure) and was guided by the concern for upholding the “economic freedom” rationale of the Treaty competition rules, a factor which, in turn, could be regarded as consistent with the strong condemnation of cartel behaviour as well as with a clear mistrust of all forms of collusion that had an “appreciable” impact on rivalry.<sup>69</sup>

It is submitted that the above considerations provide us with the material for an answer to the more general question of whether the old case law on crisis cartels could be considered still as “good law”, which may be usefully deployed in order to provide an additional competition law tool to tackle the effects of the economic crisis. It may be argued that while it may be tempting for undertakings operating in “ailing industries” to seek to engage in forms of coordinated output rationalisation, the BIDS ruling does not seem to encourage similar arrangements, in as much as it appears to put the “reasons of rivalry” before any considerations for the “viability” of specific sectors that may be going through “tough” times characterised by overcapacity.<sup>70</sup> It could be argued that, in light of the Court’s decision, the “preferred way” for dealing with the “dire straits” of any industrial crisis would be for each competitor to engage in independent, unilateral rationalisation as opposed to rivals “agreeing their way out of recession”.<sup>71</sup> Accordingly, it is suggested that while decisions such as *Synthetic Fibres* and *Dutch Bricks* could have been justified in light of their factual circumstances and could have been consistent with the demands of crises peculiar to specific industries at the time in which they were adopted, they may no longer be consistent with the trends and the needs of competition policy as the latter has developed to this day. Thus, it may be doubted that their approach may constitute a useful “blueprint” for competition policy tools to be deployed to deal with the aftershocks of the economic crisis for “real” sectors of the economy.<sup>72</sup>

It is concluded that while Article 101(3) provides in principle a framework within which the positive effects of prima facie anti-competitive arrangements, including public policy objectives, can be assessed with a view to waiving the sanction of nullity of Article 101(2), it may not provide

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<sup>66</sup> Balaguer, cit. (fn. 59), pp. 301-302.

<sup>67</sup> Andreangeli, cit. (fn. 57), p. 223; see also Van Vijver, cit. (fn. 47), p. 201.

<sup>68</sup> Andreangeli, cit. (fn. 57), pp. 223-224.

<sup>69</sup> Id., pp. 222-223.

<sup>70</sup> Id., pp. 223-224; see also, mutatis mutandis, Balaguer, cit. (fn. 49), p. 301.

<sup>71</sup> See also Balaguer, cit. (fn. 49), pp. 301-302.

<sup>72</sup> Id., p. 302.

a suitable answer to the need to deal with the effects of the economic downturn in Europe: as the brief analysis conducted so far has shown, the almost unanimous condemnation of cartel behaviour and consequently the more general distrust for any form of collusion having appreciably restrictive effects on competition support the view that allowing rivals to “agree their way out of a crisis” may not constitute an appropriate instrument for competition policy when it comes to tackling the effects of the credit squeeze on the “real economy”, and could therefore explain the preference of the Commission for other tools, such as state aid oversight and the application of the merger control rules. Thus, the next section will analyse the approach adopted by the Commission in these areas with a view to assessing the overall effectiveness of its role of “guardian of the single market” albeit in challenging times.

### 3. New challenges, new responses? Adapting the existing "toolbox" to the demands of the financial and economic crisis

#### *3.1. State aids in times of crisis: “rescue and restructuring” banks and beyond...*

The previous section analysed briefly the question of whether Article 101 TFEU and especially the legal exception provided by its paragraph 3 can provide tools to tackle the consequences of the economic crisis. It was argued that, while “crisis cartel” could have been regarded as an “acceptable” option in the 1980s and 1990s, they no longer appeal consistent with current trends and approaches underlying the application of the cartel prohibition to specific cases. As was illustrated in relation to the Barry Brothers preliminary ruling, any arrangement aimed at allowing rivals to “agree their way out of recession” is likely to be met with considerable scepticism, if not with an outright condemnation, by the authorities competent for the application of the competition rules. This section will instead be concerned with addressing the questions arising from the application of state aid rules to the rescue and restructuring of undertakings in crisis, not just in the financial sector, but also in the “real economy”.

The limited purvey of this work does not allow an examination of the framework provided by the Treaty for the purpose of overseeing the involvement of the Member States in the economy and more specifically of the rules designed to prevent the granting of aid, via state resources, that may distort competition within the single market.<sup>73</sup> Suffices to say that, according to Article 107(1) TFEU, any form of assistance, coming from public funds which may favour specific undertaking or the production of certain goods or services, thereby adversely affecting, actually or potentially, competition on the common market, is incompatible with the rules of the Treaty and therefore, with limited exceptions, prohibited.<sup>74</sup> However, as Article 107(2) and (3) make clear, there are some types of aid that are compatible with the common market: financial assistance designed, for instance, “to make good the damage caused by natural disasters” is automatically considered lawful. Other types of aid can nonetheless regarded as compatible with the Treaty: it will be up to the European Commission, upon notification on the part of the Member State concerned, to decide whether the aid in question, whether granted via a “scheme” or via “individual” assistance, to

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<sup>73</sup> See e.g. Hancher et al., *EC State Aids*, 2006; Iversen et al. (Eds), *Regulating competition in the EU*, 2008, see especially chapter IX.

<sup>74</sup> See *inter alia* Jessen, “State Aid”, in Iversen et al. (cit. 72), pp. 402-404.

decide whether this is the case.<sup>75</sup> Article 109 further empowers the Council to enact measures designed to “exempt” specific forms of aid from the duty to notify in issue; the Commission is also entrusted with the necessary powers of implementation in relation to the categories of “exempted aid”.<sup>76</sup>

Importantly, Article 108(3) imposes a duty on the notifying Member State to abstain from giving effect to the aid until such time as the procedure designed for its control has been completed;<sup>77</sup> according to Article 108, this procedure is articulated in a “preliminary” examination, to be completed within two months, at the end of which the Commission may decide that either the assistance does not constitute “aid” within the meaning of the Treaty, or that it does not appear to be anti-competitive. In any other case, the Commission will initiate a formal procedure, entailing a full examination of the proposed measure, and assisted by *inter partes* procedural guarantees.<sup>78</sup>

As to the actual approach to the assessment of the aid, the case law indicates that the Commission enjoys a certain degree of discretion when approving aid under Article 107(2) and (3) TFEU.<sup>79</sup> In this context, it will not take into account the “intention of the parties”, i.e. whether the state, in granting the aid, pursued deliberately the goal of giving “targeted” financial assistance to the recipient, in whatever form.<sup>80</sup> Nor will it take into consideration, for the purpose of considering a certain form of assistance ‘aid’, whether the latter pursued a “good cause”, i.e. the attainment of public policy goals.<sup>81</sup> What is, instead relevant is the extent to which any form of financial assistance is such that it favours the recipient by conferring to her advantages that she could not have obtained according to normal market conditions.<sup>82</sup> At the heart of this assessment is the “ordinary investor” concept, according to which financial support only constitutes aid if the terms under which it is granted by a public body would not be acceptable for a private entity operating within the free market.<sup>83</sup>

If these conditions are met, aid will be considered contrary to the Treaty if it is “selective”, i.e. if it favours the recipient vis-à-vis other entities that are in a comparable position, thus conferring to the former a competitive advantage.<sup>84</sup> This will be the case especially if the measure results in “mitigating the charges that are normally included in the budget of an undertaking”, thus putting it in a more favourable financial position than non-recipients.<sup>85</sup> By contrast, financial advantages

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<sup>75</sup> Article 108 TFEU; see Council Regulation (EC) No 659/1999 of 22 March 1999, [1999] OJ L83/1; also Commission Regulation (EC) No 794/2004 of 21 April 2004 implementing Council Regulation (EC) No 659/1999, [2004] L140/1.

<sup>76</sup> Council Regulation (EC) No 994/98 of 7 May 1998, [1998] OJ L142/1; also e.g. on aid to SMEs, see <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/08/313&format=HTML&aged=0&language=EN&guiLanguage=en>.

<sup>77</sup> See inter alia, case 120/73, [1973] ECR 1471, para. 8; for commentary, Jessens, cit. (fn. 73), pp. 421-422.

<sup>78</sup> Inter alia, Jessen, cit. (fn. 73), pp. 409 ff.

<sup>79</sup> See inter alia, case C-143/99, *Adria-Wien Pipeline GmbH and Wietersdorfer & Peggauer Zementwerke GmbH v Finanzlandesdirektion für Kärnten*, [2001] ECR I-8365, para. 30-31.

<sup>80</sup> See inter alia Commission Decision 92/11/EC, *Toyota*, [1992] OJ L6/36, Part IV; also, more recently,

<sup>81</sup> Case C-241/94, *France v Commission*, [1996] ECR I-4551, para. 19-21.

<sup>82</sup> See e.g. case C-126/01, *Gemo SA*, [2003] ECR I-13769, para. 28-33.

<sup>83</sup> See inter alia case C-39/94, *SFEI V La Poste*, [1996] ECR I-3547, para. 62.

<sup>84</sup> See e.g. case C-143/99, cit. (fn. 78), para. 35-36.

<sup>85</sup> Case C-6/97, *Italy v Commission*, [1999] ECR I-2981, para. 15-16.

stemming from the implementation of “general schemes” will not be regarded as aid that can distort competition, provided that they are “open to all economic agents” and operated in accordance with “proper objective criteria”.<sup>86</sup> In this context, the manner in which the individual measures were construed and in particular the extent to which they result in specific undertakings or economic sectors being favoured will be especially important.<sup>87</sup>

As to whether aid is capable of distorting rivalry on the market or it threatens to do so, the Court of Justice held in *Commission v Italy* that this assessment must be conducted bearing in mind the goal of the relevant Treaty rules, i.e. the objective of preventing Member States from favouring certain undertakings or the supply of specific goods or services and thereby seeking to interfere with the “normal” functioning of competition within the common market.<sup>88</sup> In this context, whether the measure sought to achieve goals of public interest, including, e.g. social protection, was not regarded as relevant.<sup>89</sup> what was, instead, central was the extent to which the financial assistance in question could reduce the ability of rivals to the recipient to expand their position on the market or new rivals to attempt to enter the market.<sup>90</sup> For this purpose, the Commission will have to conduct a counterfactual analysis, by comparing the conditions of competition that characterised the relevant market before to those occurring after the aid was granted.<sup>91</sup>

According to Article 107(2) TFEU, some forms of aid are compatible with the Treaty: such is the case for, inter alia, certain forms of financial assistance targeted at social objectives, aid aimed at compensating the consequences of natural disasters and assistance for certain areas of Germany affected by the reunification: in authorising aid under this provision, the Commission enjoys very limited powers of appreciation, being able only to scrutinise the notified measures to ensure that they meet the criteria provided by the Treaty and are not disproportionate to the goals they seek to achieve or contrary to the general principles of EU law or other rules of the Treaty.<sup>92</sup> Article 107(3) provides a further basis for approval of notified aid: in light of this provision the Commission can authorise state financial assistance aimed at supporting "development of certain regions or certain areas of the economy", at allowing the realisation of "projects of common European interest" and at preserving and promoting culture.<sup>93</sup> In addition, the Commission may authorise aid that is necessary to prevent and limit the impact of a "serious disturbance" in the European economy. Unlike under Article 107(2) TFEU, however, the Commission enjoys wide discretion in examining the impact of the aid on competition and the extent to which any distortion,

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<sup>86</sup> Jessen, cit. (fn. 73), p. 448; see e.g. Commission Notice on the application of the State aid rules to direct business taxation, [1998] OJ C384/3, para. 13-14.

<sup>87</sup> See *inter alia*, case C-143/99, cit. (fn. 78), para. 41; also case C-88/03, *Portugal v Commission*, [2006] ECR I-7115, para. 54-56.

<sup>88</sup> Case 173/73, [1974] ECR 709, para. 13.

<sup>89</sup> See e.g. *id.*, para. 22.

<sup>90</sup> See *inter alia* case C-169/08, *Presidenza del Consiglio dei Ministri v Regione Sardegna*, [2009] ECR I-10821, para. 61-63.

<sup>91</sup> See *inter alia* case C-6/97, cit. (fn. 84), para. 21-23.

<sup>92</sup> Jessen, cit. (fn. 73), pp. 470-471.

<sup>93</sup> *Id.*, p.. 471.

whether actual or threatened, is limited to what is indispensable to achieve the aim pursued by the notifying Member State.<sup>94</sup>

The role and scope of state aid control has evolved overtime, to respond to the changing economic conditions across the EU and to the challenges posed by globalisation and by the ensuing need, expressed in 2000 with the Lisbon strategy, to secure efficiency, openness and competitiveness of the European economy.<sup>95</sup> Consistent with this goal was therefore the resolve of the Member States to reduce the scope of their intervention in the economy and to destine public resources to "more horizontal objectives of common interest" as well as the call for a stricter scrutiny of notified aid.<sup>96</sup> As a result, the Commission reshaped its approach to the scrutiny of aid, by privileging financial assistance destined to support, inter alia, innovation as well as boosting the activity of small and medium sized enterprises;<sup>97</sup> in addition, it sought to identify more "virtuous" forms of aid by means of Notices and Guidelines as well as via the enactment of Block Exemption Regulations, in accordance with Articles 108 and 109 TFEU.<sup>98</sup>

The implementation of the Lisbon Strategy had also a significant impact on the approach to aid destined to facilitating the "rescuing and restructuring of firms in difficulty".<sup>99</sup> Already perceived as distortive by the Commission, on the ground that it could be used to "prop up" artificially inherently "inefficient" competitors, to the detriment of more "virtuous" market players, this form of financial assistance was strictly limited to "exceptional" cases.<sup>100</sup> According to the 2004 Guidelines, the Commission had to be satisfied that any State assistance was aimed at a "firm in difficulty", i.e. an undertaking that is unable with its own wherewithal to "stem losses which, without outside intervention (...) [would] almost certainly condemn it to going out of business in the short or medium term".<sup>101</sup> In this context, whereas "rescue aid" is "by nature temporary and reversible" and limited to "keeping the firm afloat" for the time required to work out a restructuring strategy or a plan for liquidation,<sup>102</sup> "restructuring aid" is inherently of a "longer term nature" and is authorised only if it is accompanied by a "feasible, coherent and far-reaching plan" destined to bring the firm "back in business and to allow it to operate without support".<sup>103</sup>

To deserve approval rescue aid must consist of "liquidity support" such as loans or guarantees granted at an interest rate that would normally be charged to "sound" enterprises and be

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<sup>94</sup> *Ibid.*; see also Commission Guidelines on state aid for rescuing and restructuring firms in difficulty, [2004] OJ L244/2, para. 6-7.

<sup>95</sup> *Id.*, para. 3.

<sup>96</sup> *Ibid.*

<sup>97</sup> See e.g. Community framework for state aid for research and development and innovation, [2006] OJ C323/1; also Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises, [2004] L124/36; see also Guidelines on Rescue and Restructuring, para. 57 ff.

<sup>98</sup> *Inter alia* Jessen, cit. (fn. 73), pp. 465-468; cit. e.g. guidelines for SMEs and also BERs...

<sup>99</sup> See Guidelines, cit. (fn. 93), para. 2-3.

<sup>100</sup> See e.g. Soltesz et al., "The "temporary framework"--the Commission's response to crisis in the real economy", (2010) *ECLR* 106 at 107-108; also Guidelines, cit. (fn. 93), para. 4.

<sup>101</sup> Guidelines, cit. (fn. 93), para. 15.

<sup>102</sup> *Ibid.*; see also, inter alia, Soltesz, cit. (fn. 99), pp. 108-109.

<sup>103</sup> Guidelines, cit. (fn. 93), para. 17.



justified on the grounds of "serious social difficulties", as well as being unable to adversely affect competition in other Member States to a significant extent; it should also be repaid within six months of the first rata being paid to the recipient and its amount should also be strictly limited to what is necessary "to keep the firm in business" for the required period.<sup>104</sup> In addition, the Member State concerned is obliged to provide, within the same six month period, the Commission with a "restructuring plan or a liquidation plan or proof that the loan has been reimbursed in full" or that the guarantees have been terminated by the same deadline.<sup>105</sup>

The approach to "restructuring aid" is, instead, more complex: according to the Guidelines, aid will only be authorised once in ten years and if the notification is accompanied by a restructuring plan detailing "appropriate" measures destined to bring the firm back to operating viably on the market within the shortest time possible.<sup>106</sup> In addition "compensatory measures", such as, *inter alia*, the divestiture of assets or reductions of capacity or of its market share must be adopted in order to ensure that any distortions of competition are kept to a minimum and that in particular "the positive effects outweigh the negative ones".<sup>107</sup> The aid recipient is also obliged to make a "significant own contribution" to the restructuring costs (50% at a minimum).<sup>108</sup> In all, the Rescue and Restructuring Guidelines, in light of the objectives set in Lisbon in 2000, sought to achieve greater competitiveness in the EU economy and to respond to the need to limit the intervention of the Member States only to cases in which aid was truly "the only way out of a crisis" for undertakings which it can be demonstrated are capable of returning to long term viability within a reasonably short term.<sup>109</sup> In particular, it was emphasised that to keep distortion of competition to a minimum the recipient is normally required to make "painful sacrifices" not just via the obligation to make a "significant own contribution" to the costs of its own restructuring, but also via the acceptance of often pervasive limits on its business freedom, such as, *inter alia*, the undertaking to close down "profitable branches" or to divest key assets, in order to limit its transient competitive advantage *vis-a-vis* other rivals.<sup>110</sup>

Paramount to the scrutiny of rescue and restructuring aid was, as was apparent from the Commission's own communications, a clear distrust for financial assistance targeted at failing undertakings and, more generally, the concern for limiting state intervention only to the most "critical" (especially due to the potential social drawbacks) and at the same time more "promising" cases. It was against this background that the Commission was faced with the demands and the concerns posed by the unravelling of the financial crisis. As was explained in section 2.1, after initially adopting a "spectator" position *vis-à-vis* the crisis developments, the Commission sought to intervene more actively in managing its consequences not only for the financial and banking sector, but also (as will be illustrated in the following subsection) in the "real economy", which was also increasingly challenged by the poor availability of credit.

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<sup>104</sup> *Id.*, para. 25.

<sup>105</sup> *Ibid.*

<sup>106</sup> *Id.*, para. 35.

<sup>107</sup> *Id.*, para. 37.

<sup>108</sup> *Id.*, para. 44.

<sup>109</sup> *Inter alia*, Stoltesz, *cit.* (fn. 99), pp. 107-108.

<sup>110</sup> *Id.*, p. 108; see especially Guidelines, *cit.* (fn., 93), para. 45-46.

In the first phase of the financial crisis, following the US sub-prime mortgage crisis and leading up and including the fall of the investment bank Lehmann Brothers, the Commission had witnessed several Member States taking direct action to rescue banks and financial institutions, ranging from the grant of guarantees and loans for recapitalisation to the outright nationalisation of some of the most distressed institutions. Thus, for instance, in the *Northern Rock/Bank of England* case the Commission de facto avoided adopting a decision on the liquidity line granted by the UK central bank to the financial institution Northern Rock on the ground that this type of financial assistance did not constitute “aid” within the meaning of the Treaty.<sup>111</sup> The Commission took the view that since Northern Rock was still able to meet its liabilities at the time in which the line was granted and the latter had been provided at the Bank of England’s own initiative, this measure did not trigger the application of Article 107 TFEU:<sup>112</sup> it was emphasised that, in any event, the grant of this short term credit facility had been backed by “high quality” guarantee and was accompanied by the obligation on the part of the recipient to pay “punitive interest rates”.<sup>113</sup>

However, the initially “conservative approach”, characterised by the application of the Rescue and Restructuring Guidelines discussed so far, was replaced by a far more proactive attitude to dealing with the consequences of the crisis. In this respect, the “turning point” was represented by the conclusions adopted by the ECOFIN ministers on 7 October 2008.<sup>114</sup> At that meeting it was agreed that state financial “interventions should be timely” and of limited duration; Member States should remain “watchful regarding the interests of taxpayers” as well as capable of determining a change in management; and shareholders of institutions in crisis should “bear the due consequences of the intervention”.<sup>115</sup> Paramount to these conclusions was the recognition that the crisis had become “systemic”, i.e. had become capable of not only leading to the downfall of “unstable” banks, but also to adversely affect “fundamentally sound” financial institutions.<sup>116</sup> At the same time, however, the Ministers expressed the view that any aid targeted at supporting failing banks should, despite being granted at national level, be inspired by “common EU principles” and in particular uphold principles of openness and non-discrimination, especially vis-à-vis non-European institutions.<sup>117</sup>

Thus on 13 October 2008 the Commission issued a Communication concerning the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (hereinafter referred to as the Banking Communication).<sup>118</sup> The Communication laid down the approach that the Commission would apply in scrutinising the state aid measures destined to troubled financial institutions occupying a “systemically relevant” position

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<sup>111</sup> Commission communication of 5 December 2007, COM(2007) 6217.

<sup>112</sup> *Id.*, para. 30-33.

<sup>113</sup> *Ibid.*; for commentary, see e.g. Gilliams, “Stress testing the regulator”, (2011) 36(1) *ELRev* 3 at p. 5-6.

<sup>114</sup> See [http://www.consilium.europa.eu/ueDocs/cms\\_Data/docs/pressData/en/misc/103202.pdf](http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/misc/103202.pdf).

<sup>115</sup> *Id.*, p. 2.

<sup>116</sup> *Ibid.* See also, inter alia, Gerard, cit. (fn. 1), pp. 8-9; also Zimmer et al., “The role of competition in European State aid control during the financial markets crisis”, (2011) *ECLR* 9, pp. 9-10.

<sup>117</sup> *Id.*, pp. 2-3.

<sup>118</sup> [2008] OJ C270/8.

within the market.<sup>119</sup> The framework proposed in the Banking Communication was expressly regarded as a derogation from the generally applicable Rescue and Restructuring Guidelines and the powers of assessment exercised by the Commission in this specific respect were based on Article 107(3)(b), i.e. on the provision conferring on the Commission the power to assess and approve aid destined to “remedy a serious disturbance in the economy of a Member State”.<sup>120</sup> According to the Communication, this requirement had been fulfilled due to the nature of the crisis and in particular to the real and grave danger that the overall financial system of the EU Members could be jeopardised as a result of the credit squeeze.<sup>121</sup>

On this point, a number of commentators emphasised that this legal basis, which had only been relied upon rarely by the Commission, entailed a rather wide power of appreciation when it came to examining individual aid proposals: it was argued that by justifying its action in light of this clause, the Commission had been able to depart from its general approach, enshrined in the 2004 R&R Guidelines, for the purpose of meeting the goals and expectations set at the 2008 ECOFIN Council Meeting.<sup>122</sup> As a result, it could adopt decisions in accordance with a more flexible set of criteria and “wave through” those forms of financial aid that aimed at attaining goals going “beyond competition”, such as the “restoration of long term profitability” of a hitherto “troubled” bank,<sup>123</sup> thereby limiting the adverse consequences of the current financial disturbance.<sup>124</sup> At the same time, however, the Commission was profoundly conscious of the need to carefully “calibrate” the scope and the nature of this financial intervention and in particular of the need to send a clear message that its approach would be limited only to “genuinely exceptional circumstances” in which the financial instability of one institution would threaten the “entire functioning of the financial markets”.<sup>125</sup> The Commission was especially concerned with preventing individual member states from relying on the “serious financial disturbance” ground to “prop up” national champions.<sup>126</sup>

As was anticipated, this cautious attitude had been rather apparent in the practice preceding the downfall of Lehmann Brothers in which the Commission had shown significant scepticism at the circumstance that the overall stability of the banking sector within a Member State could be threatened by the crisis engulfing a single institution.<sup>127</sup> Accordingly, it had been slow to authorise under Article 107(3)(b) financial assistance targeted at a specific bank, preferring, instead, to apply the rather restrictive standards laid down in the general R&R Guidelines.<sup>128</sup> However, the events of September 2008 brought into sharp focus the fact that even the instability of one operator could

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<sup>119</sup> *Id.*, para. 4.

<sup>120</sup> *Id.*, para. 6-7.

<sup>121</sup> *Id.*, para. 8.

<sup>122</sup> *Id.*, para. 3; see also para. 10.

<sup>123</sup> Zimmer et al., cit. (fn. 115), p. 114-115.

<sup>124</sup> Banking Communication, cit. (fn. 114), para. 10; see also para. 13.

<sup>125</sup> See *id.*, para. 11.

<sup>126</sup> *Inter alia*, Gilliams, cit. (fn. 112), p. 5-6.

<sup>127</sup> See *inter alia*, Commission decision of 27 June 2007, BAWAG, COM(2007) 3038 final, especially para. 168-170.

<sup>128</sup> *Id.*, para. 171 ff.; for commentary, see Gilliams, cit. (fn. 112), pp. 7-8.

provoke bank runs and, more generally, undermine the overall solidity of the banking sector within the notifying Member State, in appropriate circumstances.<sup>129</sup>

This change in approach, albeit accompanied by considerable caution, to the application of Article 107(3)(b) was made apparent in the *Roskilde* decision, adopted shortly after the issuing of the Banking Communication: in that decision, concerning the grant of liquidation aid to Roskilde Bank, the Commission held that this type of financial assistance, which constituted “aid” within the meaning of Article 107(1) TFEU, was compatible with Article 107(3)(b), on the ground that it had been designed to address the risks arising from the winding up of Roskilde Bank for the overall stability of the Danish banking system.<sup>130</sup>

However, the decision highlighted the inherently “exceptional” nature of this type of assistance and the ensuing need to scrutinise it carefully, especially as to its “appropriateness” and “proportionality”.<sup>131</sup> On this specific point, it should be emphasised that, despite not being applicable to the case, some of the general principles laying at the core of the “ordinary” R&R Guidelines should guide the assessment of liquidation aid to the extent that this is necessary to integrate the approach adopted by the Banking Communication.<sup>132</sup> More generally, it may be suggested that, although the 2008 Communication sought to make the approach to state aid supervision in the banking sector more flexible and thereby more responsive to the challenges of the post-Lehmann crisis. Thus, the Commission emphasised at the outset that these emergency measures would only be approved within the banking sector and especially to tackle the consequences that the crisis could have for the economy of the notifying Member State as a whole.<sup>133</sup> Also, while “individual” assistance could be granted, subject to approval on a case-by-case basis, the Communication seemed to prefer “aid schemes” that could be accessed, at least in principle, by all institutions, in accordance with objective and non-discriminatory access criteria.<sup>134</sup> In addition, any measure could only be of limited duration and even though it could have been difficult to predict the length of time for which it may have been required, it should have been subjected to monitoring and review at regular, short intervals.<sup>135</sup>

As to the eligibility for this type of aid, the Commission drew a distinction between “illiquid but otherwise financially sound” undertakings and those institutions who were “troubled” due to “endogenous” factors. In respect to the former, it was held that since their instability was owed to the impact of the present circumstances on their management, rather than to, e.g. “excessive risk taking”, any distortion of competition likely to follow from the grant of aid would have been limited and the scope of the intervention itself would have been narrower.<sup>136</sup> By contrast, granting financial assistance to banks or financial institutions who were experiencing turmoil due to “poor

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<sup>129</sup> Gilliams, cit. (fn. 112), p. 8 ff.

<sup>130</sup> Commission decision of 5 November 2008, COM(2008) 6498; see especially para. 54 ff.

<sup>131</sup> Id., para. 73-75.

<sup>132</sup> Id., para. 76.

<sup>133</sup> 2008 Banking Communication, para. 11.

<sup>134</sup> Id., para. 9-10

<sup>135</sup> Id., para. 12-13.

<sup>136</sup> Id., para. 14.

management” or “reckless choices” in respect to assets would have required a far more careful examination, due to their greater intensity and, consequently to the greater likelihood that they would result in significant distortion of competition.<sup>137</sup> On this point, the Communication stated that, in principle, the Rescue and Restructuring Guidelines should remain applicable to these forms of aid: consequently, the notifying state would remain obliged to provide a “restructuring plan”, whose approval is subject to the existence of appropriate compensatory measures and to the giving of a suitable and proportionate “own contribution”.<sup>138</sup>

By contrast, aid targeted at “sound but illiquid” institutions is made subject to the Communication’s less stringent conditions. In principle, according to the 2008 Communication, aid should be “well-targeted”, that is, capable of effectively address a serious economic disturbance; it should be “proportionate” to the objective being sought and “not going beyond what is required” to achieve this goal; and finally, it should be “designed in such a way as to minimize negative spill-over effects” on rivals, other economic areas or other Member States.<sup>139</sup>

To achieve these objectives, the Commission took the view that eligibility for aid, in the form of either guarantees or loans aimed at recapitalising the recipient, should be determined in light of objective and non-discriminatory criteria and be available to both institutions incorporated in the territory of the Member State concerned and institutions which have “significant activities” therein.<sup>140</sup> These guarantees should only cover certain types of liabilities, such as, *inter alia*, retail deposits, which are to be selected having regard to the nature of the difficulties experienced by the institution and to what is “necessary to confront the relevant aspects of the current financial crisis”, ostensibly to avoid “generating moral hazard” and thereby aggravate the crisis itself.<sup>141</sup> Any form of financial assistance should also be granted for a limited period of time: although, in derogation from the R&R guidelines, there is no fixed deadline of 6 months for repayment, the Communication states that any measure should be subjected to regular review at least every six months.<sup>142</sup>

In addition, any financial contribution should be “limited to a minimum”, that is, it should “ensure an adequate private sector contribution from the beneficiaries and/or the sector” to its costs, in the form of “adequate remuneration” or, if required, of the “coverage of at least a considerable part of the outstanding liabilities incurred” by the recipient.<sup>143</sup> Finally, to avoid or at least minimize any distortion of competition resulting from the aid, the latter must entail the imposition of “appropriate mechanisms to minimise (...) the potential abuse of the preferential situations of beneficiaries” and also limiting the risk of moral hazard.<sup>144</sup> These “safeguards” can entail behavioural constraints, aimed especially at preventing aggressive expansion by the beneficiary, the introduction of limits as to the latter’s market share or presence in the industry or as to its ability to

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<sup>137</sup> *Ibid.*; for commentary, *inter alia*, Zimmer et al. (fn. 112), p. 15.

<sup>138</sup> *Id.*, para. 14-15; see e.g. Zimmer et al., *cit.* (fn. 112), pp. 11-12.

<sup>139</sup> Banking Communication, *cit.* (fn. 114), para. 15.

<sup>140</sup> *Id.*, para. 18; see also para. 35 and 37 for recapitalisation schemes.

<sup>141</sup> *Id.*, para. 19-20.

<sup>142</sup> *Id.*, para. 24.

<sup>143</sup> *Id.*, para. 26; see also para. 38 for recapitalisation schemes.

<sup>144</sup> *Id.*, para. 27; see also para. 39 for recapitalisation schemes.

engage in “advertising invoking the guaranteed status” or the “prohibition of conduct (...) irreconcilable with the purpose” of the assistance, such as, e.g., issuing new “stock options for management”.<sup>145</sup>

The Communication also makes clear that, state aid being temporary even in these cases, its supply must be accompanied by the provision of “necessary adjustment measures for the sector”, including, if appropriate, the liquidation of some of the beneficiaries.<sup>146</sup> In this specific respect, when assistance is given as part of a recapitalisation scheme, the Commission will ensure that the results of the operation are “coherent” with those arising from an “ordinary” recapitalisation, i.e. one authorised in accordance with the R&R Guidelines, to account for the circumstance that these types of operation are, by their very nature, an irreversible impact on the market.<sup>147</sup>

The Banking Communication was followed by a number of Guidelines dealing with specific forms of aid to financial institutions, ranging from recapitalisation to the management of “impaired assets”.<sup>148</sup> These documents are destined to supplement the discipline contained in the Banking Communication and, in that context, provide additional requirements for the purpose of obtaining the authorisation of notified aid: for instance, the 2009 Restructuring Communication makes clear that the notifying Member States must provide a “viability report” in order to demonstrate that, through the provision of the aid, the bank will be restored to long-term ability to conduct safely its business.<sup>149</sup>

Thus, in the *Aegon* decision, for instance, the Commission emphasised that the report should explain the weaknesses and the difficulties characterising the aid recipient;<sup>150</sup> it should also illustrate what measures the latter proposes to adopt in order to address them and show how the recipient is going to return to long term viability, that is, which measures it is going to put in place in order to become capable, once again, of meeting its liabilities and, in particular, to cover all its costs and to secure an “adequate” return on capital.<sup>151</sup> Consequently, it was suggested that, while the Banking Communication and its “supplementary” documents aim to respond to the demands of the crisis by promoting a more flexible and in many ways relatively more “generous” approach to aid scrutiny, the Commission is likely to conduct a very thorough inquiry as to how these more lenient criteria are met in each case and for this purpose it is going to require the aid recipients to provide an exhaustive and sound case in support of intervention, by demonstrating how, in detail, they are going to restore their business activities to long term viability.<sup>152</sup>

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<sup>145</sup> *Id.*, para. 29.

<sup>146</sup> *Id.*, para. 29; see also para. 41-42 for recapitalisation schemes.

<sup>147</sup> *Id.*, para. 42.

<sup>148</sup> See Commission Communication on the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition, [2008] OJ C10/2; also Commission communication on the treatment of impaired assets in the Community banking sector, [2009] OJ C72/1; for commentary, see inter alia Kapsis, “The impact of the recent financial crisis on EU competition policy for the banking sector”, (2010) *J Int’s Trade L and Pol.* 256 at 264-265.

<sup>149</sup> Commission communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, [2009] OJ 195/4, see especially para. 55 ff.

<sup>150</sup> Commission decision of 17 August 2010, COM(2010) 5740, para. 98.

<sup>151</sup> *Id.*, para. 97; see also para. 99.

<sup>152</sup> See e.g. Gilliams, cit. (fn. 112), p. 14-15.

Importantly, the Commission also undertook to provide clearance of new aid measures destined to prevent spill-over effects stemming from the lack of confidence in the financial sectors very rapidly, sometimes even overnight. A very important example of the quicker and more streamlined administrative arrangements was represented by the 2008 approval of the aid scheme proposed by the UK authorities for the purpose of propping up its own baking sector, which was imperilled as a result of excessive credit exposure and use of leverage.<sup>153</sup> The notified package comprised a recapitalisation and a guarantee scheme along with the provision of short term liquidity.<sup>154</sup> In its decision the Commission confirmed the UK Government assessment of the scope and the depth of the crisis and took the view that the risks that the lack of liquidity could have for the British economy at large were such as to justify the application of Article 107(3)(b).<sup>155</sup>

Thereafter, the Commission assessed the aid package and found that it fulfilled the three parameters of “appropriateness”, “necessity” and “proportionality”: first of all, all the measures were available to all the “solvent” financial undertakings whose stability may be jeopardised by the credit squeeze; second, the assistance was limited in its duration and scope, as well as securing to the state an “adequate return on its investment”. And finally, the recipients had to accept significant limitations in their business freedom, designed to prevent them from engaging in “aggressive expansion” and in strategies that could irremediably distort competition to their advantage.<sup>156</sup> As was anticipated in section 2.1, the British authorities were especially concerned with reinforcing the stability of the Lloyds Banking Group, following its takeover of Halifax/Bank of Scotland.<sup>157</sup> As will be considered in more detail further below, Lloyds had acquired HBoS, which faced serious risks of bankruptcy due to its aggressive lending practices and its excessive use of leveraging: to ensure the overall stability of the merged entity, the British Authorities allowed the Lloyds Banking Group to benefit from the domestic Asset Protection Scheme, designed to refund part of Lloyds’ losses and to provide state guarantees to back the issuing of new shares. The recipient also undertook to provide a significant own contribution toward covering the costs for restructuring and to divest significant portions of its portfolio of activities, especially in the retail banking sector, so as to allow a new entrant to penetrate this market segment and thereby facilitate the intensification of competition.<sup>158</sup>

Following the publication of the Banking Communication, the “impaired asset relief measure” was eventually approved, together with a restructuring plan, in December 2009:<sup>159</sup> the Commission took the view that thanks to the assistance provided by the British Treasury, the recipient could have returned to long term viability as well as reacquired the confidence of the markets, by “shedding” the riskiest assets and upholding “good management” practices.<sup>160</sup> It was

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<sup>153</sup> See Press release of 13 October 2008, IP/08/1486; decision N507/2008, C(2009) 6058,.

<sup>154</sup> See Press release of 13 October 2008, IP/08/1486; decision N507/2008, C(2009) 6058, para. 36 ff.

<sup>155</sup> *Id.*, para. 44; see also para. 39-41.

<sup>156</sup> See para. 45 ff.; see especially para. 68-69.

<sup>157</sup> See especially decision N428/2009, 14 December 2009; see also Press Release IP/09/1728.

<sup>158</sup> See Press Release IP/09/1728 of 18 November 2009.

<sup>159</sup> See Press release IP/09/1915; Commission decision N422/2009 and N621/2009, of 14 December 2009.

<sup>160</sup> Commission decision N621/2009, para. 148 ff.

emphasised that, both to avoid moral hazard and limiting undue distortions of competition, the recipient would undertake to contribute significantly to the value of the aid and also to divest key elements of its most profitable businesses.<sup>161</sup>

Similar concerns also guided the Commission's decision in respect to the joint guarantee scheme granted by Luxembourg, Belgium and France in order to support the stability of Dexia, another financial institution active in the banking and insurance markets: Dexia was heavily exposed on the stock market and held risky assets which in turn, due to the impact of the financial crisis, could jeopardise its stability and thereby creating a serious systemic risk for the whole market.<sup>162</sup>

In November 2008 the Commission, in accordance with the Banking Communication's requirements, approved the provision of the joint guarantee. It was held that the notified financial assistance would facilitate Dexia in accessing the finance required to reinforce its stability and thereby restore confidence of the market and of consumers in the recipient's viability;<sup>163</sup> it would also be limited in time and scope and remunerated on the basis of an interest rate determined in light of the ECB's recommendations, thus complying with requirements of necessity and proportionality.<sup>164</sup> Importantly, the aid to Dexia was approved very swiftly for an initial six-month period, subject to continuous supervision and, if the requirements in question continued to be complied with, to the submission of a restructuring plan securing the bank's return to long term viability.<sup>165</sup> Full approval of the guarantee was eventually obtained, subject to conditions, in March 2009.<sup>166</sup>

In light of the forgoing, it is suggested that the framework made up of the 2008 Banking Communication and of its "supplementary" Notices are designed to allow the Commission to reconcile the integrity of the Common Market principles with the demands of managing the aftershocks of the financial crisis in Europe and especially to prevent individual states from "championing" domestic financial institutions to the detriment of institutions whose seat was located elsewhere in the common market.<sup>167</sup> At the heart of the Commission's effort is a concern for limiting the distortions caused by the granting of "selective" aid to banks on the part of public authorities, through the imposition of strict time limit as to the duration of the assistance, the application of objective and non-discriminatory eligibility criteria and the provision for an adequate "private sector contribution" to the costs of recapitalisation and restructuring of financial institutions in crisis.<sup>168</sup>

It is however clear that, to attain these objectives, the Banking Communication carved a number of exceptions to the approach generally applicable to rescue and restructuring operations

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<sup>161</sup> *Id.*, para.153 ff.

<sup>162</sup> See Press Release IP/08/1745. Commission Decision of 19 November 2008, case NN45/4008, COM(2008) 7388; see especially para. 36 to 44.

<sup>163</sup> *Id.*, para. 60-65.

<sup>164</sup> *Id.*, para. 68 ff.; see especially para. 71-72.

<sup>165</sup> See inter alia Press Release IP/08/1745; also Decision, *cit.* (fn. 161), para. 77-78.

<sup>166</sup> Commission Decision, case C9/09, of 19 March 2009, COM(2009) 1960, see especially para. 77-79.

<sup>167</sup> See e.g. Zimmer et al., *cit.* (fn 114), pp. 12-13.

<sup>168</sup> Kapsis, *cit.* (fn. 135), p. 265.



and enshrined in the 2004 Guidelines: first of all, the framework established in the 2008 document is applicable not just to failing” institutions which may require “rescue aid”, but also to banks which were “fundamentally sound but illiquid”, due to factors beyond their control.<sup>169</sup> A second derogation concerns the nature of the aid: as was noted earlier, under the 2004 Guidelines, only rescue aid that is by its nature “temporary and reversible” will be authorised; by contrast, the 2008 Communication envisages that rescue aid aimed at banks through recapitalisation, which is by its own nature irreversible, will be amenable to authorisation.<sup>170</sup> And thirdly, the “once in ten years” limit is not applicable to aid to financial institutions.<sup>171</sup>

In respect to aid targeted at “fundamentally sound but illiquid” undertakings, it should be emphasised that, as was anticipated earlier, these recipients, even when they benefit from aid aimed at their recapitalisation, are not obliged to provide the Commission with a “restructuring plan” or with a plan on the implementation of the notified measures; however, they remain obliged to supply a plan detailing how they can “cover [their own] financing needs also in the long term.”<sup>172</sup> Thus, it could be argued that, despite not expressly requiring the same detailed plans as with “ordinary” R&R operations, the Commission has imposed de facto requirements for aid recipients to give “genuine assurances” that through the financial assistance they will return to long term viability.<sup>173</sup>

In addition, the circumstance that “compensatory measures” are imposed on all beneficiaries and for that purpose are “tailor-made to address the distortions identified on the markets” contribute to ensuring that a “level playing field” across the relevant market is maintained for the medium- and long-term.<sup>174</sup> The 2008 Banking Communication was accompanied by a number of administrative “adjustments” to the scrutiny and approval procedure and in particular by an express commitment of the Commission to examine notified measures as quickly as possible, and preferably within 24 hours of submission.<sup>175</sup>

Against this background, it may be queried whether the Commission has succeeded in its stated aim to address the challenges of the financial crisis, especially for the banking sector. It was noted earlier that, after initially taking a “back seat” position vis-à-vis the unfolding of the crisis itself, the Commission sought to adopt a far more proactive stance with a view to addressing these challenges while at the same time maintaining the integrity of the single market principles. It was argued that, on the one hand, the Commission accepted somehow reluctantly to adopt the relatively more flexible framework for assessment provided in Article 107(3)(b) TFEU (i.e. the “serious disturbance of the economy” ground);<sup>176</sup> on the other hand, however, it laid down a set of requirements, such as, inter alia, the obligation for the notifying Member State to apply “objective

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<sup>169</sup> Banking Communication, cit. (fn. 114), para. 13; for commentary see Gilliams, “Stress testing the regulator”, (2011) 36(1) ELRev 3 at p. 11.

<sup>170</sup> Gilliams, cit. (fn. 138), p. 12.

<sup>171</sup> Id., p. 13.

<sup>172</sup> Id., p. 16.

<sup>173</sup> Ibid.; see also Kapsis, cit. (fn. 135), p. 265.

<sup>174</sup> Id., p. 20.

<sup>175</sup> See e.g. <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1495&format=HTML&aged=0&language=EN&guiLanguage=en>.

<sup>176</sup> Id., p. 7-8.

and non-discriminatory” conditions, the duty to “offer sufficient guarantees for the aid recipient’s long term viability” and the provision for frequent review of the implementation of the assistance,<sup>177</sup> all of which were designed to secure adherence to, as far as possible, single market and genuine competition principles.<sup>178</sup>

Thus, in light of the forgoing remarks, it may be concluded that the 2008 Banking Communication constituted evidence of the Commission’s “smart pragmatism” in reconciling these sometimes divergent objectives.<sup>179</sup> Guided by the need to tackle the crisis’ consequences and prevent it from spilling over to other areas, the Commission employed the existing state aid tools in more flexible, speedier and therefore more responsive ways. As was aptly put by Gilliams, the circumstance that the Commission decisions were hardly even challenged should be taken as a confirmation of the fact that, all in all, the approach adopted in the 2008 Communication represented a “fair and balanced deal” for banks and for the member states. However, it is clear that the Communication only addressed the challenges posed by the crisis to the banking sector, without directly addressing its impact on the real economy and especially the consequences of the “credit squeeze”. The next section will therefore deal in brief with the “Temporary Framework to support the access to credit” (hereinafter referred to as Temporary Framework)<sup>180</sup> during the crisis and in that context will examine the question of whether the rules on state aid were effectively applied to secure the liquidity of businesses operating in the “real economy”.

### *3.2. The financial crisis and the “real economy”: the “Temporary Framework” for “real” enterprises affected by the credit squeeze*

The previous section provided a brief analysis of the approach adopted by the Commission in respect to state aid granted to banks and emphasised how, at the heart of these efforts, was a concern for reconciling the need to take swift action in order to tackle the adverse effects of the crisis with the integrity of the single market: this “balancing” was expressed in the adoption of a relatively more flexible and generous approach to state aid, albeit subject to many of the more scrupulous requirements that had formed the backbone of the generally applicable R&R Guidelines. It is however clear that the Banking Communication only dealt with the serious disturbances, whether actual or potential, arising from the instability of financial institutions; it did not, therefore, lay down any measures designed to tackle the “aftershocks” of the crisis for enterprises operating in the “real economy”, i.e. those undertakings that ran non-financial activities and which required access to credit for the purpose of financing their commercial ventures.

Especially after the downfall of Lehmann Brothers it became clear that the financial crisis had become “systemic”, in the sense of, inter alia, having spread to the “real economy”. The effects of the credit squeeze were aptly captured by the Commission in its 2011 Communication on a “Temporary Union framework for State aid measures to support access to finance in the current financial and economic crisis”:

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<sup>177</sup> Id., p. 8; see also pp. 24-25.

<sup>178</sup> Id., p. 9-10.

<sup>179</sup> Gilliams, cit. (fn. 138), p. 25.

<sup>180</sup> Commission Communication on the Temporary Union framework for State aid measures to support access to finance in the current financial and economic crisis, [2011] C6/5.

“(…) The financial and economic crisis caused a serious downturn of the real economy, hitting households, business and jobs. Expectations on growth rapidly dropped and both trade and investments were quickly scaled down. Banks had, on the one hand, to deleverage and absorb losses and, on the other hand, to re-price risks, thereby becoming more risk-averse. Even creditworthy businesses faced sudden problems in gaining access to finance.(…)”<sup>181</sup>

To respond to these challenges, the Commission, once again, derogated from its “traditional” approach to state aid, enshrined in the R&R Guidelines, with a view to providing a temporary “lifeline” to those undertakings which, despite being fundamentally solid, are faced with serious challenges to their viability due to the scarce availability of credit. For this purpose, the Temporary Framework Notice, issued in January 2009 and originally in force only until the end of 2010, stated that financial assistance targeted at undertakings that find it difficult to access finance through the “normal channels” will be authorised under Article 107(3)(b) if it meets certain criteria. These criteria concern the type of assistance, the state of the recipient and the conditions at which the aid is granted. It is clear from the Communication that the Commission was especially concerned with avoiding that the Temporary Framework could be used to circumvent the limits of the R&R Guidelines and in particular could be applied in a way that defeated the objectives and the key principles of the single market, especially by encouraging a “subsidy race” among Member States.<sup>182</sup> On this point, it should be emphasised that the Commission was particularly vigilant in assessing the measures proposed by the German government to support the stability and restore the long term viability of Opel in 2009: <sup>183</sup> Commissioner Kroes, speaking in front of the European Parliament, made clear that the provision of financial assistance under the Temporary Framework could in no way be subjected to additional conditions, linked, for instance, to restrictions as to the location of the investment and to the retention of staff in specific areas of the single market.<sup>184</sup>

For this purpose, the Communication made clear that this type of aid could only be offered as part of a national scheme, regardless of where they had their seat and could not favour national over non-national goods or services.<sup>185</sup> In respect to eligibility, only undertakings that are fundamentally financially “solid” and who have experienced difficulties in accessing credit after 1 July 2008 can benefit from this assistance.<sup>186</sup> In addition, the Communication does not prejudice the applicability of other instruments, such as, *inter alia*, aid supplied to support research and development or regional aid, if the recipient meets the relevant thresholds governing eligibility for this kind of assistance: however, aid under the Temporary Framework cannot be combined with financial

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<sup>181</sup> Commission Communication on a Temporary Union Framework for State aid measures to support access to finance in the current financial and economic crisis, [2011] OJ C6/5, para. 1.1.

<sup>182</sup> See *id.*, especially para. 1.2; for commentary, see Soltesz et al., *cit.* (fn. 99), pp. 108-109.

<sup>183</sup> See *inter alia* Commission decision on aid to Opel Europe, Memo/09/411, 23 September 2009.

<sup>184</sup> See Speech given to the European Parliament, Plenary Session of 14 September 2009, SPEECH/09/388.

<sup>185</sup> Communication, *cit.* (fn. 167), para. 2.3; see also Soltesz, *cit.* (fn. 99), p. 109.

<sup>186</sup> Communication, *cit.* (fn. 167), para. 1.2.

assistance deemed to fall outside the scope of Article 107 on the basis of the “De Minimis” rules that is being supplied to cover the same costs.<sup>187</sup>

Member States are limited in the number options that they can choose from as regards the type of financial assistance that they can provide: the Communication states that, to benefit from this “more lenient” regime, aid must be granted in the form of either a loan for up to Eur.500,000 over two years, or of a state guarantee for bank loans granted at a special interest rate.<sup>188</sup> These “advantageous” loans can also be granted directly by the State.<sup>189</sup> Importantly, when the aid is granted in the form of state guarantees, the latter cannot exceed 80% of the value of the loan, which in turn cannot be of a higher value than the value of the wage bill of the recipient; as to the level of interest rate, the Communication states that “preferential” rates are set at 15% if the recipient is a small /medium sized enterprise, or by the premium rate calculated by the Commission on the basis of the “safe harbour” clauses contained in the Annex to the Communication.<sup>190</sup>

The possibility to provide “cheap state loans” is another key feature of the Temporary Framework: states can grant “public or private loans” at preferential rates, calculated solely on the basis of central bank overnight rates and thus, significantly lower than “normal commercial rates”.<sup>191</sup> This form of support appears particularly attractive, since it does not seem to be subject to the same “wage bill” limit as other forms of assistance: however, the Commission will be willing to supervise closely these measures to ensure that they are “strictly necessary” to overcome temporary liquidity problems.<sup>192</sup>

Due to the limited purvey of this paper it is not possible to analyse in any more detail the temporary framework. However, some remarks can be made: it is undeniable that the issuing of the 2008 Communication sought to provide a “more lenient” regime vis-à-vis the one otherwise applicable, in light of the R&R Guidelines to respond to the immediate dangers of the financial crisis for the “real economy”.<sup>193</sup> The Commission was faced with the challenge of providing an effective response to the effects of the credit squeeze on “non-financial” enterprises and at the same time of maintaining the integrity of the single market principles, including those of genuine competition.<sup>194</sup> It is suggested that the long-held view that state aid should be “exceptional” and limited only to cases in which it was both appropriate and “necessary and proportionate” was reflected in a number of features of the Temporary Framework, such as, inter alia, the limited options available to the member states as regards the forms of available assistance and the limits as to the value of loans and guarantees.<sup>195</sup>

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<sup>187</sup> *Id.*, para. 2.6; see also Soltesz, p. 110.

<sup>188</sup> Communication, cit. (fn. 167), para. 2.2; also Soltezs, cit. (fn. 99), pp. 109-110.

<sup>189</sup> *Ibid.*

<sup>190</sup> Communication, cit. (fn. 167), para. 2.3.

<sup>191</sup> *Id.*, para. 2.4; see Soltesz, cit. (fn. 99), p. 113.

<sup>192</sup> Soltesz, cit. (fn. 99), p. 113; also, *mutatis mutandis*, Marsden and Kokkoris, “The role of competition and state aid policy in financial and monetary law”, (2009) JIEL 875 at 888-889.

<sup>193</sup> *Inter alia*, Soltesz et al., cit. (fn. 99), pp. 109-110.

<sup>194</sup> *Id.*, pp. 108-109.

<sup>195</sup> *Id.*, p. 114.

In addition, and out of a concern for upholding principles of non-discrimination and market openness, the Framework enshrines a clear preference for “general schemes”, as opposed to individual aid, and emphasises the need for aid to be applicable to all undertakings operating in a specific economic sectors, on the basis of objective and transparent criteria.<sup>196</sup> At the same time, however, some flexibility is allowed, such as the possibility to “cumulate” aid under the Temporary Framework with other forms of assistance and the “benevolent” provisions as regards especially “cheap loans”, thus showing the willingness of the Commission to adopt a more generous approach to state intervention designed to overcome the consequences of the credit squeeze.<sup>197</sup>

The Temporary Framework was however criticised for the lack of flexibility on other important aspects. For instance, the Communication does not contain any indication of the criteria applicable to determine if the former are “sound but in difficulty” due to the credit squeeze. Also, it is clear that unlike under the R&R Guidelines, Member States are tightly constrained when it comes to both the nature of the assistance that they can grant and the amount for which the latter can be supplied, especially if it takes the form of guarantees. On this point, Soltesz argued that the 80% rule constitutes a “serious obstacle when it comes to structuring and negotiating financial agreements”, since it obliges de facto each recipient to find and provide an additional guarantee to cover the risk concerning the remaining part of the loan.<sup>198</sup> Also, there is no full legal certainty when it comes to granting these types of aid: no formal “notification procedure” is provided and consequently the risk is that, when individual Member States wanted to grant aid subject to conditions that are not “perfectly mirroring” the Communication, they would notify their schemes just to be on the safe side, something that the Framework wanted to avoid.<sup>199</sup>

Overall, commentators argued that the Temporary Framework may not always provide a more “attractive” option to individual states compared with the ordinary R&R Notice, mainly on the grounds that the latter entails greater flexibility, in terms of choosing among the available forms of financial assistance, for the Member States, as well as potentially allowing for 100% loans and guarantees.<sup>200</sup> Also, even though the Temporary Framework does not require the submission of “restructuring plans” or indeed the supply of an own contribution, it would appear that the Commission tends to “read additional conditions” into it, so as to prevent it from becoming a tool to circumvent the limits of the R&R.<sup>201</sup> In light of the forgoing it may be concluded that the Temporary Framework represented an ambitious attempt to address the shockwaves that the credit squeeze has had (and continues to have, even though its period of applicability has now expired) for the real economy. However, it is also apparent that it remains in many aspects relatively inflexible and therefore not always able to provide the assistance that is appropriate to meet the needs of the firms that are potentially eligible for financial assistance. It is acknowledged that the Commission was faced with the need to reconcile the concurrent, and sometimes diverging demands of managing the crisis on the one hand and of “keeping the single market together” on the other, and

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<sup>196</sup> *Id.*, p. 110.

<sup>197</sup> Communication, cit. (fn. 167), para. 2.4. and 2.6; for commentary, inter alia, Soltesz, cit. (fn. 99), p. 113.

<sup>198</sup> Soltesz, cit. (fn. 99), p. 111-112.

<sup>199</sup> *Id.*, p. 114.

<sup>200</sup> *Ibid.*

<sup>201</sup> *Id.*, pp. 114-115.

therefore it could not afford to “sell state aid cheaply”. However, it is equally clear that on its own the Temporary Framework could not give a unitary answer to these challenges which therefore required, alongside these “generally applicable” standards, the continuing vigilance of the Commission on individual aid measures via the notification procedure.

### 3.3. Industrial restructuring in times of credit squeeze: the role of EU merger policy in the economic crisis

The previous sections briefly analysed the approach adopted by the EU Commission in the supervision of state aid measures destined to “cushion” the economy from the consequences of the financial crisis: it was argued that, despite maintaining a critical attitude to state intervention in the economy, the Commission was prepared to utilise its powers in this area relatively flexibly and pragmatically, with a view to responding to the challenges created by the crisis both for the banking and financial sectors and, more widely, for the “real economy”. At the heart of this effort was the need to counterbalance the demands of managing the crisis and especially of preventing the credit squeeze from damaging fundamentally “solid” companies active in “real” sectors of the economy with maintaining the integrity of the single market, in particular with a view to avoiding the emergence of “national champions” and, more generally, permanent distortions of competition.

It is suggested that similar concerns have guided the Commission in its approach to merger policy. In a speech given in March 2011, Commissioner Almunia observed that although the recession had resulted in a drop in mergers and acquisitions overall, the restructuring of certain economic sectors (such as, among others, energy and air transport) had continued as the expression of “defensive strategies” adopted by companies affected by the downturn and operating within the same market.<sup>202</sup> This trend toward the “consolidation” of potentially “ailing” businesses into stronger and bigger conglomerates is a well-known response to challenging times;<sup>203</sup> however, it is also liable to have potentially negative consequences for competition, such as an increase in concentration and, as a consequence, greater ease of coordination, if not of tacit collusion, among competitors and the creation of artificial barriers to entry vis-à-vis potential competitors, who would be faced with powerful, often national incumbents.<sup>204</sup> At the core of the merger policy agenda was a more general concern for upholding single market principles and thereby avoiding “protectionist pushes” on the part of the Member States.<sup>205</sup>

It may be argued that the initially “passive” role adopted by the Commission at the onset of the financial crisis, coupled with the demands of addressing the challenges that the latter entailed for the continued existence of the financial sector, prompted the Member States to act unilaterally, especially by “orchestrating” mergers designed to salvage ailing companies:<sup>206</sup> but how can such

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<sup>202</sup> “Merger Regulation in the EU after 20 years: EU merger control has come of age”, speech given on 10 March 2011, SPEECH 11/166.

<sup>203</sup> See e.g. Lowe, “Competition policy and the economic crisis”, (2009) 5(2) CPI, available at: [http://ec.europa.eu/competition/speeches/text/cpi\\_5\\_2\\_2009\\_en.pdf](http://ec.europa.eu/competition/speeches/text/cpi_5_2_2009_en.pdf), pp. 16 ff.

<sup>204</sup> See inter alia Geradin et al., “Industrial policy and European Merger Control: a reassessment”, (2011), available at <http://ssrn.co/abstract=1937586>; see especially pp. 13-14 and 17-18.

<sup>205</sup> Ibid.; see also, inter alia, Marsden and Kokkoris, cit. (fn. 193), pp. 877-878.

<sup>206</sup> Geradin et al., cit. (fn. 205), pp. 17-18.

action be justified if the merger in question clearly has a “Community dimension”? It should be emphasised that Article 21(4) of the Merger Regulation, which authorises Member States to adopt “appropriate measures to protect legitimate interests”, so long as these measures remain compatible with the core principles of EU law and aim to address “non-competition concerns”.<sup>207</sup>

Thus, it was suggested that this provision could not be invoked to overcome the concerns for the integrity of competition raised by the Commission and, consequently to “by-pass” its decision to declare the merger incompatible with the common market solely for the purpose of, *inter alia*, maintaining the financial stability within one Member State.<sup>208</sup> Against this background, it may be argued that the concentration involving Lloyds TSB and Halifax/Bank of Scotland presented both the European and the British competition authorities with a clear challenge: on the one hand, it made the the OFT and the British authorities realise the magnitude of the challenges of the nearly looming downfall of a major bank, with clear risks for the overall economy. And on the other hand, it prompted the Commission to reflect on how it should react to the risks for the unity and integrity of basic EU principles, such as the need to preserve the openness and the rivalry of the internal market, especially *vis-à-vis* the danger of “protectionist” pushes.<sup>209</sup>

As is well known, the Commission approved *ex post* the United Kingdom’s decision to authorise the merger in the public interest, despite the concerns for competition that the latter raised.<sup>210</sup> It should be emphasised that the UK authorities had been confronted with similar questions. However, in the event the British authorities, rather than relying on the domestic framework for the assessment of transactions *prima facie* giving rise to “relevant merger situations”, carved an additional “public policy exception”, *i.e.* the need to maintain financial stability, to justify the ministerial approval of the merger without it being necessary for the latter to be referred to the Competition Commission.<sup>211</sup>

Although this decision was probably the only way forward to address the predicament in which HBOs was, it posed important questions for the future of merger policy in tough times, when industrial consolidation had the potential of becoming more and more important as a “way out” of the crisis.<sup>212</sup> In particular, it became especially clear that in order to prevent the Member States from distorting competition and hampering the openness of the single market, the Commission had to adopt a far more involved attitude to merger review.<sup>213</sup> In 2009, the then Commissioner Neelie Kroes argued that the merger control framework was sufficiently flexible to provide principled and timely treatment for notified transactions, not just by making full use of the swift procedure prescribed by the Regulation, but also by relying on established legal and economic concepts, such

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<sup>207</sup> See *inter alia* Pouncey and Bukovics, “Merger control, credit-crunch style”, (2009) 30(2) ECLR 67 at 70.

<sup>208</sup> *Id.*, p. 71.

<sup>209</sup> *Id.*, p. 72-73.

<sup>210</sup> See e.g., *mutatis mutandis*, press release IP/08/1496 of 13 October 2008, available at: <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1496&format=HTML&aged=0&language=EN&guiLanguage=en>.

<sup>211</sup> See OFT report, 31 October 2008, available at: <http://www.of.gov.uk/OFTwork/mergers/decisions/2008/LloydsTSB>, and Conclusions of the Secretary of State for Business, Innovation and Skills, available at: <http://www.bis.gov.uk/policies/business-law/competition/mergers/mergers-with-a-public-interest/maintaining-the-stability-of-the-uk-financial-system>. For commentary see Marsden and Kokkoris, *cit.* (fn. 193), pp. 879-880.

<sup>212</sup> *Id.*, p. 880; see also Gerard, *cit.* (fn. 1), p. 8-9.

<sup>213</sup> See e.g. Geradin *et al.*, *cit.* (fn. 205), p. 17.

as the failing firm defence.<sup>214</sup> She observed that the EU merger rules allowed the Commission to deal rapidly with the challenges posed by the crisis and especially to take into account the rapidly evolving market conditions, without the need for further changes to the present system.<sup>215</sup>

Philip Lowe, then Director General for Competition, commenting on the recent mergers occurred in the banking sector, expressed the view that, while financial stability may be the primary driver in the short and medium term, it was indispensable to protect and strengthen the competitive structure of this and other markets in the long run.<sup>216</sup> Thus, he suggested that the Commission should continue to rely on its framework for merger control in order to respond to the consequences of the crisis and especially to ensure that public interventions in the economy do not have irreversible anti-competitive effects.<sup>217</sup> In doing so, he argued in favour of the continued application of the “general” merger rules to operations resulting in the nationalisation of financial institutions, with a view to determining if the latter constituted a “concentration” within the meaning of the Regulation.<sup>218</sup> If this requirement is met, the question is whether the transaction can be cleared under the Merger Regulation: in this context, it was queried whether the “failing firm” defence could represent a possible ground upon which to found a clearance decision.<sup>219</sup>

Although the limited scope of this paper does not allow a detailed discussion of this defence, it is reminded that, according to the Horizontal Merger Guidelines, the Commission can declare a *prima facie* anti-competitive merger compatible with the common market if one of the merging entities is a “failing firm”. This requirement is meant to be fulfilled if “the allegedly failing firm would in the near future be forced out of the market because of financial difficulties if not taken over by another undertaking”; in addition, it must be shown that there would not be any “less anti-competitive alternative purchase than the notified merger” and, finally, that without the concentration, “the assets of the failing firm would inevitably exit the market (...)”<sup>220</sup> At the heart of the defence is the need to satisfy the Commission that the market structure would deteriorate to the same extent regardless of whether the merger itself was allowed to go ahead.<sup>221</sup>

Despite being couched in relatively flexible terms, the defence has been notoriously difficult to invoke: decisions such as, *inter alia*, *BASF/Pantochem/Euridiol* and *Kali & Salz* show that the Commission was prepared to accept it only in very limited circumstances. Thus, in *BASF* it was emphasised that there was a “clear cut” risk of bankruptcy and, due to the circumstances in which the target undertaking had been, no “alternative purchaser” could be identified.<sup>222</sup> And in *K&S* the Commission emphasised the peculiar circumstances of the industry, in which only another

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<sup>214</sup> Speech given at the IBA 13<sup>th</sup> Competition conference, 11 September 2009, available at: <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/09/385&format=HTML&aged=0&language=EN&guiLanguage=en>.

<sup>215</sup> *Ibid.*

<sup>216</sup> Lowe, *cit.* (fn. 204), p. 16.

<sup>217</sup> *Ibid.*

<sup>218</sup> *Id.*, p. 16-17.

<sup>219</sup> *Id.*, p. 18.

<sup>220</sup> Commission Horizontal Merger Guidelines, [2004] OJ C31/5, para. 90.

<sup>221</sup> *Id.*, para. 89.

<sup>222</sup> Commission decision of 11 July 2001, COMP/M.2314, [2002] L132/45, see especially para. 144-145 and 147-148.



undertaking was active and therefore found it “inevitable” that the acquiring firm would have acquired the market share of the target company, whether the merger had taken place or, instead, whether the former had exited the market due to the financial and industrial “dire straits” in which it was.<sup>223</sup> On this point, it was often argued that such a restrictive interpretation of the defence reflects the Commission’s concern for ensuring that mergers can be cleared on this basis only if there is a clear lack of causality between the transaction and the worsening of the competitive structure of the market.<sup>224</sup>

This restrictive approach was however criticised, largely on the ground that it may withhold approval for mergers that could limit the wider social and economic aftershocks of industrial restructuring. It was also suggested that preventing mergers concerning failing firms, by slowing down exit, could affect the decision of new entrants to attempt to establish themselves on the market.<sup>225</sup> On this point, Kokkoris argued that since “(...) a way of entering in a market is the acquisition/merger with an incumbent”, allowing undertakings to rely on the failing firm defence to seek to establish themselves on a new market may actually result in an increase in competition in the long run, since it would permit new entrants to rely on the customer base and infrastructure of an existing, albeit ailing, company, thus reducing, to a degree the impact of fixed and other start-up costs.<sup>226</sup>

Against this background, it is not surprising that Mr Lowe was not entirely convinced of the possibility of authorising mergers in the banking and financial markets on this ground, even in times of crisis.<sup>227</sup> He accepted in principle that concentrations involving “unsound” banks or financial services’ providers could fulfil the conditions of the defence in certain cases. However, he argued that the lack of reliable information as to the existence of, *inter alia*, an “alternative purchaser” for the failing business would be especially problematic not only due to the “sensitive” nature of the evidence, but also due to the effects that a “collapse” of the market could have on any remaining competitors.<sup>228</sup> In addition, the delays often characterising the “testing” such a complex defence could jeopardise the success of similar mergers since it could contribute to market volatility.<sup>229</sup>

As was pointed out by the former Commissioner, another challenge for the merger control framework in times of crisis is that posed by the need to provide a swift decision on proposed operations: while the merger control framework is famous for its tight time-limits, it soon became clear that, especially in respect to transactions involving banking and financial undertakings, time was of essence for the viability of the whole concentration. This issue became apparent, for instance, in the context of the takeover of Fortis, a Belgian bank whose stability had been thrown in

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<sup>223</sup> Commission Decision 94/449/EEC, IV/m. 308, [1994] OJ L186/38, para. 71-73.

<sup>224</sup> See e.g. Marsden et al., *cit.* (fn. 193), pp. 878.

<sup>225</sup> Kokkoris, “Failing firm defence in the European Union: a panacea for mergers?”, (2006) 27(9) ECLR 494 at 507.

<sup>226</sup> *Ibid.*

<sup>227</sup> Lowe, *cit.* (fn. 204), p. 18.

<sup>228</sup> *Ibid.*; see also Brouwer, “Horizontal mergers and efficiencies: theory and anti-trust practice”, (2008) 26(1) *EJL & E* 11, pp. 13-14.

<sup>229</sup> See *inter alia*, *mutatis mutandis*, Pouncey and Bukovics, “Merger control, credit-crunch style”, (2009) 30(2) ECLR 67 at 71.

question as a result of the financial crisis, on the part of BNP Paribas.<sup>230</sup> The Commission cleared the transaction, subject to the obligation for the merged entity to divest its credit card business, for the purpose of allowing the entry of a new rival on that market segment, two weeks before the deadline: according to Ms Kroes, “this decision is a perfect example of the Commission's ability to reconcile a rapid response to the credit crisis with the need to ensure that competition law plays its role in the defence of legitimate consumer interests.”<sup>231</sup> It was emphasised that the Commission had succeeded in delivering clearance of a key transaction for the viability of the Belgian financial market, within a tight time frame without “economising” in the scope and integrity of its appraisal.<sup>232</sup>

Allied to the questions concerning the time scale within which mergers should be cleared in times of crisis are also issues concerning the market testing of remedies that may be required to secure clearance: it was suggested that ensuring that modifications to proposed transactions are properly and thoroughly examined remains very important, in as much as it ensures that markets, even when going through periods of restructuring, remain open and competitive.<sup>233</sup> In *Lufthansa/Austrian Airlines*,<sup>234</sup> for instance, the Commission cleared the notified transaction, which affected competition on key routes within continental Europe, subject to a complex set of remedies, both structural and behavioural. In that decision it was recognised that the crisis affecting the aviation industry was likely to depress the incentive of airlines to enter the routes in question.<sup>235</sup> Consequently, the Commission took the view that relieving “slot congestion” was indispensable to ensure that the market would not only remain open and competitive in the short and medium term, but would also attract new entry in more florid times.<sup>236</sup>

Commenting on this decision, the then Commissioner Neelie Kroes expressed the view that even when individual industries were going through “consolidation phases”, the assessment of remedies would be necessary to protect consumer interests and secure rivalry in the long run.<sup>237</sup> It was added that the relative flexibility of the requirements applicable to the testing of remedies in the EU rendered the merger regime extremely responsive to change and especially to the need to countenance any detrimental effects of industrial restructuring on competition and market access.<sup>238</sup>

In light of the above, it can be concluded that the financial crisis and especially its aftershocks on the “real economy” have challenged many of the “established” principles and legal and economic approaches guiding the Commission’s approach to mergers. Despite adopting an initially

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<sup>230</sup> Commission decision of 3 December 2008, case M.5384, available at: [http://ec.europa.eu/competition/mergers/cases/decisions/m5384\\_20081203\\_20212\\_en.pdf](http://ec.europa.eu/competition/mergers/cases/decisions/m5384_20081203_20212_en.pdf).

<sup>231</sup> Press release of 3 December 2008, IP/08/1882.

<sup>232</sup> See e.g. Lowe, cit. (fn. 204), p. 18.

<sup>233</sup> Lowe, cit. (fn. 204), pp. 17-18.

<sup>234</sup> Commission decision of 28 August 2009, COMP/M.5440, available at: [http://ec.europa.eu/competition/mergers/cases/decisions/m5440\\_20090828\\_20600\\_en.pdf](http://ec.europa.eu/competition/mergers/cases/decisions/m5440_20090828_20600_en.pdf).

<sup>235</sup> Id., para. 386.

<sup>236</sup> Id., para. 388.

<sup>237</sup> Commissioner Neelie Kroes, Press release of 28 August 2009, IP/09/1255. For commentary see e.g. Weitbrecht, “Mergers in an economic crisis”, (2010) 31(7) ECLR 276 at 279-280.

<sup>238</sup> Lowe, cit. (fn. 193), p. 18.

passive posture toward industrial restructuring, as was the case with HBoS/Lloyds, the Commission soon sought to adopt a more proactive stance, by seeing to “stretch” the existing legal and economic framework for assessment in order to ensure that the integrity of the common market and especially that the openness and rivalry of the EU markets would not be jeopardised. Quicker procedure, extensive and at the same time flexible remedies’ testing and a limited but at the same time “responsive” use of the failing firm defence emerged as key tools to deal with these challenges within the merger context which, overall, proved to be, once again, a reliable tool to uphold the internal market’s principles. However, it is also clear that, just as in the area of state aid, the Commission’s central role in the wider context of competition policy was challenged by the unfolding of the crisis. The next section will conclude by reflecting on the wider implications that dealing with these events have had on the Commission’s actual role as well as on the overall framework for the enforcement of EU competition law.

#### 4. Bruised and battered? The implementation of EU competition policy and the economic crisis: tentative conclusions

The forgoing sections sought to provide a snapshot of some of the responses given by the tools of EU competition law to the challenges posed by the 2007 financial crisis and by its aftershocks for the "real economy". It was illustrated how the EU Commission, after having been caught in some way "unawares" by the unfolding of the crisis, thus remaining passive, to some degree, to its demands, soon was capable to develop its own response to it. From the adoption of the Banking Guidelines to the publication of the Temporary Framework regulating state aids in, respectively, the banking and financial sector and in the wider context of the "real economy" to the adoption of more flexible, quicker approaches to the scrutiny of mergers, the Commission sought to use its own array of policy and legal tools to the full. At the same time, however, it was also ready to "ditch" old style instruments, such as the application of the legal exception to "crisis cartels", to remain coherent with its commitment to the fight against cartels. At the heart of this response was a deeply felt need to maintain the unity and integrity of the internal market, even in the face of very dangerous and disquieting times, and especially to preserve its competitiveness and openness in the long term. In light of these considerations, it may be argued that a picture which mixes continuity and change seems to have emerged: it can be suggested that "established" tools have been deployed to deal with the demands posed by the crisis. In doing so, however, the Commission has shown remarkable flexibility, both substantively and procedurally.

Thus, having regard to the banking sector, it was able to derogate from the rigorous approach enshrined in the R&R Guidelines in order to provide a relatively more generous "custom-made" framework for the assessment of state assistance to banks and financial institutions, in which aid would, for instance, be available to a wider range of eligible entities and its provision be no longer limited to cases in which its effects would be "reversible": however, in doing so it refrained from giving the Member States a free hand and instead sought to uphold some of its key principles, such as the obligation to make aid available to all the eligible subject, without any limits based on, e.g. residence or nationality, and the possibility to impose commitments to allow for rivalry to be maintained.

A broadly similar approach also seemed to underscore the Temporary Framework: the Commission allowed the Member States to provide several forms of financial assistance, all

targeted at addressing the risk of failure caused by a lack of liquidity. However, it sought to enforce upon the Member States to duty to make this aid available subject to principles of transparency and of non-discrimination, with a view to avoiding market foreclosure resulting from putting those undertakings who did not receive assistance at an unjustifiable competitive disadvantage. It is submitted that merger policy is yet another area in which this "continuity/change cocktail" is clearly visible: faced with the need to uphold its exclusive jurisdiction and to prevent Member States from erecting "national champions", the Commission confirmed its commitment to a strong, scrupulous and, at the same time, "realistic" approach to merger scrutiny. A greater albeit "guarded" willingness to apply the "failing firm defence"; a quicker timetable for the assessment of individual transactions and a continuing exhaustive review of remedies were all part of the mix. However, they were deployed while taking into account the timing constraints and the policy demands often involved in individual concentrations.

Against this background, one could legitimately ask whether "all is well" in competition law and policy in times of crisis: and again, the answer should be inevitably more nuanced than just a straight positive or negative one. As was anticipated in section 2.1, the Commission did not "dive in" immediately in order to deal with the demands of the financial crisis. The initial phase of the crisis saw it taking a back seat and preferring a "wait and see" approach, which in turn allowed the Member States to take the lead and deal with the "emergencies" occurring in their own jurisdictions. However, the risks that this passive role could have for the whole "European project", for the integrity of the common market and, perhaps more pragmatically, for the strength of its own leadership contributed to the Commission's "awakening": its proactive role in shaping the Member States' policies as regards state aid and in that context the choice of overseeing this type of assistance by relying on Article 107(3), whose remit allowed it greater scope for manoeuvre demonstrated its willingness to interact more closely with domestic authorities in order to avoid protectionist reactions to the crisis. At the same time, its renewed commitment to a quicker and more flexible merger review allowed the Commission to take a leadership-type, more proactive and more efficient approach to merger review, whose procedural structure and substantive underpinning resisted relatively robustly to the pressure.

It is however undeniable that, five years on, many of the challenges created by this systemic economic and financial crisis remain: Member States may have "trouble-shot" relatively effectively when it came to salvage banks. However, this came at the price of far more concentrated markets, in which entry remains difficult and the implementation of divestiture and other remedies is far from complete. Other sectors, ranging from the automotive industry to aviation and other transport industries, also remain characterised by a more restricted pool of rivals and by the existence of several "alliances" and other loose cooperation arrangements.

Thus, it is concluded that competition law comes out of the crisis largely intact but also "bruised" by the effects of the crisis. It is accepted that some of the outcomes of the agenda deployed for its "management" may be reversed overtime--e.g. by a careful policy of divestiture of assets or the gradual return of governmental funds and guarantees. However, it is equally clear that other effects may be more difficult to "wipe out", such as, inter alia, the perceived difficulty for new entrants to challenge incumbents in key sectors, such as aviation. In many ways, the old adage "time heals all wounds" may help summing up what awaits EU competition policy in the post-crisis economic era. Nonetheless, it cannot be denied that time is something which, due to the irreversible consequences of the crisis itself and of the responses to it for rivalry and market openness, is now in

relatively short supply. Thus, it may be preferable to think about the future as something which is largely unwritten and unpredictable still, as well as confined in a relatively small horizon.

## **Tolga Bolukbasi, ‘European Union and Continuity and Change in Labor Market Policies in Pre-Accession Countries: Insights from the Case of Turkey’**

### **EXTENDED ABSTRACT**

This paper attempts to answer the questions of (i) how we can account for continuity and change in labour market policies in pre-accession countries, (ii) whether the European Union (EU) plays any role in such processes of continuity and change, and (iii) if so, under what conditions the EU has an impact. It does so through an analysis of labour market policies in Turkey as a case study of pre-accession to the EU. The case of employment policy in Turkey constitutes a ‘crucial case’ due to three main reasons: First, Turkish labour markets are characterized by a very high degree of misfit with the targets announced in the EU’s European Employment Strategy (EES) given the substantially lower levels of labour force participation rates and employment policies, and the relatively weaker institutional structure of employment policymaking which, according to the Europeanisation research programme, would invite powerful adaptational pressures stemming from the EU level. Second, Turkish employment policy is currently undergoing change with frequent media coverage on efforts at launching a national employment strategy for the first time in the country. Finally, the issue of unemployment features as *the* most important problem for the public in Turkey according to opinion surveys. In order to examine the causal dynamics of continuity and change in Turkish labour market policies, the paper is based on a ‘bottom-up research design’ relying on case study methods and process tracing techniques. Empirical data is obtained through an analysis of legislative acts, parliamentary minutes and print media reporting as well as qualitative interviews carried out with key policy makers and social partners.

The paper is organized as follows. It first reviews the three parallel modes of employment policy-making in the EU which are comprised of the classic Community method of legislating rights and implementation through directives, ‘law via collective agreement’ aiming to promote active participation of social partners at both the EU and domestic levels, and most recently, the EES based on the Open Method of Coordination (OMC) relying on peer learning, persuasion, benchmarking and peer review, which are typical examples of ‘soft law’.

Second, it focuses on the defining features of the EES characterized by ‘flexicurity’ which is declared as the ‘EU’s approach to labour markets’ in EU official documents which aims at building the foundations of a ‘social investment state’. The paper relies on the ‘policy structure approach’ depicting a policy regime through focusing on the principles, objectives, procedures and instruments. The *principles* embodied in the EES are informed by the concept of ‘flexicurity’ which has four dimensions: (i) contractual arrangements providing sufficient flexibility to both workers and employers; (ii) effective active labour market policies (ALMPs) supporting transitions between jobs and from unemployment and inactivity to employment; (iii) life-long learning systems helping workers to cope with rapid change, unemployment spells and transition to new jobs, and enabling them to remain employable throughout their careers; and (iv) modern social security systems facilitating labour market mobility and transitions with adequate income support during absences

from the labour market. In terms of the *objectives*, the EES aims to activate labour market outsiders and promote high rates of employment through setting quantified target rates. The *procedures* in the EES rest on the participation of social partners in policymaking processes both at the domestic and EU level. While coordination is secured through the EES for member states, it is carried out through the drafting of a 'Joint Assessment Paper' for pre-accession countries. In terms of the *instruments*, the EES relies on financial instruments provided through the European Social Fund for member states and the Instrument for Pre-Accession (IPA) for pre-accession countries as well as modernised public employment services institutions.

Third, the paper reviews the academic literature on Europeanization, which has largely rested on top-down research designs. This literature points to contradictory findings in terms of the role that the EES plays in domestic labour market policy-making, which range from significant EES impact to no impact at all. The paper observes that the current state-of-the-art is marred by two problems. First, to the extent that the studies embrace a top-down research design and thereby overlook the independent causal impact of the interplay of domestic interests and institutions, they take the causal impact of the EES for granted. Second, these studies almost invariably focus on member states with the exception of a few analyses on pre-accession countries.

Fourth, when this Europeanization literature is taken as the analytical lens to extrapolate the dynamics of continuity and change in pre-accession countries, we would expect weak adaptation not only due to weak adaptational pressures stemming from low levels of credibility of EU membership in Turkey and the non-binding character of the EES, but also because of the deep segmentation of Turkish labour markets precluding any comprehensive reform attempt in the direction of the EES.

Fifth, the paper summarizes the dynamics of continuity and change in the employment policy regime in Turkey by focusing on whether there have actually been changes in the principles, objectives, procedures and instruments, and if so, whether the EU had played any role therein. The paper concludes that there has actually been greater-than-expected change, albeit variegated across different policy areas embodied in the flexicurity approach. In policy areas whereby powerful domestic interests (i.e. the ruling government and big business) neither show resistance to, nor actively pursue reform (such as in the case of active labour market policies and life-long learning systems), the EU appears to play a role in bringing about change in the direction of the EES. The outcome, however, is represented by a modest change due to the weak adaptational pressures area stemming from the EU in this policy. In other policy areas whereby preferences of domestic interests are in line with the intended direction of reform envisioned by the EES (such as in the case of labour law and social security systems), the degree of change appears to be conditional on the strength of institutional lock-in effects. In this context, should preferences of domestic interests remain in accordance with the priorities of the EES whilst facing weaker institutional lock-in effects, this study finds significant change. However, while the direction of such change is in parallel with the EES priorities, these exclusively bear the imprints of domestic interests as the reform outcome proves to be more protracted than in the case where the EES would have bred independent causal impact. In contrast, should institutional lock-in effects prove to be strong enough to counterweigh the constellation of domestic interests whose preferences remain in line

with priorities of the EES, the paper finds very limited change – much less than that found in the case of weaker institutional inertia. In these final two cases, the EU functions only as a primary leverage by domestic interests rather than having an independent causal impact as the current literature may suggest.



# **Annette Bongardt, 'Lisbon, Environmental Policy and Competitiveness'**

## **Summary of presentation**

The paper discusses the issue of competitiveness and environmental constraints in general terms and proceeds to evaluating the EU objective of a competitive, low-carbon economy as an EU industrial strategy.

It sets out the importance of the environment as a basis for economic activity (natural capital / input to production, life-support system) and the challenges for sustainability (the planet's limited absorption capacity of waste and pollution; exhaustible vs. non-exhaustible resources; management issues). The non-sustainability of current production and consumption patterns in any business as usual scenario emerges as a result of global environmental impact (influenced by population, affluence, technology). Studies point to limits to growth and the need for a governance system that takes a more long-term view (most recently Randers, 2012, for the Club of Rome). This suggests the need for adequate policies to correct market failures and unsustainable behaviour.

The EU stance on sustainability is anchored in the treaties. Sustainable development is a treaty objective, environmental protection has been granted a special status (cutting across other policies - environmental mainstreaming) and the single market has been put at the service of EU societal goals, notably sustainability. With the financial and economic crisis and the sovereign debt crisis that reinforced the need for growth, the challenge facing the EU resumes to sustainable growth. EU growth objectives are of course framed by the competitiveness rationale against the background of globalisation. They have come to integrate environmental protection under the headings of a shift to a competitive low-carbon economy (in a later phase of the Lisbon strategy) and green growth (Europe 2020 strategy). The latter has been defined by Hallegatte et al., 2011) as growth that is efficient in terms of natural resource use, minimises pollution and environmental impacts, and is resilient (accounting for natural hazards).

The paper first addresses the question as to whether there is any potential conflict or trade-off between environmental protection and efficiency. It reviews economic theory with respect to pollution (pollution damages as negative externalities), the issue of internalisation (efficiency-enhancing, although not always sufficient on its own) and the optimal level of pollution (Pareto optimality). It discusses how to implement the efficient level of pollution (and production), either through the market (Coase theorem, applicable under certain demanding circumstances, notably well-defined property rights and low transaction costs) or policies. The objective can consist in implementing the efficient level of pollution (fraught with high information requirements) or else aim at cost-effective implementation (selecting the least-cost abatement programme at a given pollution level). The instrument mix stretches from communication instruments and voluntary agreements to command-and-control instruments (traditional regulation) to market or economic instruments. As for the latter two, although both could be least-cost in theory, governments will often lack the higher information requirements of command-and-control instruments. Market instruments comprise notably taxes (environmental taxes / Pigouvian tax), subsidies, and

marketable emission rights. They price the environment and environmental damage costs. They have a dynamic effect (promoting innovation), change underlying (unsustainable) behaviour and are cost-effective; they are also associated with a double dividend (benefiting the environment and providing the state with receipts). Command and control traditional regulation has a static effect and tends to be more expensive in terms of abatement, that is, foregoing more output to achieve environmental goals. Still, regulation may be more indicated in certain circumstances (e.g., similarity of firms' cost structures, concentrated market structures). The implications for competitiveness and growth are that economic instruments, which work with and through the market mechanism, are more apt: They promote innovation (in new green goods, services, technologies) and have least-cost properties for implementing environmental targets. Given that market instruments, which modify incentives, work with the market mechanism, they presuppose a functioning market.

It should be noted that environmental protection does not necessarily imply an output loss. Environmental protection might give rise to win-win situations but also imply trade-offs. In the latter case, the greater freedom of choice of abatement solutions afforded by market instruments lowers abatement costs for society, as firms tend to know better than the government how to best and cheapest abate pollution. The concept of green growth implies the idea to shift the production frontier outward (through new green goods, services, technologies and sectors). To do so, it is of course important to create the right framework conditions (macroeconomic stability, property rights, low transaction costs, etc.) as to promote long-term investments.

Environmental policy in the EU addresses coordination needs in the internal market (level playing field) and externalities (transnational, but also global). Although the Rome Treaty had not mentioned the environment, the EU gained competences with respect to the environment already from the 1970s onwards, with an explicit treaty base since the Single European Act in 1987. With the subsequent treaty revisions, the EU moved from unanimity voting to qualified majority voting and from the cooperation procedure to co-decision. The Lisbon treaty confirmed environmental policy as a shared competence and extended it to climate change. Energy, where the EU had had no competences, became a shared competence. However, important exceptions persist, notably in regard to taxation and energy sources, where the unanimity requirement applies. Climate change and energy policies are of course linked, as it is fossil energy sources that cause climate change. However, the energy section in the Lisbon treaty comprises just one article outlining objectives (i.e., supply security, competitive pricing, sustainability, plus European networks). Although two out of the three original Communities had been about energy (European Coal and Steel Community, 1952-2002) and Euratom), the EU does not have any specific energy instruments. As a result, energy has been dealt with through the prism of the single market (liberalisation), associated with the need for regulation of the sector (network industries).

Environmental governance has been brought under the logic and rationale of the single market, which is also reflected in the philosophy of regulation. From a command-and-control approach it moved (from the 5<sup>th</sup> Environmental Action Programme onwards) to a bottom-up approach, with new flexible instruments and market instruments. The EU Emissions Trading Scheme (ETS), an economic instrument, which became the EU's flagship environmental policy, is a case in point.

Regulatory concerns had shifted from the regulation of acute problems (1972-) to the harmonisation of regulation to assure a level playing field in the internal market (1987-), to the use of framework regulations with a view to efficiency and policy effectiveness with integration and implementation cost concerns (1992-) to networks and policy learning with a view to sustainable development (1998-). However, the EU ETS marks a break with the latter approach, in that the instrument is characterised by the (re-)centralisation at the EU level.

The ETS is the EU's principal instrument for effecting a shift to a low-carbon economy (covering about half of CO<sub>2</sub> emissions, the remainder resting on (weaker coordinated) member state action). As a cap-and-trade carbon scheme, the EU ETS prices greenhouse gas emissions in the market. Prices reflect economic scarcity, determined by supply (fixed but adjustable caps) and demand. If sufficiently high, they provide an incentive for pollution abatement (with least-cost characteristics). Emissions trading makes use of the market mechanisms to implement environmental targets: it is the most efficient firms that abate more pollution (least-cost properties with minimisation of foregone output), while less efficient firms will have to buy licences, which aggravates their costs, and will be penalised (out-priced) in the market.

The EU ETS is the first regional carbon market in the world and the EU is first in moving to a polluter-pays-principle logic. The ETS (presently in its second phase, 2008-12) has become increasingly centralised at the EU level: it came to feature EU targets (rather than national allocation plans), a common registry, centralised auctioning platforms (although Germany notified an exemption) and a (gradual) implementation of the (treaty-based) polluter-pays-principle, notably in its third phase (2013-2020). There is a recognition that supply caps need to be controlled for prices to be sufficiently high as to provide adequate incentives for investments in greener goods and services and in technologies (experience of member state over-allocation of licences in a first, experimental pre-Kyoto commitment phase, 2005-7, with a collapse of carbon prices; the effect of the crises in the second, Kyoto commitment phase, 2008-2012, has also depressed prices). Three problems remain. First, due to the crisis impact, carbon prices are too low to incentivise abatement (need to tighten ceilings). Second, there is uncertainty as to what happens beyond 2020 in the fourth phase; the absence of intermediate targets between 2020 (-20%) and 2050 (EU Council agreed 80-95% cuts) is claimed by some industry to discourage medium- to long-term investments in less carbon-intensive technologies. As a result, the EU ETS review is to be brought forward from 2018. Third, there is a need to rethink other policies (e.g. renewables) for efficiency in function of the ETS instrument, to the extent that those could have an impact on demand and thus prices. Under a cap-and-trade scheme, those would depress demand, but with a fixed supply this would just depress prices, whereas that pollution levels would remain the same (at lower prices some inefficient firms would get back into the market).

As for the international competitiveness issue (carbon leakage) and the issue of a competitive low-carbon economy as an EU industrial strategy, the paper concludes that the EU is committed to (and set to fulfil) its Kyoto commitments and that it has set in motion a legislative climate and energy package that is to cut CO<sub>2</sub> emission by 20% until 2020 (extensible to 30%, depending on the commitments of other major polluting countries). Given the uncertainty surrounding a possible Kyoto successor global agreement, the question resumes to whether the EU shift to a low-carbon

economy is viable in isolation or whether it is compatible with the need for competitiveness in a globalised economy. The paper analyses the EU industrial low-carbon economy strategy in terms of costs and benefits. It puts forward that benefits accrue in terms of a first-mover advantage and in terms of signalling a country's long-term commitments, with trade and foreign direct investment benefits. As for the costs, employing the ETS, a market instrument, it is argued that: First, not all firms but only carbon-intensive firms (using fossil energy sources) and those exposed to international competition may be affected; second, that thus far only a hand-full of sectors were covered and that the firms received emission rights for free (transfer from tax payers to polluters); and third, that even if firms start to (gradually) pay for their pollution rights this is precisely the idea behind the scheme to incentivise green growth (and hence not an undesirable side-effect). Also, the EU can make recourse to various instruments should there be distortions of competition in the international arena due to carbon leakage. Of course, if there was a global climate agreement and a global carbon market (in fact, some countries are implementing carbon trading, such as Australia, China, California in the US) this would facilitate a cap on global emissions (through a global monopsony).

In conclusion, the benefits of a EU low-carbon economy appear to outweigh the costs. The EU ETS is a market instrument and as such assures least-cost implementation of environmental targets and stimulates innovation and growth. As for the issue of international competitiveness, the risk of carbon leakage is over-rated and the EU has instruments at its disposal to deal with possible international distortions.

# **Paul Copeland and Mary Daly, 'Social Policy under Europe 2020: Ungovernable and Ungoverned'**

## **Abstract**

This aim of this paper is to analyse recent developments in EU social policy under Europe 2020, notably the target to reduce the number of individuals living in poverty by 20 million. It does so by developing an analytical framework that situates the ideas or policy substance, the role of politics and governance mechanisms at the centre of analysis and searches for the inter-relations among them. We suggest that policy areas are subject to conditions of governability relating to: ideational coherence; degree of prioritization within the policy hierarchy; and adequacy of governance mechanisms. Using these as a test of the policy target on poverty and social exclusion reveals that EU social policy, as conceived by Europe 2020, is both ungovernable and ungoverned. The target is ungovernable because Member States have adopted approaches that draw from very different philosophies and their level of ambition is much below that of the EU, which means that on present numbers the target is some 5 to 8 million short of the 20 million targeted. And it is ungoverned because of uncertainty around its legal status, and ambiguity over who is to govern it and exactly how it fits in the Europe 2020 process.

## **Keywords**

Europe 2020, governance, poverty and social exclusion, the politics of EU social policy.

## **Introduction**

This paper focuses on EU social policy as it is configured in relation to poverty and social exclusion by the Europe 2020 programme. The purpose is, through a case study of the poverty target, to critically review the ideational and policy substance, the politics and the governance mechanisms. The paper also aims to develop insights pertaining to social policy in an EU context at the present time and how it should be studied. For at least a decade now social policy has been a most innovative field of EU governance. The Lisbon Strategy in particular heralded new methods, procedures and resources for social policy and provided a new impetus for social Europe. Under the new Europe 2020 programme, the main objective for the EU with respect to social policy is to reduce the number of individuals living in poverty and social exclusion by 20 million. In contrast to the qualitative approach taken during the Lisbon decade, the first quantitative target for EU social policy appears to signify significant progress in the construction of social Europe and combating poverty. The aim of this article is to assess whether this is the case.

Theoretically, the analysis positions itself within the new modes of governance literature (e.g., de Búrca and Scott 2006; Héritier and Rhodes 2011; Zeitlin and Trubek 2003). Drawing from Borrás and Radaelli's (2011) concept of governance architecture, we probe the interaction between ideas or policy concepts, politics and governance mechanisms. This framework is then used to identify and examine empirically the conditions of governability in the domain of poverty and social exclusion

within the EU context. The case study reveals the complexities involved in maintaining the momentum in EU social policy that was generated during the Lisbon Strategy, as well as the fundamental complexities of policy-making and politics within the sphere of EU social policy. It is insightful also about the problems facing European societies and a European Union which itself features huge diversity with respect to poverty, material deprivation and joblessness. The paper makes the argument that because of weaknesses in the way the poverty target in Europe 2020 is constructed it is effectively ungovernable and, furthermore, that the particularities of the governance architecture as a whole mean that social policy is to all intents and purposes ungoverned. The claim, then, is of a double set of weaknesses that interact. The explanation offered centres on ideational incoherence (at a number of different levels), insufficient prioritization, and significant inadequacies in the governance procedures.

The paper is organized into four main parts. The first offers a short overview of Europe 2020, focusing on introducing the content and governance procedures for the social policy/poverty measures. The second part briefly considers the literature on EU governance using it as a base upon which to develop the approach adopted here. The third part of the paper presses the argument about the ungovernability of the poverty measures, considering in turn the coherence of the ideas and policy focus in light of Member State diversity, the place of poverty and social exclusion in the political and policy hierarchy of the EU, and the nature of the governance process in place. The fourth section brings the paper to a close by highlighting key elements of our analytic approach and the most significant insights yielded by its application to the poverty and social exclusion target.

### **1. Social Policy in Europe 2020: A Brief introduction**

As the successor to the Lisbon Strategy which ran from 2000 to 2010, Europe 2020 is the vehicle that takes forward the EU's policy commitments for the next decade. It rests on three economic reform objectives that are designed (in theory) to be mutually reinforcing: 'smart growth' based on a knowledge economy; 'sustainable growth' promoting resource efficiency; and 'inclusive growth' focusing on high levels of employment and social cohesion. 'Integration' is the middle name of Europe 2020 (European Commission 2010a). It aims for two types of integration. In the first instance, it aims to bring four different areas of policy - economic policy, employment policy, social policy and environmental policy - into a single process. Secondly, Europe 2020 aims to synchronize governance processes and procedures by the creation of a business cycle for EU matters - the European Semester. This refers to the streamlining of policy co-ordination into a six-month cycle. The cycle is started each year in January when the Commission publishes the Annual Growth Survey (AGS) which then provides the basis for the Spring Council's strategic advice on policies. Taking this guidance into account, the Member States present and discuss their medium-term budgetary strategies through Stability and Convergence Programmes and, simultaneously, draw up National Reform Programmes setting out the action they will undertake in areas such as employment, research, innovation, energy and social inclusion (taken to refer to poverty and social exclusion, pensions, and health and social care). Then, based on the Commission's assessment of these two documents, the Council issues country-specific guidance by June and July. On this basis and the policy advice from the European Council and the Council of Ministers, Member States finalize their draft budgets for the following year.

In terms of policy substance or content, targets, flagship initiatives and guidelines are the key elements of Europe 2020. Starting with targets, five areas are selected for policy integration and reform through quantified targets: employment; spending on research and innovation; climate change and energy use; early school leaving and participation in tertiary education; and poverty and social inclusion. In the case of the latter – the focus of this article - Europe 2020 commits to a poverty target whereby Member States will together lift some 20 million EU citizens out of poverty by 2020 (out of a total of 120 million people in such a situation). The EU has never seen anything quite like this before. Lacking a legal competence and a strong mandate in social policy, the EU has only ever engaged with poverty in a ‘light touch’ kind of way (Bauer 2002).

In a second tier, the Europe 2020 programme consists of 10 integrated guidelines. Six of these are on economic policy and four relate to employment policy. The latter include a guideline on poverty and social exclusion (guideline 10) which refers to ‘*promoting social inclusion and combating poverty, clearly supporting income security for vulnerable groups, social economy, social innovation, gender equality, and the poverty headline target.*’ The other three employment guidelines relate to increasing labour market participation and reducing structural unemployment, developing a skilled workforce, and improving the performance of education and training systems and increasing tertiary education participation (European Commission 2010a).

The Flagship initiatives form the third element. Jointly undertaken by EU and national actors and steered by the European Commission, the Flagship Initiatives centre on thematic priorities intended to support the achievement of the five EU-level targets. One of the seven Flagship Initiatives is devoted to poverty and social exclusion. This is the European Platform against Poverty and Social Exclusion. The term ‘platform’ is meant to refer to a hub or host of initiatives oriented to bringing about social and territorial cohesion. The rhetoric around the Platform emphasizes especially innovation and experimentation in social policy – ‘innovative social protection intervention’ (European Commission 2010a: 5). The Platform aims to: address the needs of groups particularly at risk, tackle severe exclusion and new vulnerabilities; break the cycle of disadvantage and step up prevention efforts; and function better and more efficiently in times of budget constraints. Five areas of action have been identified (European Commission, 2010b, 2010c). These are:

- Delivering action to fight against poverty and social exclusion across the policy spectrum;
- Making EU funds deliver on the social inclusion and social cohesion objectives;
- Promoting evidence-based social innovation;
- Promoting a partnership approach and the social economy;
- Stepping up policy coordination between the Member States.

How are these developments to be theorized?

## **2. Theoretical Framework: Governance Architectures and Politics**

The new governance literature is essentially concerned with the changing structure of political and administrative authority and, in an EU context, the move to more diverse and less law-bound

methods of collective decision making and policy implementation (as exemplified by the Open Method of Coordination - OMC). This is a large and diversified set of literature, but, strange as it may sound, the inclusion and conceptualization of politics is not unproblematic (e.g., Borrás and Greve 2004; de la Porte and Pochet 2004; Eberlain and Kerwer 2004; Héritier 2003; Héritier and Rhodes 2011; Hodson and Maher 2001; Radaelli 2003; Trubek and Mosher 2003; Zeitlin and Trubek 2003). When the politics of the Lisbon Strategy is analysed, the analysis is usually located at Member State level with a preference for the ‘blocking’ impact of national politics on compliance with EU policy. Within this frame, work by Büchs (2007), Graziano (2011), Gwiazda (2011), Heidenreich and Bischoff (2008) and Mailand (2008) among others has identified the importance of numerous intervening variables such as: the preferences of key institutional and social actors; ‘goodness of fit’ and ‘misfit’ at the domestic level; government preferences; compliance with non-OMC EU policy; and the domestic economic situation. Studies concerning the politics of the Lisbon Strategy at EU level, particularly that surrounding its formation and re-launch (Apeldoorn *et al* 2008; Archibugi and Coco 2005; Begg 2006, 2007; 2009; Sapir, 2007), have developed in a largely separate stream to those on the effectiveness of EU public policy. The result is an artificial binary in the field between approaches concerning either the public policy of Lisbon, but which prioritize politics at national level, or the politics of Lisbon at EU level, but which have few connections to the policy content.

In an attempt to overcome this and other weaknesses in the literature, Borrás and Radaelli (2011) propose the overarching framework of ‘governance architecture’ to conceptualize the politics and institutional elements of strategies developed by international organizations. For these authors governance architectures, such as the Lisbon Strategy and Europe 2020, represent ‘strategic and long-term political initiatives of international organizations on cross cutting policy issues locked into commitments about targets and processes’. In the Borrás and Radaelli framing, governance architectures are situated at the meso level between the multi-level governance of an international institution and an individual policy programme. They are conceived as comprising ideational and organizational components. The ideational component is defined as: a set of fundamental ideational repertoires, expressed in notions such as ‘governance’, ‘competitiveness’, ‘sustainability’, ‘knowledge based society’, the ‘market’ and a discourse that uses the ideational repertoires in order to discipline, organize and legitimize the hierarchical relationships between the goals and the policy instruments. Taken together, ideas and discourses give shape to the overall attempt to socialize actors into a specific frame of reference that is supposed to make sense of a complex world of cross-cutting policy problems. The organizational component comprises: formal and informal organizational arrangements (politico-organisational machinery) where the ideational repertoires and discourses are defined and patterned through complex political processes of a multi-level nature and the selection of policy instruments and their procedural requirements. According to Borrás and Radaelli, analysing the different components of a governance architecture in combination with Kingdon’s (1995) multiple streams approach enables the researcher to understand how governance architectures emerge and how they are maintained and adapted over time. On a second level, Borrás and Radaelli argue that Member State compliance with a governance architecture should be analysed through the Europeanization lens.

This is a major contribution that takes the field forward in several ways. In the first instance, Borrás and Radaelli aim to go beyond the existing binaries which have proven to be a major



difficulty in EU studies (see also Jenson and Mérand 2010). One of the biggest advances of the governance architecture approach is to offer an integrated or encompassing framework that takes account of both the many fields in which the EU is now active and the EU's attempt to integrate these through innovations in governance. Furthermore, analysis of arrangements for governance is to be simultaneously considered with and analysed in relation to the ideas and discourses involved in the policy portfolio, making for a more interactional and dynamic approach. In many ways its integrated framework – melding ideas, culture and norms with material and organizational factors – mirrors the breadth and degree of integration of the Europe 2020 programme itself.

We agree with Borrás and Radaelli in fundamental respects and see what we are about here as an early attempt to apply their framework to a specific policy domain. However, we believe their framework has to be further developed to analyse concrete policy areas within the EU. The Borrás and Radaelli framework is generic and global (and arguably too abstract). It also has a thrust towards stasis, implying that a policy area is to be conceived as being structured by the prevailing ideational and organizational components at any one moment in time. They are interested in 'big moments' - usually the launch/re-launch of a strategy. Our reservations with the approach extend also to politics in that in our view it underplays the role and place of politics and the conceptualization of the EU as a political system. While Borrás and Radaelli integrate politics in a horizontal manner into their framework (in the sense that politics is seen to be implicit in the ideational repertoires, the strategic use of discourses, the organizational arrangements and the selection of policy instruments), their framework has a structuralist bias. Among other things this imbues it with a tendency to view the instruments and governance arrangements in a politically neutral and somewhat homogeneous way.

We suggest the utility of bringing in insights from the political sociology approach (Kassim and Le Galè 2010; Lascoumbes and Le Galè 2007). In essence, this perspective problematizes the selection of policy instruments and calls for a move beyond the limited sense of social and political factors that pervades existing work in this regard. Among the main critiques advanced are that norms tend to be reified and treated apart from the actors who use them to guide their actions, that the selection and operationalization of instruments tend to be treated on functional rather than political grounds, and that scholarship is more focused on institutions in and of themselves (institution centric) rather than institutions as a vector of power built through socio-political processes (Jenson and Mérand 2010; Kassim and Le Galès 2010; Favell and Guiraudon 2011). underlying point, then, is that ideas, discourses, governance instruments and arrangements are inherently political, the subject of ongoing power struggles between actors, and are continually being remade (rather than fixed). Moreover, instead of being politically neutral, instruments and governance arrangements confront actors with structures of opportunity and privilege certain courses of action, interests and actors over others (Kassim and Le Galè 2010: 4). From this perspective, all the elements of governance architectures are to be conceived as located in hierarchies of power and privilege.

This perspective brings the following insights to bear on the analysis of policy areas : (1) elements of the governance architecture always involve a set of meanings which cannot be disconnected from the wider social and political context; (2) governance architectures are to be conceived as involving a set of political relations that shape the choice and implementation of policy instruments, ideas and discourses; (3) policy domains and the procedures whereby they are governed are inherently political in nature and both reflect and generate hierarchies of power and authority.

These insights lead us to consider the conditions whereby a policy programme can be taken forward or not in an EU context. Such conditions centre upon: the coherence and meaning of the elements of a policy instrument/domain in an ideational sense, how and where the policy instrument fits politically in the policy process, and the nature and strength of the governance arrangements put in place.

The analysis to follow in the next section seeks to address these sets of issues.

### **3. Poverty and Social Exclusion within Europe 2020**

*How meaningful is the poverty target?*

*Ceteris paribus*, the agreement on the poverty target represents a step forward for the development of EU social policy. Targets are in many senses the epitome of rationality and betoken crystal clear agreement on policy goals. They imply a plan-led approach to a problem, calling upon a clear set of objectives and the achievement of well-specified goals which are realizable and are meaningful politically. To what extent is this the case with the poverty and social exclusion target?

The Europe 2020 poverty target is exemplary in several respects. For example, it sets a clear time deadline and is ambitious (rather than tokenistic). Its ambition may be gauged from the fact that it aims to achieve a reduction of some 17% in poverty prevalence across the EU by 2020. To give some idea of the scale of this ambition, over the course of the eight years of relative growth in Europe (2000-2008) relative income poverty in the EU remained unchanged (Cantillon 2011). A further relevant aspect of the poverty target is that the EU is very specific about its constituents. In fact, the term poverty target is something of a short-hand in that it is defined to be based on three dimensions: income poverty, severe material deprivation and/or jobless households. For the purposes of achieving the target, poverty in the Member States can relate to any one, two, or all three of these phenomena. The EU poverty target is, then, a (relatively complicated) construct in that Member States have a choice of which of the three approaches to adopt, and they may even opt for an alternative approach provided they justify its usage in terms of how it will contribute to the EU target overall.

Our first reservation begins here and problematizes especially the fact that Member States have a choice of not just the level to set their target at but which indicator or ‘problem’ to use for their target’s focus. To be sure, there are justifications for opening up the target – for example the nature and extent of the problems facing Member States (in general and on the three poverty indicators chosen) vary and so some leeway is advised. However, we suggest that the target risks being unworkable because of philosophical and policy incoherence. This directs attention to the underlying policy approach, the empirical nature and manifestation of the phenomenon invoked by each indicator, and wide variations in the extent to which Member States experience each of the three phenomena.

First, in terms of policy approach what seems like a coherent set of indicators actually digs deeply into diverse philosophies of welfare and views about the best approach to combat poverty and social exclusion. The first element – being below a 60 percent cut-off of median income – is the classic relative poverty measure based on how one’s income compares to the societal average. As an approach to social policy it calls for either income redistribution (if poverty is seen in terms of falling below a relative income threshold) or the guaranteeing of a basic or minimum income threshold below which no one should fall (if an absolute approach is taken). The EU has never settled on relative income poverty as a definition of poverty – even though it is the most widely-used definition of poverty in Member States - and the redistributionist social policy model implied by a relative poverty approach has had limited appeal or support at EU level compared with minimum income schemes which have secured a stronger consensus. The second component of the target – being without at least four items out of a nine-item list of ‘deprivations’ – picks up on lifestyle deprivation and access to customary standards and styles of living. It addresses one of the weaknesses of the relative income poverty threshold which is that it does not give sufficient weight to living standards, especially in countries where living and income standards are low (De Graaf-Zijl and Nolan 2011: 425). As a policy response, adequate income is important here, too, but so also are social services and measures to combat social exclusion (such as for example better educational and labour market opportunities for people). The third dimension of the target links into household joblessness – the number of people in a household where the adults worked less than 20% of their total work-time potential during the reference period. Two concerns underlie this: work intensity on the part of individuals sharing the same household or family; the psychological predisposition towards employment and the morally corrosive effects of joblessness, especially in an intergenerational sense. This does not problematize unemployment *per se*, then, but rather its distribution or concentration among people living in the same household or family. The perceived solution is to intervene in what is viewed especially as a family or intergenerational cycle whereby people become demotivated, and disadvantage and poor access to the labour market become more entrenched as time passes and generations succeed each other. There are three required policy actions involved: to make more jobs available; to target these jobs towards people sharing households where there is too little engagement with employment; and to make people in these households available for employment and wanting to be employed.

Problems in choosing the right policy approach are compounded by weaknesses or lack of strong linkages between the three dimensions of the poverty target in reality. In this regard, research suggests that, while there is a strong relationship between income poverty and material deprivation, joblessness as a characteristic of households is a very different kind of phenomenon and one that is only poorly correlated with either poverty or material deprivation (de Graaf-Zijl and Nolan 2011). A jobless household is the odd one out in several respects. First, people living in such households are not necessarily poor. Nolan and Whelan (2011: 16) demonstrate that over a quarter of people classified as being in jobless households in the EU as a whole are from professional and managerial classes and only 43% are drawn from the working classes, suggesting at a minimum that this population is highly differentiated and that people live in jobless households for a host of reasons among which may not be a shortage of money. Their findings lead them to suggest that joblessness might be better thought of as a factor leading to income poverty or material deprivation than as an

indicator of poverty per se (ibid: 18). Hence, measures to address household joblessness will not contribute hugely to reducing poverty and material deprivation and *vice versa*.

A further set of challenges is posed by the fact that poverty, material deprivation and jobless households vary widely in their prevalence within the Union and across Member States. Of the three, income poverty is the most extensive problem. Affecting some 17% of the EU population in 2008 – this is equivalent to at least 80 million people. In comparison, around 8% of the EU's population experience severe material deprivation and a similar proportion of people live in so-called jobless households. In addition the prevalence of each varies widely among Member States. Hence, income poverty in 2008 varied from a low of 8.6% in the Czech Republic to a high of 25.7% in Latvia. Similarly material deprivation is a very rare phenomenon in some Member States (such as the Netherlands and Sweden where it affects fewer than 2% of the population) but a very common one in others (like Bulgaria and Romania with respective prevalence of 41.9% and 32.2%). Variation is extreme also in the jobless household's phenomenon (encapsulated by a rate of 4% in Cyprus and 19.8% in Ireland). This variation helps to explain the catholic nature of the agreed definition of poverty and social exclusion for the purposes of the target and underlines how the constitution of the poverty target might be political. But reality hits home in other ways as well. For not only does the nature of the most pressing problem vary by country but so too does the overall scale of the problem. When the three elements of the target are assembled together, the EU-wide variation is such that the population for the target varies from 14.8% of the total population in the Netherlands to 44.3% in Romania (Nolan and Whelan 2011: 15). So addressing the target is a much bigger problem in some countries than others. And it is the new Member States as well as those in the Mediterranean region together with the UK and Ireland which face the greatest challenge in meeting the target. The underlying point to be emphasized, then, is that what seemed like a rational idea at the time of agreeing the target – to have it diversely constituted - has profound implications. These exist both at national level - in regard to how the poverty target fits with the national social policy model and the scale of the response required to meet the EU target – and at EU level – in terms of whether such a diversely-constituted approach to poverty is meaningful as a political goal. . What seems like a coherent target, therefore, masks great incoherence and huge differences in the nature and scale of challenge.

*Where does the target sit in relation to other policy objectives and the policy hierarchy?*

One of our main claims is that governance architectures are not value-free arenas in which agreed objectives and policy instruments are given an equal weight. Rather they are embedded in political strategies that privilege certain interests and actors over others, create hierarchies of priority, and reflect a broader set of socio-political relations between actors and interests. Furthermore, given the dynamics often surrounding the aims and objectives of governance architectures, such relations are continuously in flux and the subject of ongoing power struggles. Given this, to fully understand the significance of a policy objective within a governance architecture, it is necessary to locate the objective in the hierarchy of priorities.

The re-launched Lisbon Strategy institutionalized a historical and structural separation between social policy on the one hand and economic, monetary and employment policy on the other

(Tholoniati 2010). This has always been a source of criticism on the part of social actors, and has left a lingering suspicion that poverty and social exclusion are afterthoughts or ‘add-ons’ to the process of European integration. Therefore, the integrative ambition of Europe 2020 was trumpeted as one of its strengths, especially in relation to establishing more formal linkages between the different policy pillars (economic, monetary and employment) and the inclusion of poverty and social exclusion into the mainstream governance process (via its incorporation into the employment pillar). This notwithstanding, we consider that the hierarchy of priorities and objectives within Europe 2020 is such that the ‘integrated’ nature of Europe 2020 does little to improve the ‘add-on’ status of social policy within the EU. The poverty target is situated low in Europe 2020’s priorities and its achievement is derivative of progress in other policy areas.

Europe 2020 privileges activity and progress within the macro-economic pillar over other pillars and thereby empowers actors within DG Economic and Financial Affairs (DG ECFIN), as well as those operating in Finance Ministries at the national level, over any other grouping of decision-makers. At the heart of Europe 2020 are two aims: first, to modernize and increase the competitiveness of the EU; and second, to reduce Member State budget deficits and total levels of debt (i.e., fiscal discipline). Member States are to abide by the concept of fiscal sustainability in their monetary policies and developments within the economic and employment pillars (which includes the poverty target) are to demonstrate an appreciation of this principle. In other words, developments in the thematic components of Europe 2020 are rendered a function of progress in the macro economy. This principle has been further emphasized by the Commission which has proposed that selected thematic issues “could also be addressed to the extent that they have macroeconomic implications through the recommendations under the BEPGs” (European Commission 2010c: 28). In other words, despite the Commission arguing that Member States “must find room in their budgets” for thematic issues (European Commission 2010a: 3), if macroeconomic conditions become unfavourable, i.e., excessive government deficit or debt level, then spending on the thematic components of Europe 2020 should be restricted until ‘sound’ public finances are re-established.

Moreover, the EU’s response to the euro-zone crisis exacerbates these tendencies and reinforces the hierarchy of priorities within Europe 2020 (Leschke *et al* 2012). That is, the various reforms to the EU’s broader economic governance reinforce the objective of macro-economic discipline. This further disadvantages social actors and their ability to make progress on the poverty target. In all, the EU has implemented a so-called ‘six-pack’ of measures. The two most important reforms have been the strengthening of the fiscal rules under the Stability and Growth Pact, known as the Euro Plus Pact, and the Excessive Deficit Procedure to address the issue of current account deficits. The Euro Plus Pact is designed to be a more stringent successor to the Stability and Growth Pact which had not been consistently adhered to across the Member States. The Pact continues to use the OMC but has come under criticism for promoting fiscal austerity while simultaneously seeking to reduce unemployment by implanting market-oriented structural reforms (Leschke *et al* 2012).

Although these two developments do not directly address the poverty target, indirectly they reinforce the hierarchical relationship among both priorities and different socio-political groups within Europe 2020. Therefore, as the Euro zone crisis has continued to gather momentum, the

broader set of reforms to the EU's economic governance has reinforced the low priority of the poverty target. Moreover, since 14 of the EU's 27 Member States currently have government debt levels above the 60 per cent of total GDP threshold (Eurostat 2011: 1) raising the possibility of a 'fine', there are strong incentives for such Member States to reduce their government debt via spending reductions, leaving few resources to address the poverty target. Furthermore, EU/IMF lending programme countries are not required this year to submit full National Reform Programmes but a letter of update outlining the state of play and possible updates of the national Europe 2020 targets and Euro Plus Pact commitments. One could say, then, that the normal process of Europe 2020 is being suspended for these countries. It is hard to interpret this other than that these countries – with poverty levels among the highest in the EU - are not bound by the 10 guidelines and five targets of Europe 2020. The hierarchy of priority within the objectives of Europe 2020 therefore weakens the progress social actors can make with respect to achieving the poverty target.

### *How adequate are the modes of governance?*

During the Lisbon decade, the OMC in poverty and social exclusion operated outside of the mainstream governance cycle. It formed its own logic centring on policy review and learning which did not feature Country Specific Recommendations by the Council/Commission for the Member States as a tool of governance. In this respect, the OMC social inclusion was one of the weaker OMC governance processes. The incorporation of poverty and social exclusion into the employment pillar suggests a strengthening in its governance, since employment is generally considered to be an advanced and developed sphere of the OMC (Tholoniati 2010). This is because the employment pillar features an annual governance cycle of commonly agreed guidelines, the reporting of progress in the form of National Reform Programmes, and peer review with the issuing of Country Specific Recommendations. However, this shift in the governance of poverty and social exclusion does not necessarily signify an improvement to the mode of governance in the poverty/social exclusion and could actually signify the opposite.

The first point to note is that the full incorporation of poverty and social exclusion into the employment pillar creates legal uncertainties surrounding its governance. Employment policy has an explicit place in the Treaty under Article 148 and this provides the legal mandate for the governance of the employment strategy, including the issuing of Country Specific Recommendations. In contrast, the Treaty grants the EU loose and inchoate powers in relation to poverty and social exclusion. The issuing of Country Specific Recommendations in this domain is therefore contentious and a source of dispute between the Commission and some Member States. Three countries in particular are vehemently opposed to its use for social purposes (DK, PL and UK). The legal basis of the incorporation of poverty and social exclusion into the employment pillar is therefore in doubt, undermining its legal status and thereby governance. In sum then, although social exclusion and poverty are now subject to an annual cycle under Europe 2020, Member State engagement remains voluntary and the issuing of Country Specific Recommendations contentious and to date little utilized.

The second issue concerns the high degree of uncertainty surrounding the governance of the poverty target, particularly with respect to who governs it. Under the auspices of the Council, both

employment and poverty/social exclusion are the responsibility of the Employment and Social Policy Council (EPSCO), but within EPSCO they are governed separately by the Employment Committee and the Social Protection Committee respectively. Moreover, following the launch of Europe 2020 the OMC social exclusion, which had centred around the Social Protection Committee, was suspended. This has left a high degree of uncertainty as to both the process and who is responsible for monitoring and encouraging progress towards the poverty target in the Member States. The reintroduction of some elements of the OMC has not clarified the situation. If anything, the agreement that Member States must now produce National Social Reports in addition to National Reform Programmes has led to confusion even if such reports are to be synchronized with the European Semester and the National Reform Programmes. It is difficult to see this as a major development which improves the clarity as to who is responsible for the poverty target. First, the modalities of reporting and review – and in particular what status the National Social Report will have re Europe 2020 – are unclear. Second, the re-launching of a social reporting procedure appears to result from a minority of EU-level social actors, especially the Commission's Directorate-General for Employment (DG EMPL), attempting to regain some control and input into the EU's economic reform strategy. In sum, there remains continued uncertainty as to who is responsible for the governance of the poverty target and such uncertainty undermines the progress that can be made.

The third and final point is that the ambiguities surrounding the governance of poverty and social exclusion within Europe 2020 have been further heightened by the uncertainties of the purpose and function of the European Platform against Poverty and Social Exclusion. The aim of the Platform is to create a commitment among the Member States, EU institutions and the key stakeholders to fight poverty and social exclusion. In doing so, it intends to identify best practice and promote mutual learning, establish EU-wide rules, and make necessary EU funds available. However, the purpose of the Platform remains unclear, particularly with respect to the supposed difference between the Platform and the OMC social exclusion developed during Lisbon.

Overall then, the governance of poverty and social exclusion is based on a voluntary agreement between the Member States in which there is a high degree of uncertainty and ambiguity.

#### **4. Conclusion**

Essentially, any EU target is only as good as the targets that are uploaded to the EU level. When it comes to the poverty and social exclusion target it is subject to two main risks: that Member States will choose a focus that is not consonant with the EU's way of conceiving poverty; or that they will choose a target that is too low to make a sufficient contribution to the EU-level target. The achievement of the Europe 2020 poverty target rests, therefore, on a double jeopardy.

Regarding the actual definitions chosen by the Member States, the latest information suggests that the first jeopardy has come to pass. Seven Member States (CZ, DE, DK, EE, FR, SE, UK) have exercised the choice implicit in the framing of the target and opted for a different set of indicators to that of the EU and an eighth country - Luxembourg - has set no target at all. This makes for some 11 different kinds of target in all (seven from the aforementioned Member States, plus the four implicit

in the EU target). This underlines our claim of imperilled governability because of incoherence. In terms of the actual targets set, the second jeopardy has also occurred in that the estimates available to date point to a great shortfall in the EU target. In fact, the EU target is short by between 5 and 8 million. The ‘lost millions’ are a casualty of the impossibility of ensuring that the Member State targets and priorities cumulate appropriately to those at EU level.

The framework that we constructed and applied here, drawing both on Borrás and Radaelli’s concept of ‘governance architecture’ and insights from political sociology about the political underpinnings of ideas, agency and institutions treated ideas, politics and governance mechanisms as inter-related but contested. Governance architectures are not value-free arenas, but are sites of political struggle between various social actors which construct hierarchies of priorities and power, and thereby serve to determine whether a policy programme can be taken forward in an EU context or not. Furthermore, rather than being ‘static’ entities or institutions, governance architectures are dynamic and continuously being remade. The framework therefore unpacks the hierarchy of objectives, instruments and positioning between various groupings of socio-political actors and policy domains, highlighting that there are conditions of governability for any policy area. These conditions relate to: ideational consistency; political and policy prioritization; and the adequacy of the governance mechanisms.

Applying the framework reveals that EU social policy, as conceived by the poverty target in Europe 2020, is both ungovernable and ungoverned. First, the target is ideationally incoherent representing a patchwork of different, and often competing, ideologies with respect to poverty and social exclusion. While the target may make sense in terms of the diverse set of factors that contribute to poverty at Member State level as well as diverse national approaches to dealing with it, as an EU-level entity, the target – covering as it does income poverty, severe material deprivation and jobless households among other problem areas – subsumes very different perspectives and represents such an uncertain, and unclear, compromise with respect to how poverty and social exclusion should be defined and addressed that it is effectively ungovernable. A second factor contributing to its ungovernability is that not only does the poverty and social exclusion target have a low place in the hierarchy of priorities and objectives within Europe 2020, but it has been further marginalized as a result of the EU’s response to the financial crisis which has set in stone fiscal discipline and spending limits. Rather than being an independent policy area that is ring-fenced from other developments, its achievement is dependent upon progress in other policy areas, particularly the macro economy. A third set of factors highlights the ungoverned nature of the target - not only is there legal uncertainty as to whether Country Specific Recommendations can be issued for the target (unlike the employment area with which it is conjoined), but ambiguity remains over who is responsible for its governance and the exact purpose and function of the mechanisms for its implementation (including the Platform against Poverty and Social Exclusion and the OMC).

All of this leads us to the view that Europe 2020 does not represent significant progress for EU social policy. Europe 2020 rests on an expectation that a ‘joined-up’ governance process (which is to be realized by targets, integrated guidelines and the European Semester) will lead to the upgrading of social policy and increase the chances of poverty and social exclusion being part of an integrated approach. What we have demonstrated in this paper is that Europe 2020 is incapable,



because of ideational, political and institutional weaknesses, of bringing social policy in from the margins of the European integration process. While it is novel in an EU context to have a target for poverty and social exclusion, and the target itself has some innovative and ambitious elements, it does not signify a strengthening of the EU's commitment to social policy.

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# **David Howarth and Lucia Quaglia, 'Economic Governance and the chimera of financial system stability: The political economy of new capital requirements in the European Union'**

## **Abstract**

The Basel III Accord on a 'Global regulatory framework for more resilient banks and banking systems' was issued in late 2010 as the cornerstone of the international regulatory response to the global financial crisis. Its adoption into European Union (EU) legislation has, however, been met with considerable member state reticence and intra-EU negotiations are ongoing. This paper investigates the domestic political economy of new capital requirements in the EU, arguing that the institutional features of the domestic banking sector convincingly account for the divergence in EU member state preferences on capital rules.

## **Introduction**

Since the global financial crisis delivered a major blow to the financial stability of much of the European Union (EU), financial regulation has moved to the centre stage of debates about the future of EU economic governance (for an overview see Buckley and Howarth 2010; Mügge 2011; Posner 2009; Quaglia 2012). Capital requirements for banks have traditionally been regarded as one of the main instruments to ensure the stability of the banking sector and hence financial stability tout court. In 1988, the Basel Committee on Banking Supervision (BCBS) issued the Basel I Accord on 'International convergence of capital measurement and capital standards', which was updated by the Basel II Accord in 2004 (revised in 2005, see BCBS 2005). Over time, these 'soft' international rules have been incorporated into (legally binding) national legislation. In the EU this was done through the capital requirements directives (CRD) (see Underhill 1998; Christopoulos and Quaglia 2009).

The Basel III accord (hereafter Basel III) was issued in late 2010 as the cornerstone of the international regulatory response to the global financial crisis (BCBS 2010). Its adoption into EU law has, however, met with considerable member state and EU institutional reticence. The EU directive and regulation to be adopted (referred to collectively as CRDIV) will likely qualify the application of the Basel III capital requirements in the EU. The EU is one of the largest financial jurisdictions worldwide and some scholars have indeed pointed out its 'market power' (Damro 2012). In terms of total banking assets and liabilities, the EU's internal market is larger than that of the US. Hence, the implementation of Basel III into EU legislation will be consequential not only for its large internal market and the 6000 European banks therein, but also for the stability of the international financial system. Third jurisdictions, first and foremost the US, which is the main counterpart of the EU in international financial fora, are also concerned about potential regulatory arbitrage and competitive advantages accruing to European banks as a result of the 'distinctive' implementation of Basel rules in the EU.

This paper investigates the implementation of the Basel III accord into EU legislation with a view to make sense of two (related) issues. First, despite financial integration in Europe and the rise of

pan-European banking groups, profound differences remain in both national banking systems and national regulatory frameworks. Hence a heated intra-EU political debate erupted on the proposed legislation. Second, the UK, which in the past had supported ‘light touch’ regulation (Hodson and Mabbett 2009; Posner and Veron 2010), favoured new strict rules on capital. By contrast, France and Germany called for a ‘looser’ definition of capital and lower capital requirements, contradicting their ‘market-shaping’ approach to financial regulation, which predominated since the financial crisis on a range of financial issues in the EU (Quaglia 2010; Zimmerman 2010), internationally (Fioretos 2011) and especially in government discourse (Buckley and Howarth 2010). However, the positioning of EU member states on EU legislation implementing Basel III deviates from these expectations.

The paper proceeds as follows. Section 2 reviews the literature on the politics of EU financial regulation. Section 3 provides an overview of the negotiations and the content of the new capital rules in the EU. Section 4 investigates the domestic political economy of these rules in the main European countries. It is argued that the institutional features of the domestic banking sector and other domestic political economy considerations convincingly account for the divergence in EU member state preferences on Basel III. This section demonstrates the incomplete nature of European economic governance and accounts for the intergovernmental character of many EU negotiations in this policy field.

## **2. The State of the Art**

The political economy literature on financial services regulation in the EU has developed differing views on the subject. Story and Walter (1997) stressed the intergovernmental character of the negotiations on financial market regulation in the EU in the 1970s, 1980s and early 1990s. As the title of their book suggests, their work regarded financial market integration as the ‘battle of the systems’, whereby the member states were keen to set EU rules that were in line with their domestic regulatory approach and did not create comparative disadvantages or adjustment costs to national industry and the public authorities. However, they also stressed the importance of ‘ideas’ about regulation, the state and financial services (for a similar argument, see also Grossman 2004). Underhill (1997), like Story and Walter, highlighted how the ‘triangle’ of the three main financial systems in the EU – the British, the French and the German – played out and shaped EU financial regulation in the 1980s and early 1990s. These accounts tend to be intergovernmental, overlooking the role of other important actors, such as the European Commission and industry. This chapter builds on and develops further this line of enquiry by examining the ‘battle’ of the systems on a key piece of financial legislation: capital rules.

A second body of scholarly work has viewed the Commission as the core supranational actor driving financial market integration (Posner 2005; Jabko 2006). Posner (2005: 20) stressed the ‘intended and unintended bureaucratic actions’ of the Commission in the creation of new stock markets in Europe in the 1990s. By contrast, Jabko (2006) showed how the Commission was able to ‘construct’ the single market by emphasising different meanings of the word ‘market’ to different audiences, forming a coalition that pushed through financial market reform in the late 1990s and early 2000s. These accounts somewhat overemphasise the role of the Commission in the making of

financial regulation. This policy area is still jealously guarded by the member states. Moreover, the Commission has seen its influence reduced in the EU policy process since the time of the charismatic Presidency of Jacques Delors. Yet, the Commission has been activist in its efforts on financial regulation, in particular since the outbreak of the international financial crisis in 2008. A third stream of literature has focused on the role of the private sector in promoting European financial market integration (Bieling 2003; Mügge 2006, 2010; Macartney 2009, 2010; Van Apeldoorn 2002). These works emphasise either the structural power of transnational capital or the lobbying activities of financial institutions which ‘captured’ the public authorities in various ways (Baker 2010; Underhill, Blom and Mügge 2010). Amongst the most prominent were the ‘economic’ or ‘material’ capture, given the size and importance of the financial sector in certain countries and the economic resources available to industry for lobbying, and the ‘intellectual’ capture, based on the high level of expertise and technical knowledge at the disposal of the private sector and often tapped into by the regulators themselves. This literature tends to underplay the fact that the financial industry, even the main transnational players, often have competing interests. This chapter investigates the preferences of the financial industry (mainly banks) on capital rules in the main member states on the basis of their capital positions and business models.

Other scholars have focused on networks of supervisors in the EU (Coen and Thatcher 2008; De Visscher et al. 2008; Quaglia 2008), an approach which, however, has limited explanatory power in the making of level 1 legislation (or framework legislation), because the ‘technical’ authorities (i.e., financial supervisors) are only consulted during the legislative process, whereby legislation is proposed by the Commission and co-decided by the Council of Ministers and the European Parliament. The network based approach is more successful when applied to level 2 legislation in which the so-called ‘committees of supervisors’, recently transformed into EU agencies, are the main players.

Other studies have applied a constructivist analysis to the subject, pointing out that in the 1980s and 1990s a dominating paradigm for financial services regulation emerged internationally and in the main jurisdictions, including Europe. They have referred to it as the ‘neoliberal’ paradigm (Best 2003; Gamble 2009) or as a ‘governance light’ approach, which favoured ‘market-based governance’, based on a benign view of financial markets and grounded in efficient market theories (Underhill *et al.* 2010: 10). This regulatory paradigm was sponsored by the US and the UK, which prior to the crisis exercised considerable influence in international regulatory fora (Baker 2010; Helleiner and Pagliari 2010).

In the EU, regulatory liberalism came to dominate EU financial regulation from the mid-1990s onwards until the outbreak of the global financial crisis (Mügge 2011). Over time, according to Donnelly (2011), there was a gradual convergence, which he refers to as ‘collusion’, amongst member states’ norms of financial market regulation, paving the way to an agreement to delegate functions at the supranational level in the early 2000s – the so-called Lamfalussy architecture (see Quaglia 2007). In a similar vein, but with more emphasis on persisting differences of regulatory approaches, Quaglia (2010a, b) pointed out two main competing coalitions of interests and ideas struggling to shape financial regulation in the EU in the 2000s: the ‘market-making’ coalition, led by the UK, also included Ireland and the Nordic countries; and the market-shaping coalition, led by

France, also included Italy, other Mediterranean countries and, in several instances, Germany (see also Zimmerman 2010).

This paper investigates member states and financial industry preferences on capital rules through a comparative political economy (CPE) analysis. In so doing, it addresses the apparent contradiction in EU member state broader regulatory preferences mentioned in the idea-based literature and their specific preferences on EU capital requirements legislation. The CPE analysis embraced here sees member state preferences determined by a combination of political economy factors and, notably, the institutional features of the domestic banking sector (see Allen and Gale 2000, Hardie and Howarth 2013). Our analysis involves digging into the balance sheets of banks in the main EU countries, their assets and liabilities (i.e., how banks are funded). The impact of state intervention during the recent financial crisis on banks' capital position is also considered.

### **3. The content and negotiations of the new EU capital legislation**

The Basel III accord was signed by the BCBS in December 2010 (BCBS 2010). The new rules: provide a more restrictive definition of what counts as capital; increase the risk weight of several assets in the banking book and introduce capital buffers; set up a recommended and potentially obligatory leverage ratio; and outline international rules on liquidity management. All in all, the new rules increase the proportion of capital that must be of proven loss absorbing capacity (going concern), i.e., core tier one (equity) capital, over Basel II requirements, and will be phased in gradually from January 2013 until 2019. The Basel III accord is an agreement between national regulators gathered in the BCBS, hence it has to be implemented into national (and / or EU) legislation in order to become legally binding.

In July 2011, after extensive consultation conducted in parallel with the work of the BCBS, the EU Commission adopted the CRDIV legislative package designed to replace the CRDII with a directive that governs the access to deposit-taking activities (Commission 2011a) and a regulation that establishes prudential requirements for credit institutions (Commission 2011b). After its approval, the proposed directive (Commission 2011a) will have to be transposed by the member states in a way suitable to their own national environment. It contains rules concerning the taking up and pursuit of the business of banks, the conditions for the freedom of establishment and the freedom to provide services, the supervisory review process and the definition of competent authorities. The directive also incorporates two elements of the Basel III accord, namely the introduction of two capital buffers on top of the minimum capital requirements: the capital conservation buffer identical for all banks in the EU the countercyclical capital buffer to be determined at national level. The proposed EU regulation (CRR) (Commission 2011b) contains prudential requirements for credit institutions and investment firms. The proposed regulation covers the definition of capital, increasing the amount of own funds that banks need to hold as well as the quality of those funds; it introduces the Liquidity Coverage Ratio — the exact composition and calibration of which will be determined after an observation and review period in 2015; and the need to consider a leverage ratio, subject to supervisory review.

The Commission's CRDIV draft, which would implement Basel III into EU law, is the most substantial of all the post-financial crisis regulatory measures entertained to date at the EU-level but its draft also involved watering down or modifying the Basel III guidelines in ways to meet EU member state demands (IMF 2011; *Financial Times* 30 January 2012). Table 1 outlines the main differences between Basel III and CRDIV.

**Table 1: CRDIV versus Basel III**

	<b>Basel III</b>	<b>EU Commission draft (20.7.2011) CRDIV</b>
<b>Definition of Capital</b>	Core Tier-1 defined as common shares – strict criteria set – and retained earnings only. Hybrids banned in Core Tier-1 and restricted in non-Core Tier 1.	Marginally broader definition of Core Tier-1: to include 'silent participations'. Broader use of hybrids in non-Core Tier 1.  More detail on the required characteristics of CET 1 instruments for mutual and cooperative entities, including potential derogations from specific requirements.
<b>Level of Capital</b>	Total regulatory capital (tier-1 and tier-2) must be at least 8 per cent of risk-weighted assets (RWA). Core tier-1 at 4.5 per cent and total Tier- 1 at 6 per cent of RWA. Total regulatory capital with capital conservation buffer set at 10.5 per cent and up to 13 per cent with countercyclical capital buffer (which can include some hybrids). Up to 10 per cent of insurance subsidiary capital can be double counted.	Same ratios but double counting of insurance subsidiaries allowed and more flexible rules on hybrids.  Single rule book / maximum harmonisation approach adopted.
<b>Leverage ratio</b>	Set as a backstop to risk-based capital. To test a minimum Core-Tier 1 leverage ratio of 3 per cent (non-risk based) from 2013-2017; with possible inclusion thereafter.	Leverage ratio to be considered.
<b>Liquidity</b>	Net Stable Funding Ratio introduced; and Liquidity Coverage Ratio (LCR) to cover 30 day period of 'acute market stress'. Strict criteria as to what counts as an eligible liquid asset.	NSFR seen as an option: may be imposed after an observation and review period.  Less prescriptive language on what counts as an eligible liquid asset under the LCR.



<b>Transition periods</b>	Capital: 2015	Capital: same as in Basel III
	Capital buffers: Phased in between 2016 and 2019.	Capital buffers: same as Basel III.
	Liquidity: LCR by 2015; NSFR by 2018.	Liquidity: LCR by 2015; NSFR <i>may be</i> adopted from 2018.

The CRDIV draft was criticised by many regulators and by the IMF for failing to incorporate key Basel III elements (IMF 2011). The Commission ‘softened’ its definition of Core Tier I capital relative to the Basel III recommendations in some areas — effectively allowing ‘silent participations’, that is, state loans that make up a significant part of public Landesbanken capital. The Commission’s draft limits the role of the leverage ratio designed to limit risk-taking at banks. The almost unique reliance on the risk-weighted core tier 1 ratio in the Commission’s draft CRDIV, which was in line with what agreed in Basel III, was criticised for inadequately representing the health of the European banking sector (*Financial Times* 30 January 2012). On liquidity, the Commission adopts the less prescriptive definition of liquid assets for the Liquidity Coverage Ratio (LCR) to include ‘transferable assets that are of extremely high liquidity and credit quality’ and ‘transferable assets that are of high liquidity and credit quality’. The Commission’s draft lacks of a firm commitment to implement the Net Stable Funding Ratio by 2018 called for in Basel III. The proposed regulation also sets higher capital requirements for Over the Counter (OTC) derivatives that are not cleared through Central Counterparties (CCPs). The use of a regulation, which once approved is directly applicable without the need for national transposition, is designed to ensure the creation of a single rule book in the EU. The regulation eliminates a key source of national divergence. In the CRD II, more than one hundred national discretions (differences in national legislation transposing the EU directive) remained. Yet, the Commission also proposed a maximum capital ratio which was opposed by many who argued in favour of EU standards that exceed the Basel minimum because of prevailing balance sheet uncertainties in the EU, the lack of EU-wide resolution arrangements and a fully unified fiscal backstop. The analysis below will demonstrate that most of these modifications to Basel III in CRDIV owe to French and German demands.

Following the agreement on Basel III and during the intra-EU negotiations on CRDIV, some of the compromises reached in the BCBS unravelled. Several EU member states, the European Parliament (EP) and even the Commission itself called for the taking into account of ‘European specificities’ in incorporating the Basel III rules into the CRD IV, reopening some of the issues that had caused friction within the BCBS. Basel III applied to internationally active banks, whereas EU legislation was to apply to all banks, making some Basel III provisions — notably the calculation of tier 1 — impossible to apply in EU member states without a massive shift in the structure of a large range of banks and banking systems. The EP also emphasised competition concerns and the need to ensure an ‘international level playing field’. Of particular concern was the fact that in the US, the Basel III accord would be applied only to financial institutions with over (US)\$50bn in assets, whereas the new rules will be applied to all banks in the EU, as in the case of Basel I and Basel II (EP 2010, 2011).

### 3. The domestic political economy of new EU capital rules

This section engages in a domestic political economy analysis of national preferences on EU capital requirements. These preferences reflect three factors: the capital, and thus competitive, position of national banks; national banking and financial system structure; and related macro-economic considerations (the impact of Basel III on the wider economy).

#### *Capital position*

The first explanation focuses specifically on the capital position of banks and relates to the likely impact of recapitalization upon their market share and competitiveness. Basel III / CRDIV will force banks to hold 6 per cent tier-1 and 8 per cent tier-1 and tier-2 capital by 2015 and four years later, with the capital conservation buffer of 2.5 per cent to be phased in by 2019, 8.5 per cent and 10.5 per cent respectively. The obligation to raise a bank's tier-1 capital ratio can have one or both of two effects. To get to those requirements the banks either need to reduce lending (i.e., decrease the RWA denominator) or retain earnings (i.e., increase the capital base numerator). If the former is undertaken then profits will be lower; if the latter then discretionary payments such as dividends on equity will decrease. *Ceteris paribus*, both developments make the bank less attractive to investors. However – it might also be noted – some investors will be focused more upon long-term stability of banks, especially in the difficult market conditions of the early 2010s. For internationally active banks without equity capital, such as German Landesbanken and French mutuels, Basel III menaced a significant overhaul of their capital structure and their legal status — although exceptions could have been allowed which did not apply to commercial banks with listed equity. While the capital position of national banks varies, systemic patterns can be detected. The studies and impact assessment of the BCBS of new Basel III rules were conducted at the aggregate level. Nonetheless, even the BCBS warned about differentiated effects across countries, without identifying those with banking systems most affected (BCBS 2010). Of the three large EU member state governments considered here, the German was most determined in its opposition to the ban on hybrids — that is, capital which has some features of both debt and equity and notably 'silent participations' (*Financial Times*, 10 September 2010) and the introduction of a leverage ratio. The German government was the most in favour of maximum harmonization rule in order to prevent better capitalized banks from gaining competitive advantage and expanding market share at the expense of undercapitalized (German) banks. German banks (both commercial and Landesbanken) were most heavily exposed to a ban on hybrids. As noted above, the British government, was most in favour of tighter capital rules and most opposed to a maximum harmonization rule. A perusal of the equity and tier 1 capital for systemically important British, French, German banks shows why the German government in particular had good reason to oppose the rigid tightening of capital requirements (see Tables 2 and 3). Data on tier 1 capital show that the most of the main British banks would have limited difficulties to meet the 6 per cent Basel III standard even in adverse conditions. However, most now would risk failing to meet the 8.5 per cent level (which includes the 'capital conservation buffer' required by 2019. The data on French banks suggest their strong position but the double counting of insurance subsidiaries — which Basel III recommends banning — inflates the tier 1 capital ratio significantly in most cases. Faced with adverse capital conditions, the two large German commercial banks would only narrowly respect the Basel III target for 2015.

**Table 2: Tier 1 capital (as a percentage of total assets) main British, German and French systematically important banks\***

<b>Recall:</b> Basel III target of 6 per cent / or 8.5 per cent with the 'capital conservation buffer' from 2019.	<b>2012 baseline scenario</b>	<b>2012 adverse</b>	<b>2011 baseline scenario</b>	<b>2011 adverse</b>
<b>UK non-weighted average</b>	10.4	7.45	9.75	7.95
<b>RBS</b>	9.1	6.3	9.2	7.2
<b>HSBC</b>	10.7	8.5	10.3	8.8
<b>Lloyds (includes HBOS from 2009)</b>	11.7	7.7	10.2	8.1
<b>Barclays</b>	10.0	7.3	9.3	7.7
<b>FR. non-weighted average</b>	9	7.4	8.5	7.7
<b>BNP-Paribas</b>	9.8	7.9	9.1	8.3
<b>Soc Gen</b>	8.3	6.6	7.9	6.8
<b>Credit Agricole</b>	9.4	8.5	8.8	8.4
<b>BP (BPCE from 2010)</b>	8.5	6.7	8.1	7.2
<b>DE. Non-weighted average</b>	8.8	6.4	7.85	6.75
<b>Commerzbank</b>	8.7	6.4	8.9	7.2
<b>Deutsche</b>	8.9	6.4	6.8	6.3

Source: EBA \*Results of the stress test based on the full static balance sheet assumption without any mitigating actions, mandatory restructuring or capital raisings post 31 December 2010 / 11 (all government support measures fully paid in before 31 December 2010 / 11 are included).

The implications of the new capital rules were potentially greatest for the many non-listed public sector and mutual banks (a much more significant element of the German and French banking systems than in the UK) which did not use equity, relying on other capital to meet capital requirements in the past including hybrids. Table 3 shows the tier 1 capital ratios for the German Landesbanken. Proportionately, the ban on hybrids would hit the German banking system and in particular the Landesbanken which explains the CRDIV draft provision to continue to allow only the one form of hybrid on which they rely to meet the core tier-1 ratio: 'silent participations'. The ban on all other hybrids was also incorporated into the EBA's late 2011 stress-tests of systemically important banks, leading one German bank, Helaba (the Hessen-Thüringen LB) to pull out to avoid public failure, on the grounds that it was not consulted on this ban (*Financial Times* 13 July 2011). It is also important to note that the ban on hybrids also hits the two large German commercial banks, as witnessed by Commerzbank's efforts in early 2012 to replace its hybrid capital with equity demonstrate in order to improve its core tier-1 position (*Financial Times* 23 February 2012).

**Table 3 Tier 1 capital of German Landesbanken**

<b>Recall: target of 6 per cent / 8.5 per cent</b>	<b>2012 baseline scenario</b>	<b>2012 adverse</b>	<b>2011 baseline scenario</b>	<b>2011 adverse</b>
<b>HSH Nordbank</b>	105	55	104	98
<b>NordLB</b>	48	37	48	43
<b>LBBW</b>	77	62	77	67
<b>DZ Bank (Coop)</b>	82	59	81	68
<b>Bayerische LB</b>	90	71	91	81
<b>WestLB</b>	88	61	88	73

Source: EBA. \*Results of the stress test based on the full static balance sheet assumption without any mitigating actions, mandatory restructuring or capital raisings post 31 December 2010 (all government support measures fully paid in before 31 December 2010 are included)

Basel II guidelines and CRDII rules on bank capital allow banks to amass assets with high credit ratings without setting capital aside to cover potential losses. This allowed many banks in Europe to become highly leveraged despite meeting international rules on capital cushions. European Central Bank and several other central bank officials pushed for a leverage ratio as a simple mechanism to curb excessive risk-taking (*Financial Times*, 2 February 2012). The French, German and a range of other EU member states governments opposed the adoption of a leverage ratio to determine the quantity of capital to be held by banks, which explains why the specific Basel III provision (3 per cent or an assets to tier 1 capital ratio of approximately 33) was made more flexible in the Commission's CRDIV draft. French and German opposition reflected the much higher leverage ratios of most large banks in France and Germany (compared to the UK) and in particular the difficult situation facing German LB and French mutual banks having to respect a new leverage ratio (see Table 4) and the fear of the need to force through a rapid de-leveraging of banks. While the leverage ratio of British banks increased dramatically in the two years prior to the outbreak of the financial crisis, this had been historically amongst the lowest in the EU and it dropped quickly in 2009 and 2010. The figures for French banks appear similarly low. However, the Basel III ban on double counting the capital of insurance subsidiaries — if adopted in EU legislation — would hit leverage ratios for several French banks considerably. The French (and to a less extent Germans) pushed to lift the restrictions in Basel III on the double counting of capital in banks' insurance subsidiaries. This hit the three large French commercial banks particularly hard because of the longstanding feature the French banking system of *bancassurance*, in which insurance companies (often subsidiaries of banks) make use of banks to market their products. The system predominates in certain other EU member states, including Spain and Austria. However, the lifting of the Basel III restriction also benefited the part-state owned Lloyds-TSB, which is one of Britain's largest insurance providers.

Clearly, member states governments — including the British — continued to criticise certain elements of CRDIV as excessively restrictive. The British Bankers Association (BBA) challenged the harmonisation of the capital treatment of mortgages in arrears (*Financial Times*, 22 January 2012). The draft directive declares that all EU loans were to be treated as if they are in default when they are 90 days in arrears (which was common practice in most EU member states). However, this would overrule existing UK rules that give retail mortgage borrowers up to 180 days. The definition change would significantly increase the probability that British mortgage loans would default, a key metric in determining capital charges. The BBA estimated that the proposed regulatory changes would boost banks' capital charges on UK mortgages by 15-20 per cent, forcing many institutions either to cut lending or charge more to customers. (*Financial Times*, 22 January 2012).

The British government has been the most in favour of the big three for closely aligning CRDIV and Basel III (IMF 2011). The British and Swedish governments criticised the Commission's CRDIV draft on the grounds that it did not go far enough. In particular, the British opposed the move under CRDIV to embrace a leverage ratio for guidance purposes only and sought to keep open the possibility of imposing capital requirements higher than those eventually set by EU legislation, which the Commission's CRDIV draft explicitly blocked by imposing a cap. Some British policy-makers, including the Governor of the Bank of England, were critical of the Commission's rule on a maximum capital ratio, arguing that the new level of required capital should have been many times higher than the levels set out in Basel III (*The Financial Times*, 26 October 2011). The British Independent Commission on Banking recommended that large retail banks be required to have a minimum Core Tier-1 ratio of 10 per cent of risk-weighted assets which would significantly exceed the Basel III minimum of 7 per cent (Core Tier-1 at 4.5 per cent plus the 2.5 per cent capital conservation buffer and the proposed surcharge for global systemically important banks — possibly up to 2.5 per cent (*Financial Times*, 13 June 2011). Other (mainly continental policy) makers, such as the former Governor of the Bank of France, Jacques de Larosière, argued that 'Basel rules risk punishing the wrong banks', that is the 'diversified' and 'safer' continental European banks, rather the Anglo-Saxon banks which, he claimed, engaged in riskier investment banking activities (*Financial Times*, 26 October 2010 p. 11).

#### *The structure of banking and financial systems*

The second political economy explanation focuses on the structure of banking and financial systems and how these structures shape the activities of banks (Allen and Gale 2000; Hardie and Howarth 2009; Hardie and Howarth 2013). This explanation reminds us that British and French commercial banks are better capitalised because, on average, they rely more on equity finance in relative terms than banks in most continental European countries (see Table 5). As noted above, many banks on the continent such as the publicly owned German Landesbanken, cooperative and savings banks and most French mutuals do not have equity finance. Indeed, this aspect proved problematic in the incorporation of the Basel III accord into EU legislation, which contains specific provisions for the cooperative and mutual banks. Basel III was written having in mind banks funded by equity finance (hence the emphasis on common equities in core tier 1 capital), whereas many banks in the EU are based on other sources of funding.

**Table 5: Bank equity as percentage of total assets (Core tier 1)**

	UK	France	Germany
2008	3.7	3.8	2.93
2009	4.87	4.91	3.76
2010	5.37	5.07	3.88

Source ECB Statistical data warehouse. Domestic banking group and stand alone banks only.

The overall equity position of banks in all three countries improved following the financial crisis (with increases of 45 per cent in the UK; 45 per cent in France; and most in Germany at 67 per cent although from a lower position). In all three countries the equity / capital position improved in part because of significant government interventions in the banking system which involved share purchases and for the UK, government intervention came far more, in comparative terms, in the form of share purchase (6.3 per cent of GDP versus only 1.2 per cent in Germany, where the government opted more to purchase toxic assets, and 1.1 per cent of GDP in France — at end 2009) (National Central Bank figures). No other national share purchase programme came close to reaching the British level, in either real terms or in terms relative to GDP.

There are other, less obvious, features of national banking systems which explain positioning on CRDIV. French and German bank and government opposition to the use of a simple leverage rule, as opposed to risk-weighted assets, owes in large part to the relative importance of trade financing in their operations. Trade financing is high in terms of overall assets but low in terms of risk-weighted assets. Similarly, different levels of bank and banking system exposure to short-term funding on wholesale markets directed national preferences on CRDIV liquidity rules. Basel III liquidity rules effectively discourage reliance on short term funding (less than a year) on wholesale markets. Clearly British reliance on short-term funding (less than year) was the highest of the three countries in 2007, in particular short term funding of less than three months. But by 2010 this reliance had dropped dramatically, moving from above 60 per cent of GDP to 30 per cent. In the case of French banks, reliance on short term funding moved from 45 per cent of GDP to slightly above 40 per cent. For German banks it moved from slightly above 10 per cent in 2007 to slightly below 10 per cent of GDP in 2010 (own calculations on the basis of central bank data). UK banks have gone the furthest by far to reduce their reliance and increase the resilience of their funding positions and thus they and the British authorities are most comfortable with the liquidity rules and ambitious phase-in dates. This owed in large part to the early introduction in 2009 of restrictive liquidity rules in the UK, on which the Basel III and CRDIV rules were largely modelled. British banks thus had a head start on liquidity.

The European Banking Federation (EBF) joined by several national governments, including the French, pushed to make liquidity rules less prescriptive (*Financial Times*, 2 February 2012). French bank debt was of a shorter maturity by euro area standards, with 28.3 per cent up to a year at the end of 2010 compared to German figures of 2.6 per cent. French short term debt reached a peak of 36.6 per cent by late 2007 (ECB data warehouse). In Germany, bank debt was issued principally in the form of longer maturity covered bonds — itself a reflection of the ‘patient capital’ that

characterises the German financial system. Basel III includes a prolonged phase-in period for the Liquidity Coverage Ratio (2015) and the Net Stable Funding Ratio (2018), while CRDIV waters down the LCR and fails to impose the NSFR. This preference for gradualism and flexibility can be explained by concerns about the potential impact of these liquidity measures on lending, in particular in bank-based continental financial system, where banks are the main source of finance for firms, especially for SMEs.

Another metric to demonstrate bank exposure to ‘non-traditional’ forms of funding is the customer funding gap — the gap between nonfinancial company (NFC) loans and deposits (see Table 6). This drop largely stemmed from a massive decline in lending. The major UK banks’ holdings of highly liquid assets also almost tripled from 2008 to the end of 2011, accounting for 14 per cent of their total assets in November 2011 (Bank of England, Financial Stability Report, 2011). The funding gap for French banks also declined but remained far higher than British figures in both real and relative terms. French banks remained comparatively reliant upon short-term wholesale funding. The figures for German banks help to explain the caution of German government regulators on liquidity rules and the less prescriptive definition of liquidity in CRDIV as opposed to Basel III.

**Table 6: Bank customer funding gap (loans - deposits, bn.) and as per cent of loans**

	<b>UK</b>	<b>per cent of loans</b>	<b>France</b>	<b>per cent of loans</b>	<b>Germany</b>	<b>per cent of loans</b>
<b>2007</b>	770	24	554.2	29.2	853.7	24.5
<b>2008</b>	900	23.8	575	28.6	840	23.1
<b>2009</b>	580	16	495.8	24.5	820.3	22.5
<b>2010</b>	320	10.2	436	20.3	798.7	21.4
<b>2011</b>	270	8	452.5	20.4	640.2	17.4

Sources: Central bank data. Bank of England, Financial Stability Report (December 2011, p. 17, chart 2.6). Non-MFI lending and deposits.

The greater reliance of NFCs in many continental European countries on bank credit finance than the UK, the comparatively limited role of equity markets and the strong bank-industry link (*hausbank* / relational banking in Germany) further explains the preoccupation of many European governments as to the impact of Basel III on bank lending and the real economy.

#### *Differing macro-economic concerns*

This leads us to the third, macroeconomic, factor that explains differing national positions on Basel III / CRDIV. The BCBS accepted the negative implications of pushing too hard and too fast with capital rules — especially in the aftermath of a deep post-crisis recession in many European countries (see BCBS 2010). These concerns were particularly acute in some countries. The United Kingdom was not one of them. From the outbreak of the financial crisis, bank lending in the UK shrunk dramatically (Table 7). This is part of a more general story about the early deleveraging of British banks and the collapse of lending, which had previously relied on securitisation. George Osborne spoke of the ‘British dilemma’ – namely the desire to retain Britain’s world leading

position in financial services but to avoid placing the British government (and tax payer) in a position in which it was forced bail the banks out again. The British government has accepted the lending and economic growth implications of restricting bank activities and specifically decreasing the bank lending that relied directly on shorter-term unstable funding on the wholesale markets.

**Table 7: Monetary Financial Institution lending to Non-Financial Companies  
(National currencies)**

	<b>UK to NFCs (domestic only)</b>	<b>France to NFCs (euro area)</b>	<b>Germany to NFCs (euro area)</b>
<b>2007</b>	691.3	764.7	859.4
<b>2008</b>	606.1	845.6	947.5
<b>2009</b>	588.7	827.6	901.7
<b>2010</b>	561.5	838.8	893.8
<b>2011</b>	536.2	877.5	906.8

Euro area lending by German and French banks remained comparatively strong in the five years following the outbreak of the financial crisis, and was limited principally by growth in the broader economy rather than the deleveraging efforts of banks. Forcing French and, more significantly, German banks to deleverage during a recessionary period could result in a credit crunch if banks reduced their lending (cut their risk-weighted assets denominator) instead of boosting their capital (lifting their equity numerator). One IMF study from 2011 on the differential impact of Basel III rules on national banking systems echoes the findings in a range of other studies: to demonstrate a particularly significant impact upon bank lending in Germany and comparatively small drop in the UK, with France somewhere in between (Cosimano and Hakura 2011). The two large German commercial banks engaged in a significant de-leveraging from 2008 and shrunk their loan book, as did the Landesbanken. Stable bank lending levels in Germany thus owed to a rise in lending from Cooperative and Savings Banks, the backbone of the German Mittelstand (Bundesbank figures). It is the largest French commercial banks – more engaged in retail banking than their large German competitors – and the French economy as a result that were most exposed to deleveraging because of higher capital requirements. Indeed, this fact explains why the French led the charge for the addition of a maximum harmonisation rule in CRDIV — also supported by the Germans — fearing that the British and Swedish push to move beyond Basel requirements would force French banks to be just as capitalised because of investor expectations (Peston 2011). As a consequence French banks would have to decrease their lending. The French government thus sought to use EU rules to try and limit the fall-out from market pressures for greater capital: it did not matter if the markets wanted banks to increase their capital, EU rules would not allow it.



## **Conclusion: the ‘battle of the systems’ in EU economic governance**

More than two decades ago, Story and Walter (1997) argued that ‘the battle of the systems’ impinged upon financial integration and regulation in the EU. Despite the progress made following the introduction of the single currency and the re-launch of financial market integration in the early 2000s, the financial systems of EU member states retain distinctive features. These features largely explain national positions on CRDIV and the intergovernmental character of the negotiations in this field.

In countries, such as France and Germany, with less developed equity markets and greater reliance on bank credit, governments were more opposed to high capital requirements that would restrict lending. Banks and more importantly national authorities were worried that tighter capital requirements would lead banks to reduce lending to industry. Opposition thus stemmed from the relatively high dependence of NFCs (and in particular SMEs) on bank finance in a range of member states and, particularly in continental countries, the long-standing close relations between banks and industry. For the British government, features of the underlying economy, and notably the comparatively heavy exposure of British banks to mortgage lending, determined its only hostile positions on revised risk-weighting rules and harmonised arrears rules. Clearly, British banks were concerned about the implications of high capital requirements and struggled to raise capital. However, they were in a better position — on average — than most of their French and German competitors and the British government was less preoccupied with the impact of Basel III rules upon the British economy because of earlier deleveraging.

The implementation of the Basel III rules on capital requirements is politically controversial in the EU and the negotiations on the new EU legislation are ongoing. Despite thirty years of financial integration, national financial systems and preferences on capital rules remain distinct – the battles of the systems pointed out by Story and Walter (1997) persists, even though some of its elements have been reshaped. The intergovernmental politics of the CRDIV provides a useful case study of the importance of domestic political economy explanations that undermine EU-level efforts to construct financial regulation that effectively stabilises the EU banking system. A conclusion of this chapter of relevance to this volume is that the construction of EU economic governance is bound to be less effective than sought because of the diverging implications of EU-level rules for national economies. This core economic fact casts doubt on the ability of the EU to satisfy both markets, by facilitating cross border financial integration, and politics, through the provision of the public good of financial stability.

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# **Fabienne Ilzkovitz and Adriaan Dierx, 'EU Competition Policy and the Liberalisation of EU Transport Markets'**

## **1. Logistics and transport in the European Union**

Transport is essential in the everyday life of European citizens. An efficient and effective logistics and transportation system facilitates the free flow of people, goods and services within the EU internal market, thereby contributing to the competitiveness of European industry and the living standards of Europe's citizens. The logistics and transport sector accounts for around 7% of EU value added and 5% of EU employment. Within this sector, the most important subsector is road transport (representing 37% of the total value added) followed by warehousing (32%), post (14%), rail transport (7%), air transport (5%) and water transport (5%). As warehousing activities are closely linked with activities in the other subsectors, they are not treated as a separate subsector in the discussion below.

The transport sector provides essential inputs for other economic activities. On average, transportation costs represent 10–15% of the cost of a finished product for European companies. Moreover, technological progress in the transport sector can have a strong effect on overall productivity growth because of the strong linkages between transport and other economic activities.

## **2. Stepwise liberalisation of transport markets**

In order to increase the efficiency and productivity of the transport sector, the EU has made significant efforts to progressively integrate and liberalise EU transport markets which, for the most part, had been heavily regulated at national level. The liberalisation process started in the second half of the 1980s in the maritime and air transport sectors. Both sectors had been exposed to competition already at an early stage due to the international character of their activities. In the maritime sector, EU Member State nationals have had the right since 1986 to carry passengers or goods by sea between any port of a Member State and any other port worldwide. However, the EU still lacks a common regulatory framework defining how to finance port infrastructures and how much to charge for the provision of port services. Following the completion of the EU internal market in air transport in 1997, EU air carriers have been authorised to operate air services between EU airports. As a result, a number of low cost carriers have been able to enter the market and develop rapidly, increasing competition and providing a wider choice to passengers. The European Common Aviation Area agreement of 2006 extended these benefits to countries in South-Eastern and Northern Europe. Transatlantic air traffic is freer too: the 2007 EU-US air transport agreement and the 2009 EU-Canada air transport agreement (the so-called "open skies agreements") allow any EU airline to fly from any EU airport to any city in the US and Canada, respectively. Road transport was liberalised in 1992, when carriers obtained the right to operate passenger and goods transport services between Member States without discrimination on the grounds of nationality or place of establishment. However, most domestic services are still protected.

The liberalisation of the rail freight has progressed gradually with the adoption of several packages of EU Directives. The 2001 package opened the Trans European Rail Freight Network up to competition amongst international freight service providers, which was followed by packages fully liberalising international freight services in 2007 and international passenger transport services in 2010. A European Commission proposal for the opening up of national passenger transport markets is in the pipeline. In 2011, the postal sector was completely opened up to competition in 16 EU Member States. In the remaining 11 Member States the sector will be fully liberalised in 2013 only. Consequently, effective competition in the rail and postal sectors is still generally weak as reflected in high market shares of incumbents and a limited market penetration of new entrants.

### 3. Application of EU competition rules to transport markets

Competition policy aims to ensure that markets operate efficiently to the benefit of the end consumer. This is especially important in the transport sector where newly competitive markets are emerging as a result of the liberalisation process. In this sector there are strong complementarities between regulatory and competition policies. On the one hand, regulatory liberalisation offers few benefits if incumbents are allowed to use anticompetitive practices to protect their position. On the other hand, the application of EU competition rules in the sector needs to take account of the regulatory environment.

In recent years, as more transport markets have been liberalised, they have increasingly been covered by the generally applicable competition law framework:

- ☒ Article 101 of the Treaty on the Functioning of the European Union (TFEU) concerns agreements between companies, which restrict or distort competition within the internal market (antitrust enforcement);
- ☒ Article 102 of the TFEU concerns the abuse by one or more companies of a dominant position within the internal market or in a substantial part of it (antitrust enforcement). Such abuse may, in particular, consist in limitations on production or the imposition of unfair trading conditions;
- ☒ Council Regulation N° 139/2004 provides a legal basis for the control at the EU level of concentrations between companies (merger control);
- ☒ Articles 107 and 108 of the TFEU permit the monitoring by the Commission of the financial support given to companies by EU Member States (State aid control); and
- ☒ Article 106 of the TFEU affirms that public companies or companies having been granted special or exclusive responsibilities, such as the delivery of services of general economic interest, remain subject to the general competition rules.

The implementation of the above Treaty articles is guided by Council and Commission Regulations and by Commission Notices and Guidelines. In the area of antitrust, for example, Council Regulation N° 1/2003 defines the investigative power of the European Competition Network (ECN) composed of the European Commission and the national competition authorities.



Historically, services such as air transport to third countries and international tramp shipping were excluded from the application of Articles 101 and 102 of the TFEU. In parallel with the liberalisation process, the EU antitrust rules became applicable to air transport services to third countries in 2004 and to international tramp shipping in 2006. Similarly, the liner conference (a type of price-fixing cartel) block exemption granted to liner shipping companies in 1986 was repealed in 2008. As a result there are now only a very limited number of sector-specific antitrust exemptions in the transport sector. One exception worth mentioning is the maritime consortia (i.e. joint operation of liner shipping services) block exemption, which remains in effect. Agreements to jointly provide such services usually allow shipping lines to rationalise their activities and achieve economies of scale. However, the block exemption regulation does not permit shipping lines to fix prices or agree on output restrictions.

In the area of mergers, Council Regulation N° 139/2004 sets out the modalities of the European Commission control of mergers, acquisitions and other formal agreements between companies. The aim of this Regulation is to ensure that concentrations that have a European dimension do not result in lasting damage to competition. This Regulation is fully applicable to the transport sector, as illustrated by the prohibition of the proposed acquisition of Aer Lingus by Ryanair in 2007 and the proposed merger between Aegean Airlines and Olympic Air in 2011. Both concentrations concerned airlines based at the same "home" airport with very high if not monopoly market shares on a significant number of routes.

In principle, the TFEU prohibits financial support by Member States to companies (State aid prohibition). However, this general rule is complemented by a large number of regulations and guidelines setting out and clarifying applicable exceptions, thereby allowing Governments to intervene if necessary for the well-functioning of the economy. In the area of transport, for example, there are guidelines on State aid to ship management companies, maritime transport, railway undertakings and airports and airlines departing from regional airports. The European Commission has the exclusive responsibility for assessing whether these exceptions to the general prohibition of State aid can be applied. Recently, the European Commission has launched an initiative to streamline existing regulations and guidelines. The aim of this initiative is to foster growth by supporting targeted and non-distortive State aid. It is the European Commission's intention to focus enforcement on aid cases with the biggest impact on the internal market and to speed up the decision making process.

#### **4. *Main competition concerns***

The transport sector has a number of sector-specific characteristics, which affect the way the above described competition rules are being implemented. This section describes possible competition concerns resulting from the particular characteristics of the transport sector. These descriptions are illustrated by actual cases being considered by the European Commission (see Table 1 below).

**Table 1: Competition policy issues in transport**

Sector characteristics	Consequences	Policy aim	Cases	Desired outcome
High sensitivity to the business cycle	Concentration of supply during economic downturns	Ensure sufficient competition	Airline mergers	Weigh anticompetitive effects against efficiency gains
Important network effects	Possible emergence of dominant service providers	Facilitate connection to the network of the dominant service provider	Transatlantic airline joint ventures	Ensure cheap and smooth transfer between service providers
Need to have access to infrastructure network and essential services	Possibility of input foreclosure	Ensure equal access to infrastructure network and essential services	Deutsche Bahn	Ensure fair pricing of electricity for traction of trains
Compensation for provision of Services of General Economic Interest (SGEI)	Possibility of overcompensation and cross-subsidisation	Control of overcompensation for delivery of SGEI	Postal cases	Ensure level playing field for postal operators

The liberalisation of European transport markets over the past two decades has created opportunities for new entrants, resulting in a decline in concentration and the emergence of competition on fares and services offered between different transport service providers. The recent economic and financial crisis, however, has caused a sharp drop in traffic, allowing the strongest players to consolidate their position as market leaders. In air transport, for example, some of the smaller and less efficient flag carriers have gone out of business, been restructured or merged into larger entities. Looser forms of cooperation between airlines have also developed, which range from bilateral code share arrangements to alliances or joint ventures. Many European airlines are members of one of the three big alliances, oneworld, Star and SkyTeam. The main competition concerns relate to the increased concentration of supply on certain routes resulting from airline mergers and the possible anticompetitive impact of cooperation between airlines. On the other hand, increased coordination between airlines may lead to efficiency gains that can be passed on to their customers. Possible efficiency gains include: (1) economies of density, i.e. reductions in the costs per passenger associated with the increase in passenger numbers; (2) reduction of double marginalisation; (3) fare combinability; (4) better schedules; (5) a more seamless customer experience; and (6) frequent flyer programme integrations. When assessing the merits of mergers or other forms of cooperation between airlines, competition authorities need to weigh the anticompetitive effects of the increased concentration against possible efficiency gains associated with the improved coordination. In the area of mergers, however, it is the merging parties (and not the EU competition authorities) that have to bring forward the efficiency arguments. A number of conditions have to be fulfilled for these efficiencies to be taken into account, including: (1) the efficiencies should be merger-specific; and (2) the efficiencies should be passed on to consumers. Until now, no merger at the EU level has been cleared on the basis of the argument that the associated efficiency gains outweigh its anticompetitive effects.

Transport is a network industry in which consumers value a wider network reach. To the extent that large networks are more attractive to consumers and the marginal cost of adding a consumer is minimal, dominant service providers may emerge. In order for smaller players and possible market

entrants to compete, it is essential that they can connect to the networks established by the dominant market players. Competition authorities therefore try to encourage the cheap and smooth transfer of consumers between transport service providers. To illustrate, the emergence of transatlantic joint ventures involving members of the three big alliances may make it more difficult for connecting passengers from non-alliance members or airlines belonging to a competing alliance to find suitable flights. In this respect, the assurance that passengers of non-allied airlines and passengers of competing alliances can benefit from a cheap and smooth transfer to or from the transatlantic services offered by the joint venture partners would help to alleviate any competition concerns. In the transatlantic joint venture involving British Airways, Iberia and American Airlines, for example, the parties committed to enter into Special Prorate Agreements ('SPAs') with competitors on routes of concern. Such agreements allow interested airlines to attract connecting traffic from the parties on favourable commercial terms.

According to EU regulation, the provision of transport services and the operation of the transport infrastructure need to be managed separately. Nevertheless, it may be the case that the incumbent supplier of transport services and the infrastructure manager are part of the same group of companies. Moreover, the group to which the incumbent belongs may also offer ancillary services that are essential inputs for competing transport services providers. In combination, these two factors open up the possibility of input foreclosure giving an unfair competitive advantage to the incumbent over its (potential) competitors. The alternative option for competitors to duplicate the transport infrastructures can normally not be economically justified. In order to prevent a foreclosure scenario from happening, regulations and directives have been adopted to ensure equal access to existing infrastructures in the different transport sectors. In addition to such a regulatory approach, the application of the EU's competition policy tools may at times be necessary to ensure equal access to essential services. For example, the European Commission has been investigating allegations that Deutsche Bahn group, and in particular Deutsche Bahn Energie, the de facto sole supplier of electricity for traction of trains in Germany, would be giving preferential treatment to the group's rail freight arm.

Having access to transport services is essential to the wellbeing of European citizens. However, such access may not always be available without public intervention. For example, the continued operation of regional airports or rail lines serving remote areas is often dependent on public support. Under certain conditions, transport services are therefore considered as Services of General Economic Interest (SGEI), i.e. economic activities of particular importance to citizens that would not be supplied (or would be supplied under different conditions) if there were no public intervention. Such public intervention may take the form of compensation given to private companies for the services provided. However, overly generous compensation would enable such companies to cross-subsidise their other commercial activities, and thereby distort competition. In the postal sector, for example, incumbents may receive compensation from the State for the timely delivery at reasonable tariffs throughout the territory of the Member State concerned. Indeed, Member States are free (except if there is a "manifest error") to define other public services obligations, such as press distribution, if they decide to do so. However, in the Belgian Post case the Commission found that compensations provided between 1992 and 2010, mainly for press

distribution, partly exceeded the cost of fulfilling the public service obligation. In 2012, the Commission therefore ordered Belgium to recover the incompatible aid plus interests.

## **5. Conclusion**

The transport sector is important for the competitiveness and growth of the EU economy. The gradual liberalisation of transport markets over the past two decades has been aimed at increasing sector productivity and growth. The enforcement of competition policy rules in newly liberalised transport markets should reinforce the pro-competitive effect of liberalisation. Fair and strong competition brings down fares and encourages innovation, thereby giving EU firms an edge over their global competitors.

There are important complementarities between competition and regulatory policies. Competition policy helps ensure that markets that have been opened up to competition operate efficiently to the benefit of the end consumer. Such benefits may be reflected in a wider choice of products offered at relatively low prices as well as in an improved quality of service provided.

This paper has given a number of illustrations of how the particular characteristics of the transport sector may raise competition concerns. Such concerns are being addressed by EU competition rules, which try to prevent an undue concentration of supply in the sector and ensure a fair and equal access to transport infrastructure and ancillary services. Moreover, in assessing the competitive effects of mergers, joint ventures and looser forms of cooperation between transport services providers, EU competition rules allow making the trade-off between the anticompetitive and efficiency effects of cooperation. The EU experience therefore shows the value of having competition rules that can be adapted to the particularities of the transport sector.

## **Patrick Leblond, 'Fiscal Crises in the Eurozone: Assessing the Austerity Imposed by the Bail-outs'**

Forthcoming in Joan DeBardeleben and Crina VJ *The Economic-Financial Crisis in Europe*, Palgrave Macmillan.

### **Introduction**

In the aftermath of the 2008-09 global financial crisis, the European Union (EU), most especially its Eurozone member states, was hit by a number of fiscal (or debt) crises, which began in Greece in December 2009 before moving on to Ireland and Portugal in 2010 and 2011, respectively. For their part, Spain, Italy, Belgium and even France also ended up facing more or less strong headwinds from sovereign bond market investors as contagion in the form of market and political uncertainty spread throughout the Eurozone. The EU, with the help of the International Monetary Fund (IMF), worked hard to contain the debt crisis (or crises) and prevent it from propagating itself, but with limited success given the political difficulties involved in providing financial assistance to crisis-hit governments and banks (for details, see the chapter by Ross in this volume). In the end, direct financial assistance (i.e., bail-outs) had to be provided to Greece, Ireland and Portugal. In Greece's case, a second bail-out package had to be put together a year and half after the first one, this time involving a restructuring of Greece's public debt in order to avoid an outright (i.e., official) default.

These bail-outs and the economic adjustment programmes that have accompanied them have been highly controversial politically as well as economically. For instance, there are those who claim that no bail-outs should have been forthcoming and that Greece and company should have been left to fend for themselves. Then there are those who argue that the austerity packages imposed on Greece and others as a result of the bail-outs are too harsh and will only make things worse. In light of these controversies, it is worth asking ourselves whether the EU's (and IMF's) response to the fiscal crises in Europe (i.e. the bail-outs and the accompanying adjustment programs) has been appropriate under the circumstances at hand.

In order to answer this question, the present chapter is structured as follows. First, the chapter provides a review of the literature on debt crises in order to tease out the lessons that have been learned from past fiscal consolidation and economic restructuring efforts. Second, applying these lessons, it analyzes the EU's response to the fiscal crises in order to determine whether or not bail-outs and their associated economic adjustment programs have been appropriate to the situations at hand. What we find is that in fact the EU's response to the fiscal crises has been the right one and that the conditions that it imposed on Greece, Ireland and Portugal, in exchange for financial assistance, are in line with the lessons offered by past successful fiscal consolidations. However, there is an important issue that plagues the Eurozone debt crisis, and it is one that the literature does not really address. This is the fact that there have been not one, but many debt crises, with many countries in the same region that adopted austerity measures at the same time, including those countries that did not receive bail-outs. This has had the effect of making the fiscal consolidation process even more difficult, both economically and politically. Finally, the chapter concludes with the implications for the EU and the euro of the fiscal crises in Europe and the way that they have been managed.

## Lessons from Past Fiscal Consolidations

If the bailouts of Greece, Ireland and Portugal have prevented these countries from defaulting on their debts, they must nevertheless cut down their fiscal deficits drastically, and do so for a long period of time. Only once public finances are credibly back on a sustainable path will private investors be ready to buy these countries' sovereign bonds at acceptable rates of interest. The need for fiscal consolidation also applies to countries like Italy and Spain, which face serious threats to their public finances. In the end, the goal is to regain, or maintain, sovereign bond investors' confidence that their investments are safe and, as such, will be paid back in full, with interest. The issue of concern here, for policy makers, is to know what the key elements of a successful fiscal consolidation process are, in order to design a proper response to the fiscal crises.

According to studies of past fiscal consolidation efforts, reductions in current government spending are more likely to lead to sustained adjustments than increases in tax revenues or cuts in investment expenditures (Alesina and Ardagna, 2010; European Commission, 2007, p.196; Guichard et al, 2007, p.7). The reason is that cutting government consumption and transfers is more difficult to achieve politically than raising taxes and cutting investment expenditures. As such, they are less likely to be reversed. Moreover, it sends a credible signal to investors that the government is committed to a lasting fiscal consolidation exercise, which will likely lead to a reduction in the yields demanded by investors. If the fiscal consolidation exercise is primarily based on increasing tax revenues, then government spending has a tendency to grow along with the additional revenues that are generated, thereby preventing the desired fiscal adjustment from being achieved (see: Guichard et al, 2007, p.16). On the other hand, in a recent study, Paolo Mauro and his IMF colleagues find that intended or planned revenue-based adjustments grounded in reforms can also sometimes be effective alongside spending cuts (Mauro, 2011).

It is not just the size of the reductions in government spending that matters, their composition is also very important. According to Alesina and Perotti (1997), reductions in social welfare spending, as well as in government wages and employment, not only lead to more permanent fiscal consolidations, but are also beneficial for economic growth, since unit labour costs decrease. This is because cuts in government wages and employment influence wage setting in the private sector. For example, if the public sector is shedding workers or freezing new hirings, then it means that there is more competition for jobs in the private sector, which drives down the price of labour. Moreover, cuts in social welfare spending are likely to force more people to seek or remain in employment, which also contributes to the labour supply in the private sector, thereby pushing wages downwards.<sup>239</sup> Such a decrease in average unit labour costs makes an economy more competitive, which leads to higher exports and investment and, ultimately, overall economic expansion. Combining government spending adjustments with structural economic reforms significantly enhances the chances of a successful consolidation, according to the European

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<sup>239</sup> It is true that cutting social welfare benefits is likely to have a negative impact on economic growth as individuals' consumption is reduced; however, if unit labour costs decrease and it leads to greater employment in the private sector, then the negative impact on consumption will be nullified. Moreover, lower labour costs are likely to stimulate investment in the national economy, which will be beneficial to growth. The real issue is one of timing, in terms of the time lag between the removal of social welfare benefits and the positive private sector employment impact following reduced labour costs (see below for a discussion of the this issues).

Commission (2007) and Mauro (2011). Since structural reforms entail liberalizing markets for labour, products and services in such a way as to improve competition, lower costs and increase innovation and investment, they further contribute to improving competitiveness and growth in the medium to long run, which in turn helps make the fiscal consolidation exercise durable.

If the right mix of government spending reduction is good for economic growth in the medium to long term, tax increases and reduced investment expenditures tend to have a negative impact on growth (Alesina and Perotti, 1997; Ardagna, 2004). This is because they usually hurt an economy's competitiveness, which, as argued previously, is bad for exports and investment.<sup>240</sup> For instance, higher taxes are likely to lead to higher prices for goods and services. This is especially true for direct taxes on income (for both individuals and corporations) and social welfare contributions paid by businesses, whereby workers will ask for higher wages to compensate their loss of purchasing power, and businesses will pass on their increased costs to their customers in order to maintain profitability. As for investment expenditures by government, they are also important for competitiveness since they help maintain, if not improve, an economy's infrastructure (e.g., roads, ports, railways, etc.). Thus, if lowering public investment leads to a continued degradation of a country's productive public infrastructure, then the cost of doing business for firms will only increase, thereby hurting an economy's competitiveness and growth prospects. Lower economic growth also means lower revenues in the government's coffers, as well as higher social welfare expenditures.

With regards to improving an economy's competitiveness, the devaluation of the currency is often considered an easy way to make exports cheaper internationally and, thereby, stimulate growth. According to Alesina and Perotti (1997), many instances of past fiscal consolidation have been preceded by exchange rate depreciations. In fact, Lambertini and Tavares (2005) find that a depreciation of the nominal exchange rate increases the probability of a successful fiscal adjustment. This is why they conclude that countries that have adopted the euro may find it more difficult to achieve a sustainable fiscal consolidation, because they cannot effect any currency depreciation unless they abandon the euro and reintroduce a national currency, which as we will see below is no panacea. Fortunately for Eurozone member states, Ardagna (2004, p.1049) finds that exchange rate devaluations are not a necessary condition for 'successful and expansionary fiscal contractions'. Hence, a sustainable fiscal consolidation is not impossible for Eurozone countries; it may just be a little harder.

In their study of past fiscal consolidations, Paolo Mauro and his colleagues from the IMF argue that it is not so much whether fiscal consolidation is expenditure-based or revenue-based that really matters; the adjustment must be 'reform-based' with a clearly established plan that includes contingencies for the fact that things will not turn out as planned (e.g., lower than expected rates of economic growth or unforeseen political developments) (Mauro, 2011). This is why the authors argue that consolidation plans should have medium term objectives, rather than simply short term ones (i.e. three to five years rather than one year). This would provide policy makers with enough flexibility in the short term to adjust the plan in accordance with changed economic and/or political situations while maintaining the focus on achieving the stated objectives.

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<sup>240</sup> There are instances where taxes can actually improve competitiveness, especially if they replace more inefficient taxes. According to a study by Widmalm (2001), some taxes have a negative impact on economic growth while others can have positive effects.

The experience of the past few decades [...] shows that plans face sizable risks and often encounter substantial implementation difficulties along the way. Unexpected declines in economic growth, upward revisions in the initial fiscal deficit, changing priorities, lack of support among the general public, poor plan design, all have the potential to derail fiscal adjustment plans. Conversely, when favorable economic and political conditions emerge, objectives are often met or exceeded, even when plans envisage ambitious reductions in deficits and debts (Mauro, 2011, p.178).

The final issue concerning fiscal adjustment programs is whether they should be sharp – akin to the shock therapy treatment applied to a number of Central and Eastern European countries after the demise of the Soviet bloc – or more gradual in nature. There are two views on this matter. On the one hand, the political window of opportunity to instil fiscal and structural reforms in the context of a crisis is narrow before reform fatigue sets in and opposition to reforms mounts to such an extent as to make them politically infeasible. That is why it is often recommended to adopt painful measures soon after a new government has been elected. On the other hand, precisely because of the politically sensitive nature of the adjustments and reforms to be put into place, they need to be done gradually over time in order to make them palpable to the electorate and their representatives. According to the European Commission (2007, p.196), the gradual approach seems to be a better fit with a successful fiscal consolidation exercise, most especially when politically-sensitive government expenditures have to be heavily cut and/or the economy is in particularly bad shape at the beginning of the process. Although this may be so, the general evidence in support of fiscal consolidation exercises leading to government unpopularity and ensuing collapse is weak. For instance, Alesina, Perotti and Tavares (1998) find that pursuing fiscal adjustment programs does not negatively affect a government's popularity, or increase the probability that it will collapse. In a more recent study, Alesina and other colleagues obtain similar results, whereby governments are no more likely than usual to be voted out of office if they quickly decrease budget deficits (Alesina, Carloni and Lecce, 2011). These findings are also corroborated by those of Mauro (2011). Even when governments lose power during a consolidation process, the adjustment program's implementation usually remains unaffected. This is because what truly matters is the degree of support for the reduction of the deficit and debt among the general population (Mauro, 2011). It does not mean, however, that austerity measures are not generally associated with social unrest (see: Ponticelli and Voth, 2011), but the latter does not necessarily translate into electoral behaviour against the incumbent government, as unrest tends to be more associated with particular lobbies such as labour unions (Alesina, Carloni and Lecce, 2011). Therefore, although it seems reasonable to conclude that adopting a gradual approach might be more effective at ultimately reducing fiscal deficits and set public finances on a sustainable path, the evidence does cast a shadow on the political cost of 'cold shower' consolidations, as the European Commission calls them. After all, Alesina, Carloni and Lecce (2011) do not find that governments are more likely to lose power if they undertake 'large' fiscal consolidations (i.e. those leading to a reduction in the budget deficit of 1.5 per cent of Gross Domestic Product (GDP) in a given year).

### **Assessing the EU's Response to the Fiscal Crises**

From the above, it is clear that any attempt to consolidate public finances among Eurozone member states affected by a debt crisis should begin with significant (but probably gradual) cuts in current government spending, most especially wages and employment, as well as social welfare



entitlements. In addition, structural reforms to make the economy more productive and competitive should accompany fiscal adjustment efforts. Whether the EU and the IMF have adopted such a framework in the conditionality programs that they have negotiated with Greece, Ireland and Portugal in exchange for financial assistance is what this section sets out to assess. Before doing so, however, it is important to assess whether the provision of bail-outs themselves made sense for the EU.

### *Were the Bail-outs a Good Idea?*

The fact that three Eurozone countries have received financial assistance with their sovereign debt is something that will be debated for years to come, and we will only broach the surface of this debate herein as it goes beyond the scope of the present chapter. Opinions are certainly divided on whether bail-outs are the appropriate way to deal with fiscal crises inside the Eurozone.

On the one hand, there are arguments in support of core Eurozone member states (e.g., Austria, Belgium, France, Germany, Luxembourg, and the Netherlands) abandoning those on the periphery – like Greece, Ireland and Portugal – that are experiencing fiscal difficulties. Without financial assistance, the countries on the periphery would eventually be forced to default and, as a result, give up the euro and reintroduce their national currencies (or form their own monetary union). Proponents of this viewpoint argue that only then would true optimal currency areas exist in the EU,<sup>241</sup> because periphery economies are not synchronized with those of the core and, therefore, should not share a common currency and monetary policy (e.g., Feldstein, 2012).

On the other hand, there are those who argue that EU institutions and Eurozone leaders did the right thing in providing bail-out funds to Greece, Ireland and Portugal and setting up the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM).<sup>242</sup> Otherwise, the Eurozone banking system would have experienced a serious crisis, because Eurozone banks hold the majority of the sovereign bonds issued by Eurozone member states. Defaults by Greece, Ireland and Portugal would have caused serious losses to the Eurozone banking system, creating a panic and credit freeze, such as the one that occurred in the Fall of 2008, when the global financial crisis reached its apex. Investor panic would also spread to Spanish and Italian sovereign bonds, as a result of a contagion effect, which would only compound the crisis. The entire financial system would be jeopardized, and the EU would face another deep recession, just when Member States' economies were beginning to recover from the previous crisis. As during that crisis, EU governments would then have to intervene again by providing financial assistance to their banking systems, while the European Central Bank (ECB) would have to provide massive amounts of liquidity to the financial system. Given the existing weakness among both financial institutions and governments' fiscal capacities, it would not be at all clear that governments and the ECB would have the means to manage the crisis and prevent a great European depression from happening. As a result, the Eurozone and the EU would be at great risk of completely imploding, whereby every EU

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<sup>241</sup> For details on the theory of optimal currency areas, see: Kenen and Meade (2008, Chapter 2). In a nutshell, the theory aims to identify the conditions that would mitigate the limited degree of synchronicity between economies should they adopt a common currency. An optimal currency area is one where either the economies are synchronized in terms of their boom-bust cycle or they possess the necessary conditions that mitigate the absence of synchronicity.

<sup>242</sup> For details on the EFSF and ESM, see: Leblond and Paudyn (2011).

government would run for the exits and try to save its economy and financial system. History would repeat itself, as such behaviour would be akin to what happened during and following the Great Depression in the 1930s (e.g., see: Eichengreen, 1992).

Given these dire prospects, it seems fair to conclude that providing financial assistance to only a few Eurozone member states, in order to prevent an economic meltdown, was a less risky and less costly option. Furthermore, this approach offered the opportunity to use the bail-outs to finally effect much needed reforms in countries like Greece and Portugal, by imposing strict conditions for the assistance. Let's now examine whether the conditionality programs for Greece, Ireland and Portugal are appropriate under their particular circumstances.

### *Are the Conditionality Programmes Appropriate?*

The now infamously named 'PIIGS' countries (Portugal, Ireland, Italy, Greece and Spain) all faced difficult fiscal situations, even if they were in fact not identical (see: Figures 1 and 2). For instance, Spain's public debt has remained well below the Eurozone's average, and was still within the Stability and Growth Pact's limit of 60 per cent of GDP in 2010; however, its fiscal deficit jumped substantially in 2008 and 2009. As for Italy, although its public debt is the second highest after Greece's, its fiscal deficit is the lowest among the PIIGS and has remained below the Eurozone's average since 2008. Consequently, its public debt has increased less rapidly than in other Member States. But looking at debts and deficits is not enough to understand the fiscal crises.

INSERT FIGURES 1 AND 2 APPROXIMATELY HERE

There are two other factors that need to be considered, in tandem with debts and deficits, in order to fully appreciate the extent to which each member of the 'PIIGS' quintet was in trouble and, consequently, what economic remedies needed to be applied. These two factors are the economy's overall competitiveness, and the degree to which domestic banks made loans to the private sector as a function of the size of the economy. According to Figure 3, as the global financial crisis erupted, Greece and Italy had the least competitive economies among the PIIGS, but their banks were also less exposed to the national economy's performance. On the other hand, Ireland had the most competitive economy but its banks were 2.5 times more exposed to the economy's performance than those of Greece and Italy. As for Spain and Portugal, they stood in between Ireland on the one hand and Greece and Italy on the other. Thus, each country's economic situation at the beginning of the financial crisis, when combined with its level of public debt and the trend in its fiscal performance, explains in good part the outcomes described earlier.

INSERT FIGURE 3 APPROXIMATELY HERE

In the case of Greece, a high public debt with a growing fiscal deficit, owing to uncontrolled spending, tax evasion and low competitiveness, made investors panic and refuse to buy Greek sovereign debt at a sustainable rate of interest. This is why the solution to Greece's problems was to drastically cut government spending, significantly lower tax evasion and introduce reforms that would allow the economy to become more competitive. In Italy's case, the deficit has remained relatively low and the public debt stable; consequently, investors have not forced a bail-out by asking for very high yields. Nonetheless, investors have signalled concern about the low competitiveness of the Italian economy and the associated lack of economic growth by requiring higher yields to buy Italian sovereign debt. Without a decent rate of growth, it has been difficult for the government to see fiscal revenues increase while justifying cuts in welfare spending to balance the budget. This is why Italy's public debt has remained stable throughout the first decade of the

21<sup>st</sup> century (see: Figure 1) and why it is likely to remain so without appropriate structural reforms, which are needed to make the economy once again competitive.

With regards to Ireland, the problem has not been competitiveness or the government's fiscal performance; it has been a banking crisis caused by the bursting of a major real estate bubble. In Figure 3, we observe that Irish banks had the highest level of exposure to the domestic economy. In addition, their lending had served to fuel a housing boom. According to Hibers et al (2008, p.13), real house prices in Ireland experienced the second largest increase in Europe since 1985, after Spain, with the majority of the increase occurring after 1995. So when the banks went bust, the Irish government had to bail them out to save the financial system, which added close to 50 per cent of GDP to the public debt. This means that the formula for Ireland to bring public finances back to health has been, first, to get the banking system on its feet as quickly as possible, so that it no longer needs the government's help, and, second, to reduce the deficit by cutting government spending and, where possible, increasing tax revenues. These measures are meant to help stabilize the public debt, so that it can begin to decrease again once economic growth returns. In the Irish case, only minor structural reforms should be necessary to make the economy even more competitive.

For Portugal and Spain, as already mentioned, their situation is in between that of Ireland on the one hand, and Greece and Italy on the other. As opposed to Portugal, the only reason why Spain has not been forced (yet) to request a bail-out from the EU and the IMF is because its public debt has remained much lower. The main shadow hanging over Spain has been the continuing weakness of regional and local savings banks, as a result of the bursting of a housing bubble, and the extent to which the government must offer them additional financial assistance and, therefore, add to the public debt. Although Portugal did not have a housing bubble as in Spain (see: Hibers et al, 2008), its banks were similarly exposed to the national economy, and the latter's weakness could force the government to intervene. Since the public debt is about 20 percentage points of GDP higher than in Spain, such intervention could be problematic. Moreover, since the Portuguese economy is less competitive than that of Spain, the fiscal consolidation effort must be greater. Therefore, in the absence of a political consensus on fiscal austerity measures and structural reforms, sovereign bond investors simply panicked – by demanding very high yields for buying Portuguese debt – as they could not see how Portugal's government would achieve fiscal sustainability. The EU-IMF bail-out put the necessary pressure on Portuguese politicians to achieve a political consensus on necessary economic adjustments.

Let's now examine the conditions imposed by the EU and the IMF on Greece, Ireland and Portugal in exchange for receiving bail-out funds and assess whether the content of these economic adjustment programs has in fact been appropriate given each country's circumstances. The Greek program has both short term and medium term commitments to restore fiscal sustainability (European Commission, 2010a). In the short run, the program's aim involves a number of fiscal measures to shrink the country's fiscal deficit in order to stabilize public indebtedness and restore confidence in financial markets. On the expenditure side, the Greek government has committed itself to cutting government expenditures by seven per cent of GDP over the rescue package's duration (i.e., between 2010 and 2013).<sup>243</sup> This reduction in (over)spending is to occur mainly through cuts in public sector wages, employment and pensions. Social programs are also to be reviewed in terms of their appropriateness. On the revenue side, the most important measures

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<sup>243</sup> In late June 2011, the Greek rescue package was extended to 2015 and beyond, if necessary.

adopted by the Greek government were immediate increases of the value-added tax (VAT) rate, from 21 per cent to 23 per cent, and of excise taxes on fuel, alcohol and cigarettes, by ten per cent. Moreover, the government undertook to aggressively tackle tax evasion, which is notorious in Greece.<sup>244</sup>

The adjustment program also includes several structural reforms to the Greek economy, in order to render the latter more competitive in the medium term. These reforms focus on the labour and services markets. For instance, regulations are to be made more flexible so that high unemployment groups, like the young and women, may more easily enter and stay in the formal labour market. In terms of services (e.g., tourism, education, retail, transportation, energy, and professions), regulations are also to be made more flexible through liberalisation, in order to increase competition and to lower prices. For example, Greece was the only country in the EU that restricted entry into the national trucking transportation market and fixed freight rates (Barnard, 2010). The adjustment program also envisages cutting government red tape, in order to reduce the administrative burden that Greek businesses face as they go about their operations and investments.<sup>245</sup>

According to reviews conducted jointly by the European Commission, the IMF and the ECB, the Greek government generally complied with its Economic Adjustment Program in the year that followed the bail-out agreement (see: European Commission, 2010b, 2010c 2011a). This good performance allowed Greece to receive a total of €65 billion in financial assistance as of July 2011. Nevertheless, in spite of the significant progress achieved by the Greek government, the latter has been pressured to do more in terms of fiscal consolidation, since fiscal deficits were higher than expected in 2009, 2010 and 2011 because of deeper recessions than originally anticipated. As a result, the government had to agree to additional fiscal measures of 2.5 per cent of GDP for 2011, over and above those already agreed in May 2010. For the period 2012-14, it had to find an extra six per cent of GDP in new revenues and/or lower spending in order to meet the May 2010 adjustment program's targets for fiscal deficits. This new wave of austerity, in a context of growing unemployment and continued negative economic growth, has only served to enhance an already deep sense of resentment among the Greek population, which makes the implementation of reforms even more difficult. Consequently, sovereign bond investors became increasingly convinced that Greece would not be able to stabilize its fiscal situation and that a restructuring of its debt (or outright default) was the only option. In June 2011, Greece's credit rating was again downgraded, making it the lowest sovereign rating in the world (Oakley and Spiegel, 2011), with a negative outlook towards default (which is the lowest possible rating: D). In response, Eurozone member states and the IMF agreed on a new rescue package that would add more than €100 billion to the existing one, which would allow Greece to meet its public debt commitments until 2015, if not beyond. This package eventually came to be associated with a restructuring of Greece's sovereign debt, whereby private sector investors were asked (with incentives) to voluntarily accept to extend the maturities of their Greek bond holdings, as well as decrease the nominal rates of interest on those bonds. This restructuring of Greece's sovereign debt amounted to about a 50 per cent loss in the value of the holdings of Greek bonds by private sector investors. In spite of this agreement with

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<sup>244</sup> Greece's informal economy is estimated to range between 20-25 per cent of GDP (Katsios, 2006).

<sup>245</sup> According to the World Bank, Greece ranked 109th out of 183 countries in terms of the ease of doing business in 2010 (<http://www.doingbusiness.org/rankings>).

private-sector investors, there remained, at the time of writing (January 2012), much uncertainty surrounding the ability of the Greek government, now led by former central banker Lucas Papademos, to stabilize Greece's fiscal situation given the depth of the ongoing recession and the heavy political opposition by labour unions and other industry groups to fiscal and structural reforms. In spite of significant accomplishments in terms of fiscal and structural reforms, progress remained insufficient and it was evident that Greece would not be able to meet the medium term objectives set in its adjustment program. The adjustment process and the bail-out period were likely to be extended beyond the current 2015 deadline.

In Ireland's case, in exchange for receiving financial assistance from the EU and the IMF in November 2010, the government unveiled a new four year fiscal consolidation plan,<sup>246</sup> which aimed to reduce the fiscal deficit by €15 billion by 2014, in order to bring it back to a more sustainable three per cent of GDP (Ireland, 2010). The largest part of this deficit reduction exercise was to come in the form of cuts to public spending. This is because government revenues were already hurting, not only owing to the general slowdown of the economy, but also due to the particular difficulties experienced by the financial and construction sectors.<sup>247</sup> For 2011 and 2012, the government planned to cut spending by €6 billion, through reductions in social welfare payments, public service employment and pensions, general purchases of goods and services, and lower capital expenditures. In addition, the Irish government undertook to continue reforming its financial sector, as well as introducing structural reforms to its labour market and domestic services sector (e.g., legal and pharmacy professions). For instance, the national minimum wage was set to be cut by €1 per hour, in order to facilitate hiring by firms. Unemployment and social assistance benefits were also expected to be restricted, in order to create stronger incentives for people to seek paid work, while decreasing pressure on the public purse. In a sense, the idea behind the cuts seemed to be that the Irish welfare state should go back to what it was before it became unduly generous along with the real estate bubble (Alderman, 2010). Overall, the Irish adjustment program appears to have been successful, since economic growth returned in 2011, aided by strong exports. In addition, in spite of lower tax revenues, the Irish government managed to bring its budget deficit for 2011 below the target set by the program. Although Ireland's economic growth forecast was lowered for 2012, as a result of an expected global economic slowdown, most especially in Europe, the European Commission and the IMF remained confident that the Irish government would reach its fiscal deficit target of three per cent of GDP by 2015 (European Commission, 2011b). There were even expectations that the Irish government would return to the financial markets to raise funds by the first half of 2013.

As with Greece and Ireland, the Portuguese bail-out package included a series of undertakings that the government had to commit to in order to receive the promised funds at various intervals over the program's three year duration. These 'conditions' were based on the same general

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<sup>246</sup> The Irish government had already adopted €14.5 billion worth of spending cuts and tax rises in order to quell the mounting deficit. In spite of these measures, the deficit was still slated to reach 12 per cent of GDP in 2010, not including bail-out funds to the banking sector (The Economist, 2010, p.79).

<sup>247</sup> Tax revenues dropped by €14 billion between 2007 and 2009 (The Economist, 2010, p.81).

approach (or strategy) as the one applied to Ireland: fiscal consolidation, economic competitiveness, financial sector stabilization; however, in Portugal's case, the relative emphasis was on competitiveness, rather than on financial sector stabilization, with fiscal consolidation playing the same role as in Greece and Ireland (see: Portugal, 2011). Just as in Greece, Portugal's economy had been suffering from a lack of competitiveness for quite some time, making for sluggish economic growth, which in turn led to repeated fiscal deficits and a growing public debt (see: Figures 1 and 2).

In terms of fiscal policy, the goals were to reduce the deficit to three per cent of GDP in 2013, from 9.1 per cent in 2010 (see: Figure 2). Such a deficit reduction was to be achieved through both spending cuts and revenue increases. On the expenditure side of the ledger, savings were to come from a freeze in public employee wages, improvements in the effectiveness and efficiency of the public administration (including the healthcare system and state-owned enterprises), as well as reductions in government services, transfers to public bodies and local/regional authorities, subsidies to private producers, public service employment and benefits (including pensions), and capital investments. On the revenue side, gains were to come from reductions in corporate tax deductions and special regimes, as well as personal income tax benefits and deductions. Additional revenues were also to be generated by increases in the VAT as well as excise taxes on cars and tobacco.

In terms of structural reforms to make the Portuguese economy more competitive, the conditionality program envisaged reforms to the labour market, as well as to the good and services markets. With respect to improving the competitiveness of Portuguese labour, the government committed itself to, for instance, revising unemployment benefits so as to cap their duration at no more than 18 months, while their value would decline over time, except for certain categories of self-employed workers. The government also planned to make it easier for firms to hire and fire employees, while ensuring that severance payments were in line with the EU average. In addition, the government was required to improve the quality of its secondary and vocational education system, as well as its training and support schemes for the unemployed. As for goods and services markets, the Portuguese government was tasked with, *inter alia*, liberalizing its energy (gas and electricity), telecommunications, transport, postal and professional sectors, in accordance with existing EU legislation. Finally, it was deemed necessary for the government to improve the overall business environment, namely making public administration more efficient and effective and removing any special protection from competition accorded to certain sectors or (public and private) enterprises.

According to the European Commission (2011c), the Portuguese adjustment program was generally going well, although significant challenges remained. The main challenge pertained to achieving the targeted fiscal deficits in 2011 and 2012, as it was proving more difficult than expected to rein in government spending. Moreover, it was expected that the Portuguese economy would fall into recession as a result of a slowdown in global economic activity, which would hurt exports. However, the arrival in June 2011 of a new centre-right government strongly committed to fiscal and structural reforms was expected to make it easier to achieve the program's medium term objectives. Based on the new government's budget, the Commission expected that Portugal would meet its targeted deficit of 4.5 per cent of GDP in 2012, in spite of a recession projected to be more pronounced than originally forecast by the program.

## Conclusion

The economic adjustment programs imposed on Greece, Ireland and Portugal by the EU and the IMF are generally in line with the lessons offered by past fiscal consolidations, where deep cuts in current government expenditures and structural reforms to make the economy more competitive are deemed essential to a successful outcome. These are certainly the main elements contained in the Greek and Portuguese programs, although tax evasion is a major issue for the Greek government on the revenue side. In the Irish case, deep cuts in public spending are at the core of the adjustment program; however, structural reforms are less predominant than in Greece and Portugal, since the economy is already quite competitive. Cleaning up the financial system to make it self-reliant again is much more important. It is important to note that, although they set yearly targets for fiscal deficits, the programs in fact aim to achieve medium-term objectives, which are the expected results to be achieved once the program is completed. Furthermore, assumptions about forecasted economic growth and external demand for exports are also revised on a biannual basis. Hence, in line with Mauro's (2011) conclusions, the adjustment programs have flexibility built into them.

The main issue that the adjustment programs are facing are not so much popular opposition to the required fiscal and structural reforms – after all, new governments were elected in Ireland and Portugal on the basis of their commitment to implementing the programs – but deeper than anticipated recessions, which then make achieving the fiscal deficit targets more difficult and, as a result, create a demand for greater austerity, potentially pushing growth further downward. One of the main reasons for this state of affairs is the fact that many EU governments have adopted austerity measures at the same time, something that the literature on fiscal consolidation does not address. As a result, there is less opportunity for governments to get out of their fiscal mess through strong external demand for exports, which is what has happened in many successful consolidations in the past (see: Mauro 2011).

This is why some analysts of the euro crisis have argued that the German government should do more to stimulate its economy so that it can act as a locomotive for other Eurozone countries that have to stabilize their debts and reduce their deficits (e.g., Matthijs and Blyth, 2011). The problem, however, is that it is politically difficult to convince German voters that they should not only provide financial assistance to governments of countries facing fiscal crises, but they should also spend more and, in a way, indebt themselves collectively to stimulate economic growth in the Eurozone. The alternative for Germany, on the other hand, is to provide financial assistance to these countries for longer than originally anticipated as they take more time to reduce their deficits, given that overall economic growth in the euro area is slower to revive.

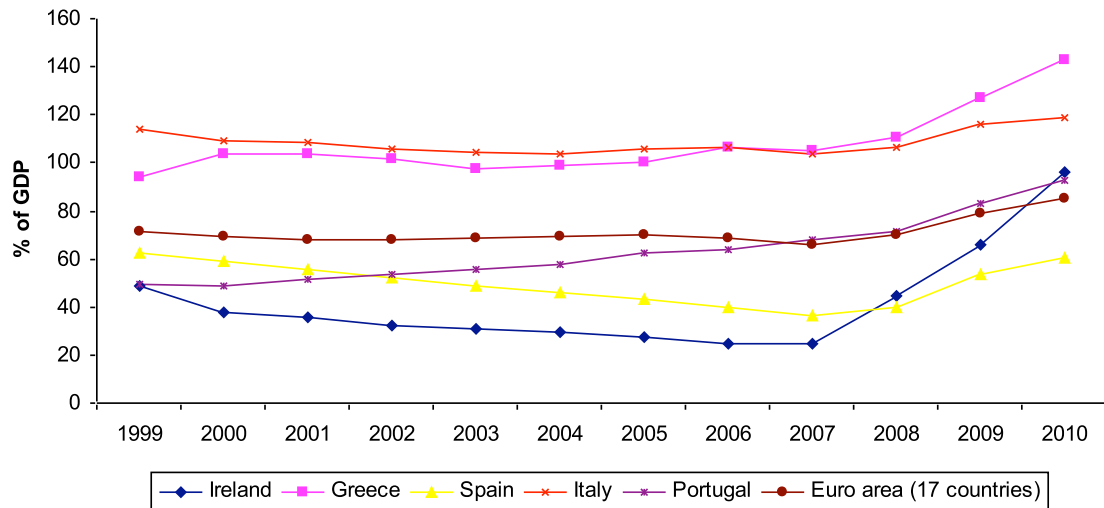
This is why an intergovernmental approach, as described by Ross in this volume, is ultimately counterproductive. What is needed is a more integrated or supranational approach to fiscal policy in the Eurozone, if not the EU. Such an approach includes not only coordinating national fiscal policies (e.g., through approval of budgets by the Council of Ministers on a recommendation of the Commission), but also creating commonly issued eurobonds. In the latter case, to be effective at keeping interest rates low for all, the eurobonds would have to be issued by a supranational agency that would only issue them for a Member State if fiscal sustainability of the public debt had been ascertained. This is the only way to deal with the moral hazard problem of jointly-guaranteed bonds by all Member States; Member States would thus be prevented from free riding on the system by issuing too many bonds (similarly to the 'tragedy-of-the-commons' problem as originally identified by Garrett Hardin [1968]).

Although important steps were taken in this direction at the December 2011 meeting of the European Council, namely in terms of greater fiscal policy coordination, more needs to be done, especially with respect to eurobonds. In spite of Ross' (this volume) scepticism that the EU can move positively in such a direction, we can expect that sovereign bond investors will continue to put pressure on EU/Eurozone governments to achieve a greater degree of fiscal integration at the EU or Eurozone level. The bail-outs may have been successful in preventing outright sovereign defaults and keeping the euro intact, but at the time of writing the 'PIIGS' countries were still facing major fiscal and economic challenges that financial markets were bound to react to for the foreseeable future. The euro's 'fat lady' has yet to sing.



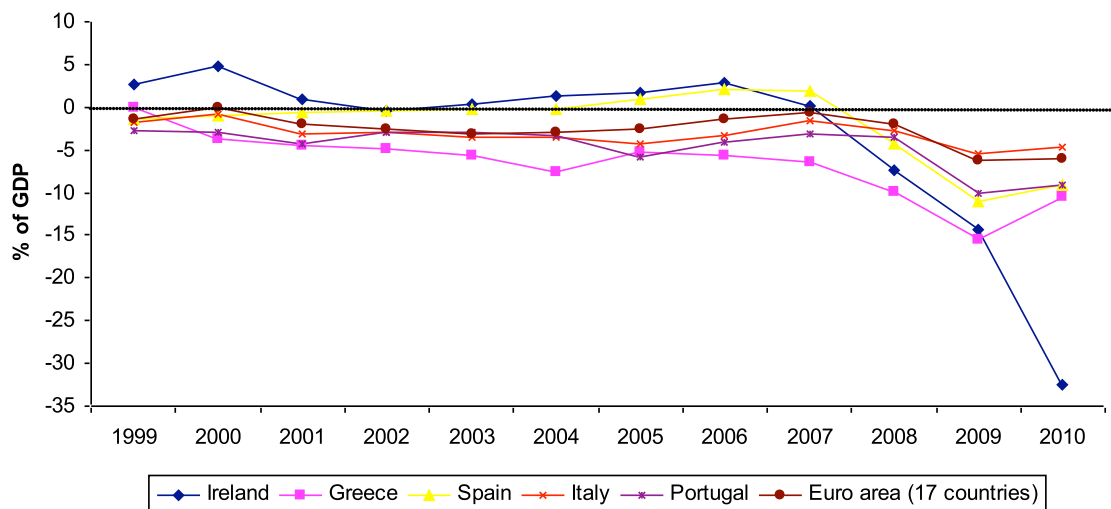
## Figures

Figure 1: General Government Gross Debt (% of GDP)



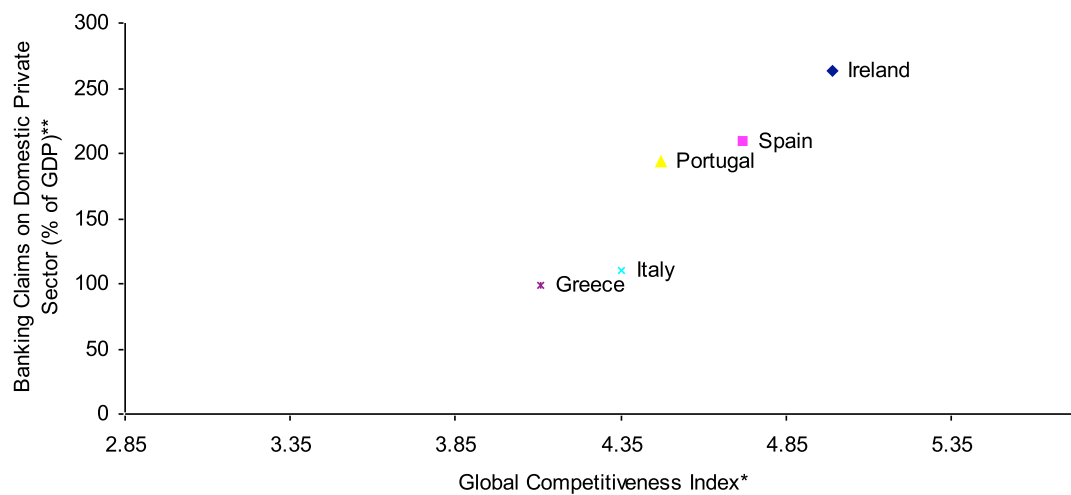
Source of data: Eurostat (<http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=teina225> [accessed 15 March 2012])

Figure 2: General Government Deficit/Surplus (% of GDP)



Source of data: Eurostat (<http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tsieb080> [accessed 15 March 2012])

Figure 3: Economic Situation of the 'PIIGS' at the Beginning of the Financial Crisis



\*2008-2009 \*\*2008 (end of year)

Sources of data: Global Competitiveness Index: World Economic Forum, Global Competitiveness Report 2008-2009, p. 10 (<https://members.weforum.org/pdf/GCR08/GCR08.pdf> [accessed 15 March 2012]); Banking Claims on Domestic Private Sector: International Monetary Fund, International Financial Statistics (Claims on other Sector/GDP, Line 22s.u/Line99b)

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## End Notes

<sup>1</sup> It is true that cutting social welfare benefits is likely to have a negative impact on economic growth as individuals' consumption is reduced; however, if unit labour costs decrease and it leads to greater employment in the private sector, then the negative impact on consumption will be nullified. Moreover, lower labour costs are likely to stimulate investment in the national economy, which will be beneficial to growth. The real issue is one of timing, in terms of the time lag between the removal of social welfare benefits and the positive private sector employment impact following reduced labour costs (see below for a discussion of the this issues).

<sup>2</sup> There are instances where taxes can actually improve competitiveness, especially if they replace more inefficient taxes. According to a study by Widmalm (2001), some taxes have a negative impact on economic growth while others can have positive effects.

<sup>3</sup> For details on the theory of optimal currency areas, see: Kenen and Meade (2008, Chapter 2). In a nutshell, the theory aims to identify the conditions that would mitigate the limited degree of synchronicity between economies should they adopt a common currency. An optimal currency area is one where either the economies are synchronized in terms of their boom-bust cycle or they possess the necessary conditions that mitigate the absence of synchronicity.

<sup>4</sup> For details on the EFSF and ESM, see: Leblond and Paudyn (2011).

<sup>5</sup> In late June 2011, the Greek rescue package was extended to 2015 and beyond, if necessary.

<sup>6</sup> Greece's informal economy is estimated to range between 20-25 per cent of GDP (Katsios, 2006).

<sup>7</sup> According to the World Bank, Greece ranked 109th out of 183 countries in terms of the ease of doing business in 2010 (<http://www.doingbusiness.org/rankings>).

<sup>8</sup> The Irish government had already adopted €14.5 billion worth of spending cuts and tax rises in order to quell the mounting deficit. In spite of these measures, the deficit was still slated to reach 12 per cent of GDP in 2010, not including bail-out funds to the banking sector (The Economist, 2010, p.79).

<sup>9</sup> Tax revenues dropped by €14 billion between 2007 and 2009 (The Economist, 2010, p.81).

# Jacquelyn MacLennan, 'Recent Developments in EU Competition Policy & Competitiveness: Outline of Remarks & Slides for Presentation'

## 1. What is competition policy?

- The “Founding Fathers” of the Coal and Steel Treaty in 1951 and the Treaty of Rome in 1957 had a fundamental aim: to bring long lasting peace to Europe. How? By prosperity, leading to economic growth and political stability. The mechanism? The internal market would be the engine for growth.
- Competition policy was seen as a key tool to achieve the internal market. The intention was that the EC would be governed by a system with fair and open markets, seen as essential for the well-being of the economy and society. In a market economy competition policy promotes the efficient operation of markets. Competition law complements regulation. The original goal of EC competition policy was to ensure that companies were not undermining the drive to eliminate government barriers to trade. The focus first was on vertical agreements sealing off international markets. There developed an understanding that horizontal market sharing agreements were pernicious as they allowed the protection of national champions. This led to the “fight against cartels”. So the objective laid down in the Treaty of Rome was in Article 3 (g): The authorities of the Community shall include a system ensuring that *competition in the internal market is not distorted*.
- The theory is that competition law should ensure that the market is working properly, on the basis that in such a market: prices decrease, innovation increases (in how product and services are delivered, and in goods and services themselves) and choice increases, so overall, the consumer benefits.
- There is now an emphasis on the structural effects of competition law in achieving an undistorted market, on the basis that this encourages the necessary restructuring of declining industries, and correspondingly encourages the creation of globally competitive companies
- The “purist” (ordo-liberal) view that the sole goal of competition enforcement should be the promotion of economic efficiency is gaining increasing acceptance in policy making. Competition agencies around the world have become increasingly sceptical about the role of industrial policy considerations in competition law enforcement. This can be seen in the treatment of “hardcore” competition law infringements, such as fixing prices or production.

## 2. What is EU competition policy in particular?

- Anti-competitive agreements - cartels, vertical agreements (Article 101);
- Abusive conduct by dominant companies (Article 102, Article 106);
- Control of mergers and acquisitions (Regulation (EC) No 139/2004) and

- State aid (Articles 107, 108, 109).

### 3. How does competition policy fit with the Commission's policies on competitiveness?

#### Europe 2020 – “Europe's growth strategy”

- Europe's industrial policy for the present decade – “*smart, sustainable, inclusive growth*”. The EU has set five ambitious objectives - on employment, innovation, education, social inclusion and climate/energy - to be reached by 2020. Each Member State has adopted its own national targets in each of these areas.
- Commission President Barroso: “*these measures will create jobs in the short term and make the European economy more competitive in the longer term.*”<sup>248</sup>
- Competition policy is a complement to the Europe 2020 policy. Need for flagship competition law initiatives and robust enforcement to be part of it.

#### Examples of competition policy initiatives which are expressly intended to increase competitiveness?

##### (1) *Financial services*

- a. Commission actively investigating *electronic payment services*  
e.g. Electronic Payment Council's process of standard setting to ensure access for new service providers.
- b. Investigation into *CDS* market  
Commission looking, in particular, at investment banks' behaviour.
- c. Investigation into financial derivatives markets linked to *LIBOR, TIBOR and EURIBOR*  
Many countries, including the EU, looking into allegations of manipulation of these rates by banks as well as other traders.
- d. Investigation into *Thomson Reuters/ S&P licensing of financial information*
- e. *NYSE/Deutsche Börse*  
Commission said: not prepared to allow “quasi monopolies”, and blocked the proposed merger on the grounds it would have controlled 90% of the market for *exchange traded financial derivatives* and would have harmed competition and consumers.

##### (2) *Telecoms*

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<sup>248</sup> <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/12/181&format=HTML&aged=0&language=EN&guiLanguage=en>

- The telecoms market has been a focus for the Commission since 1990s. It remains a focus, and also a focus of national competition policies.
- Eg Commission recently fined Polish Telecom; many incumbent operators accused of abuse of a dominant position under Article 102 of the Treaty by to restricting access of competitors to the market (currently investigations in Slovakia, Spain, Portugal)

### (3) *Standard Setting / IP*

Patents are essential monopolies granted to reward innovation and encourage invention, but they can be used to block competitors from the market and restrict competition.

- The Commission has looked particularly at standard setting procedures to ensure markets are open to new competitors, e.g. *Intel acquisition McAfee*: Commission cleared on basis McAfee open system working with other competitors focusing also on telecoms networks e.g.
- Google acquisition of Motorola Mobility
- Mobile “patent-wars”:
- *Samsung*: potential abuse of “standard essential patents” and refusal to license on FRAND terms
- Follow on from *Rambus* and *Qualcomm* cases
- complaints from Apple and Microsoft against *Motorola*
- *Mathworks* – complaint that it has refused to license software for inter-operability in ABS sector (seems to be a re-run of the Microsoft case).
- Huawei complaint against *Interdigital*: 3G patent licensing injunction sought by Interdigital to get Huawei to pay increased royalties.

### (4) *Energy*

EU Commission policy here is now very advanced. In summary: regulatory effort through 1990s to create EU market for gas and electricity instead of insular national markets. In 2005 it was evident that despite the effort, markets were not fully open so DG COMP began energy sector enquiry investigations.

Incumbent supplies have now opened up markets with commitments – see:

ENI, GDF, Suez, E.On – gas; E.On, RWE - electricity

**Result** – greater competitiveness, achieved with a combination of regulation and competition law enforcement.

**Conclusion:** can point to many examples where competition policy is being used as a tool to achieve a more competitive economy and growth in the EU.



#### 4. The effect of the economic crisis on EU competition policy

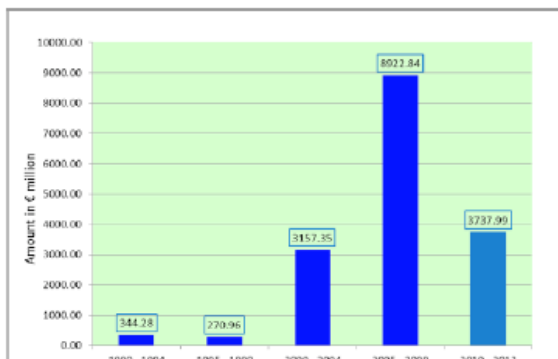
- The global financial crisis had its roots in the bursting of the US housing bubble in 2007 – but only became apparent in the EU in 2008, in particular the fall out from the collapse of Lehman Brothers in September 2008. The crisis was first seen playing out on the banks. The trickle down into the “real economy” was rapid however.
- What did the crisis mean for EU competition law?
  - First - there is no provision to suspend EU competition law.
  - Second - there has been no change to the substantive competition Articles in the EU Treaty since 1957, although there have been many Treaty changes.
  - There has been a change to the “big picture” Article setting out the *goal* of the EU regarding competition policy – but this was not related to the financial crisis. Compare Article 3(g) of the Treaty of Rome with its “replacement” - Article 3 TEU: “*The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment.*” Concept of free and undistorted competition lost.
  - In June 2007, in the heat of the final negotiations for the Treaty of Lisbon, President Sarkozy of France succeeded in his demand of having this language moved into Protocol No 27 to the consolidated Treaty on EU, which states “... *the internal market...includes a system ensuring that competition is not distorted*”. Sarkozy: “*Competition as an ideology, as a dogma, what has it done for Europe? It has only brought fewer and fewer people who vote in European elections and fewer and fewer people who believe in Europe*”.... “*This amendment gives the EU more humanity.*” The Protocol to the TFEU says “... *recognizing that the removal of existing obstacles calls for concerted action in order to guarantee steady expansion, balanced trade and fair competition*”. What is the effect? Moving the furniture. The house is still the same.
  - Since the crisis struck, have the words of the Treaty been interpreted differently in light of the changed external circumstances? Has there been a change in how the law is enforced, even if the principles remain the same? It is clear that different Commissioners responsible for competition policy have had different priorities. Has that situation simply continued?

This presentation looks at three areas of competition policy to see the impact of the financial crisis, concentrating on cartel policy.

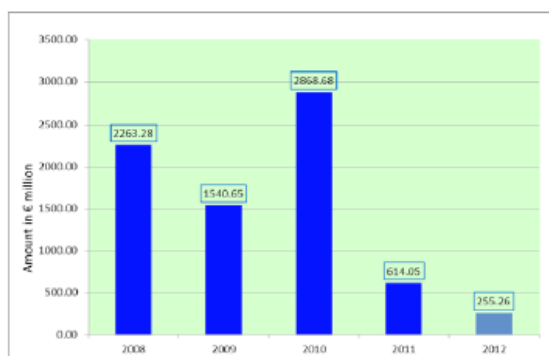
## (1) Cartels

### Cartels – Amount of fines (adjusted for Court judgments)

Amount of fines in the period 1990 - 2012



Amount of fines in the period 2008 - 2012



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### Cartels – 10 largest fines per case (since 1969)

Year	Case name	Amount in €
2008	Car glass	1,383,896,000
2007	Elevators and escalators	832,422,250
2010	Airfreight	799,445,000
2001	Vitamins	790,515,000
2008	Candle waxes	676,011,400
2010	LCD	648,925,000
2010	Bathroom fittings	622,250,782
2007	Gas insulated switchgear	539,185,000
2007	Flat glass	486,900,000

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## Cartels – 10 largest fines per undertaking (since 1969)

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Year	Undertaking	Case	Amount in €
2008	Saint Gobain E.ON	Car glass	896,000,000
2009	GDF Suez	Gas	553,000,000
2001	F. Hoffmann-La Roche	Vitamins	462,000,000
2007	Siemens AG	Gas insulated switchgear	396,562,500
2008	Pilkington	Car glass	370,000,000
2010	Ideal Standard	Bathroom fittings	326,091,196
2007	ThyssenKrupp	Elevators and escalators	319,779,900
2008	Sasol Ltd	Candle waxes	318,200,000

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- Looking at the statistics on the evolution of the number of EU cartel cases where the Commission has taken decisions, and the volume of fines, it is easy to see that there has been a certain drop in the number of cases in the last year or so where decisions have been imposed. In my view, this cannot be attributed to the financial crisis, but to other factors. However, the crisis can be seen to a certain extent in the drop in the level of fines imposed at EU level. Aggregate fines<sup>249</sup> in 2008: were €2.3 billion, in 2009: €1.5 billion and in 2010: €2.9 billion, But in 2011: 0.6 bn.
- Why? Result of:
  - change of Commissioner,
  - understanding of the impact of the crisis
  - initiative by companies before national parliaments and the European Parliament to challenge the dogma of enormous fines
  - Increase in acceptance of inability to pay claims,
  - increase of defaults on fines (deferment of payment schemes) even after fines upheld by Court:

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<sup>249</sup> Adjusted for changes following judgments of GC and ECJ.

- In addition, companies are just not paying and there appears to be little enforcement of the payment of fines by DG Budget.
- **However, there is no abandoning of the "fight against cartels"**: In particular, no overall justification for relaxing the rules. In fact, the Commission showed particularly scepticism when faced with such an approach:
 

Director General Italianer, 14 March 2012: “As competition law enforcers, cartel behavior is not something we can tolerate. I can assure you that our strict enforcement policy will not change, **especially** in these difficult economic times when cartels impose an extra cost on consumers and on the companies that play by the rules”.
- The Commission and Member State competition authorities were strongly influenced by the OECD, which argued that suspension of the cartel rules in the US after the Great Depression had slowed down the process of recovery.
- Examples of Commission approach to competition which has not eased because of crisis:
  - Pharma enquiry continues
  - Telecoms focus continues
  - Energy focus continues
  - Financial services focus continues – even against banks
  - Food supply chain: Commission and national competition authorities working together to tackle unfair trading practices resulting from contractual imbalances and differences in bargaining power between suppliers and buyers. These practices, which must be distinguished from anticompetitive practices, normally fall under national contract or commercial laws. (source: [http://ec.europa.eu/competition/publications/annual\\_report/2010/part1\\_en.pdf](http://ec.europa.eu/competition/publications/annual_report/2010/part1_en.pdf) - p. 37, 2.11; see also .)
  - New distribution rules – modernised for the internet.
  - Commission still opening new investigations in airline sector (**SkyTeam investigation** January 2012, to probe cooperation among three members of SkyTeam Alliance: AirFrance-KLM, Alitalia and Delta; investigation February 2011 into code-sharing agreement between **Brussels Airlines and Transportes AEROS Portugueses**).
- What about real **crisis cartels** – where there is a situation of oversupply in a particular sector, and a need for radical restructuring? How do the competition rules apply?
  - In the 1980s-90s, the Commission was prepared to permit agreements aimed at eliminating overcapacity in industries affected by structural crisis (*Synthetic Fibers*<sup>250</sup> *Stichting Backsteen*<sup>251</sup>), but only under certain conditions: limited to particular sector only, no price or quota discussion and only on a temporary

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<sup>250</sup> Commission Decision of 4 July 1984 (*Synthetic Fibres*), OJ [1984] L 207/17.

<sup>251</sup> Commission Decision of 29 April 1994 (*Stichting Baksteen (Dutch Bricks)*), OJ [1994] L 131/15.

basis. Some further bilateral examples of crisis agreements given an exemption under the competition rules in the chemical sector e.g. BPPL/ICI; ENI. Would the same approach be adopted now?

- Unlikely – the ECJ is now much clearer on the scope of Article 101, saying that non-competition matters (e.g. employment considerations) should not be taken into account where there is a clear detriment to competition, and even casting doubt on the application of Article 101(3). See Irish Beef<sup>252</sup>: the ECJ held that an agreement aimed at reducing production capacity in a crisis-ridden industry is a restriction “by object”, reasoning that industrial policy considerations (the need to eliminate structural overcapacity in the Irish beef industry which was in crisis) were irrelevant for the purpose of applying Article 101(1) TEFU. Such considerations could be relevant in the context of applying Article 101(3) TFEU, but the Court noted that agreements restricting competition “by object” are unlikely to fulfill the criteria of Article 101(3) TFEU.
- Bottom line: (1) now much more severe enforcement culture; (2) exemption under 101(3) harder in light of case law (3) after Regulation 1/2003, there is no notification procedure so a company has to take the risk. It might get informal advice from the Commission – but there is no longer provisional immunity or the possibility of a comfort letter.
- A good guide to the Commission’s likely approach is the Report which the Commission prepared for an OECD 2011 study on crisis cartels<sup>253</sup> – the intervention reads as if the financial crisis is not there.
- The general approach is expressed e.g. in 2009 by the Commission:

*"From a substantive point of view, it was important to maintain a rigorous enforcement of the merger and antitrust rules in order to preserve the competitiveness of European business and facilitate its emergence from the crisis."*<sup>254</sup>

The response of the COM was more about adjusting the level of fines in cartel cases and the need for state aid control measures.

- There are only very exceptional examples of cases where some softening of approach has been permitted. Annual report on Competition Policy **2010**, p. 37 ([http://ec.europa.eu/competition/publications/annual\\_report/2010/part1\\_en.pdf](http://ec.europa.eu/competition/publications/annual_report/2010/part1_en.pdf)):

*"Special attention was devoted to the dairy sector in light of the difficulties faced by dairy farmers during the recent milk crisis. Following the High-Level Group on Milk recommendations, the Commission adopted a legislative proposal<sup>163</sup> in December 2010 on contractual relationships in the milk sector. The proposal allows collective bargaining negotiations by producer organisations of milk farmers subject to certain limits based on their*

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<sup>252</sup> (Case C-209/07, *The Competition Authority v Beef Industry Development Society Ltd, Barry Brothers (Carrigmore) Meats* [2008] ECR I-8637)

<sup>253</sup> <http://www.oecd.org/dataoecd/26/61/48948847.pdf>

<sup>254</sup> Annual report on Competition Policy **2009**, p. 16 ([http://ec.europa.eu/competition/publications/annual\\_report/2009/en.pdf](http://ec.europa.eu/competition/publications/annual_report/2009/en.pdf)).

share of EU-wide and national milk production volumes. The proposal also provides for a "safety clause" allowing the competent NCA or the Commission to decide that the negotiations by a producer organisation may not take place where they would limit competition severely or where they would inflict a serious prejudice to dairy processors, in particular SMEs."<sup>255</sup>

But this is not a general justification for crisis cartels. Illustrative of this: the Greek Competition Authority refused such a justification and imposed a fine on fish farms in a crisis cartel situation. True that in such a situation fines are likely to be substantially lower.

## (2) Merger control

- The fear at the time of the crisis was that the “failing firm defence” would mean “anything goes”. Crisis gave rise to **procedural changes**: need for fast clearance decisions. However, merger decisions do not reveal that the Commission's analysis substantively changed or that concentrations are more likely to be accepted these days.

### Mergers – Number of notified / blocked merger requests (since 2006)

	2006	2007	2008	2009	2010	2011	2012
<b>Number of notified cases</b>	<b>356</b>	<b>402</b>	<b>347</b>	<b>259</b>	<b>274</b>	<b>309</b>	<b>85</b>
Cases withdrawn - Phase 1	7	5	10	6	4	9	1
Cases withdrawn - Phase 2	2	2	3	2	0	1	1

	2006	2007	2008	2009	2010	2011	2012	Total
Art 8,1 compatible (8,2 under Reg. 4064/89)	4	5	9	0	1	4	0	23
Art 8,2 compatible with commitments	6	4	5	3	2	1	1	22
Art 8,3 prohibition	0	1	0	0	0	1	1	3

The following merger requests were blocked:

- 2007 – Aer Lingus / Ryanair
- 2011 – Olympic Air / Aegean Airlines
- 2012 – NYSE / Frankfurt stock exchange

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<sup>255</sup> See also the Belgian NCA. "In 2009 we focussed also on a more proactive involvement, in particular in respect of the crisis in the agricultural sector, and especially the dairy sector. In consultation with the European Commission, another national competition authority and other departments of the Fod/Spf Economie, we have helped to define what was compatible with the rules of competition in respect of the provisional arrangement between the Agrofront and Fedis regarding the support by the distribution sector in favour of the milk producers. Equally in consultation with the Boerenbond, with het Algemeen Boerensydicat, and two other organisations, we offered guidelines concerning projects for contractual agriculture and quality labels." ([http://economie.fgov.be/en/binaries/Annual\\_Report\\_E1\\_2009\\_tcm327-100091.pdf](http://economie.fgov.be/en/binaries/Annual_Report_E1_2009_tcm327-100091.pdf))

- There are still very few blocked mergers, but not because of crisis justification. There have always been few Article 8(3) prohibitions (only 22 from 1990 – April 2012)<sup>256</sup>. Since 2008, there has been 1 prohibition in 2011 (Olympic/Aegean) and 1 in 2012 (Deutsche Börse/NYSE).

But a key point must be remembered: mergers are generally cleared with conditions i.e. structural or behavioural remedies (usually structural as easier to enforce divestitures). Knowing this, companies may offer remedies at an early stage of discussion with the Commission, in order to preempt problems.

- A truism: decisions taken at national level might be more prone to political pressures than European Commission. Industrial policy considerations more likely to figure in the equation. Can see this in a few examples:
  - Compare *Olympic/Aegean Airlines* 2011 reviewed by European Commission at EU level with *Alitalia /AirOne* reviewed by Italian Antitrust Authority in December 2008. The Commission blocked the merger on grounds that it would have created quasi-monopoly on certain national routes; the Italian merger went through, even though the transaction led to similar competition concerns, because at the time, Alitalia on brink of bankruptcy and the Italian government adopted laws effectively preventing the IAA from reviewing transaction, by raising public policy issues. See also: *IAG(group which owns BA)/BMI* which was approved with conditions in March 2012 by the Commission. Due to the losses it was incurring, BMI faced closure should the EC have initiated a phase II investigation. The EC pushed IAG to agree to surrender 14 of the 56 pairs of daily take-off and landing slots at London held by BMI. Additionally, IAG committed to allow rivals operating on long-haul flights out of London Heathrow to use its network of connecting flights.
  - Lloyds/HBOS<sup>257</sup> – very exceptional times – September 2008 – a real fear of a run on the bank in the UK. Concerns about the stability of the financial markets led the UK government to intervene in the merger review process. The transaction was not notifiable to the Commission as the turnover requirements were not met. The government effectively manipulated the legal process to ensure that the transaction was cleared on public interest grounds despite the fact that it was capable of giving rise to competition concerns, so that no competition clearance was necessary. At the time, the OFT informally threatened a sectoral enquiry in the banks in the UK. Some of the concerns were however addressed by the European Commission in its decision regarding the approval of the aid (in a form of a state recapitalization) to the ailing banks. The Commission required divestments with the view to facilitate the entry of a new competitor or the reinforcement of a smaller existing competitor on the UK retail banking market.

<sup>256</sup> <http://ec.europa.eu/competition/mergers/statistics.pdf>

Generally Commission unsympathetic to arguments based on restructuring need: ICI, Svkerunie, Tokai Carbon. FNC BV: agreement between French beef farmer federations post mad law. Court said had to find 101 (i) infringement but bigger reduction of fine justified (2006)

<sup>257</sup> Lloyds/TSB GroupPLC/HBOS case (Case ME/3862/08)



Again shows that industrial policy concerns can be highly relevant in the context of national merger control.

**Conclusion:** At EU level, the failing firm defence has not been a panacea to approve all mergers with no remedies.

### (3) State aid

- Without doubt, this is the area where the impact of the crisis has been most pronounced.
- When national banks were in crisis, the only possible reaction in terms of a bail out at the time was national.<sup>258</sup> So it was to be expected that the Member States took the immediate steps they considered necessary. The question was how should the EU apply the state aid rules in such a situation?
- The Commission had some – but very limited – experience from the accession process for the Czech Republic, and other acceding Member States in 2004 and 2006. Article 107(3)(b) TFEU provides that aid to remedy a serious disturbance in the economy of a member state may be considered to be compatible with the common market. The Commission considered that the crisis that hit the financial markets in 2008 and its potential overall impact on the economy of member states, justified the use of Article 107(3)(b) as a legal basis for aid measures to address this systemic crisis.
- The Commission in fact responded very quickly. Particularly in relation to aid to banks. Commission Kroes put in place an EU emergency regime. The Commission considered 43 banks and is still discussing the restructuring of more than 20. Officials were available day and night, and decisions were taken with unprecedented expediency.
- In addition to the procedural “re-tooling”, in 2008 and 2009 4 communications were issued to create framework for the approval under Article 107(3)(b) of aid in favour of banks and financial institutions hit by the financial crisis:
  - (1) Communication on the application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (the Banking Communication)
  - (2) Communication on the recapitalisation of financial institutions in the current financial crisis (the Recapitalisation Communication)
  - (3) Communication on the treatment of impaired assets in the banking sector (the Impaired Assets Communication)
  - (4) Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis (the Restructuring Communication)
- 1 December 2011 – Commission extended State aid crisis framework for banks to take account of sovereign debt crisis.

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<sup>258</sup> The Spanish Government has just been pressurised to agree to a Eurozone bail out for its banks, rather than try to rescue the situation using its own funds.

- Further major changes have just been announced by Commissioner Almunia.
- When look at the Commission statistics for crisis and non-crisis aid over the past years, can see that there is no substantial increase, and even a slight reduction of state aid, if leave aside sector-specific crisis aid. Aid to the financial sector is now said to be about €1.6 trillion.

## 5. Conclusions

- The OECD view that history shows that the relaxation of anti-trust enforcement prolongs and worsens impact of crisis, and prevents healthy recovery, has been very influential on approach of EU Commission and NCAs.
- Overall, with exception of State aid to banks, the crisis has had a limited impact on EU competition policy.
- Has been certain impact in area of cartels: Commission recognizes that business delinquency is more likely in times of crisis so (i) fight against cartels remains the key priority (ii) fines are still used as the basic tool to ensure deterrence but there is some moderation in the amounts and the approach to applications of inability to pay (iii) but crisis cartels are unlikely to be accepted.
- Mergers: business as usual
- Change of Commissioner & Director General - both of whom are economists, not lawyers, not generalists - has shifted focus of EU competition law to tackling the structure of competition in the market, with less interest in individual agreements unless they cover a very major market or have highly important implications. This approach has been exacerbated by the background of the economic crisis.
- The Commission has become very proactive in explaining how competition benefits consumers and achieves economic growth by aiding competitiveness: see website, speeches etc. Preemptive justification?
- Apart from state aid - where it's a now a different world from 2008 – the conclusion as regards EU competition policy is: crisis, what crisis?

# Georg Menz, 'Employers and Migrant Legality: Liberalization of Service Provision, Transnational Posting, and the Bifurcation of the European Labour Market'

The grabbing hands grab all they can. All for themselves, after all: It is a competitive world. Everything counts in large amounts.”  
Depeche Mode, Everything Counts [July 1983]

## 1. MAPPING THE CHANGING COMPOSITION OF THE EUROPEAN LABOUR MARKET

European labour markets have undergone epochal transformations over the course of the past fifteen years. This is particularly true for continental Europe, where relatively strong unions, organisational coherence amongst employers, and sophisticated juridical regulation led to fairly regulated labour markets with low degrees of wage dispersal. However, this assessment of unified and regulated labour markets, already somewhat inaccurate during the era of Fordism and the long postwar boom, no longer adequately captures the dynamics of contemporary labour markets, due to the gradual structural transformation of labour market regulation. This transformation is driven by the transnationalization of production strategies, neoliberal policy reform, and changing commitments amongst employers.

In this process of carefully induced disintegration, migration plays a significant role, which is often underappreciated or neglected altogether. Migrants are channelled into new substandard tiers of the labour market and are thus used to promote the elaboration and ensure their permanent character. Employers proactively use and abuse migration as a tool to achieve more pronounced disparity in terms of wages and working conditions. The recent re-discovery of labour migration in Europe therefore needs to be assessed in terms of a strategic tool in securing greater differentiation of the labour market. Apart from migration from outside of Europe, intra-European mobility is an important issue in this respect as well, both in terms of simple labour mobility and regarding the transnational provision of services involving the temporary posting of workers across European borders. Given the formidable size of the intra-European wage gap, the exploitation of labour migration is an important and lucrative strategy in undermining formerly more structured and regulated labour markets that is currently not sufficiently appreciated in the existing literature.

This article submits three chief arguments. Firstly, it demonstrates how debates in comparative political economy can be significantly enhanced and improved by taking seriously developments in European labour markets induced by immigration. The comparative political economy literature does not take migration into consideration and, conversely, there has been a dearth of scholarly migration accounts, at least in political science, that focus on the labour market implications of the movement of people. This article seeks to address this lacuna, arguing that labour migrants, both legal and undocumented, are used to help perpetuate the disintegration of European labour markets, both in systems commonly still regarded as subject to considerable

regulation, greater homogeneity and, not least, union influence, such as Germany, and in those regarded as much more liberalised and heterogeneous already, namely in the United Kingdom. Labour migration can therefore be utilised as a conscious employer strategy in helping to liberalise and deregulate labour markets.

Disintegration of formerly tightly organised labour markets are not caused by, yet arguably promoted by labour migration. This argument is substantiated by an in-depth study of sectoral labour market developments. Secondly, it is argued that some of this structural transformation ought to be understood as being related to structural changes in the role of the state. The modern European state has cast off reservations associated with the era of embedded capitalism and is more aggressively enabling the pursuit of accumulation, entailing a business-friendly stance towards labour migration. Thirdly, and relatedly, employers are active agents in driving forward the liberalization of labour migration, including the analytically somewhat distinct, yet related liberalization of service provision. Thus, immigration from outside of the European Union (EU) is being promoted and supported by active lobbying. In addition, the EU liberalization of service provision is being exploited as a mechanism of prying open new access channels to labour markets. The agency of employers and its significance are also somewhat underappreciated in the current literature. It is also worth noting that this inferior legal status pertaining to labour migrants might in some cases even apply to citizens of EU member states.

## 2. ORDERLY DISINTEGRATION : THE USE AND ABUSE OF LABOUR MIGRATION

Recent debates in comparative political economy have focused on the implications of economic liberalization in Europe, exploring in particular whether domestic factors engendering the embrace of neoliberal ideology or more general tectonic shifts often attributed to globalization and European integration are primary causes for liberal change (Crouch and Streeck 1997, Streeck and Hoepner 2003, Streeck and Hassel 2004, Amable 2005). More recent contributions, especially those informed by the varieties of capitalism approach, contest that earlier pessimistic predictions of convergence on a minimalist liberal Anglo-American model of capitalism are inaccurate, suggesting instead a taxonomy that encapsulates coordinated market economies (CMEs) and liberal market economies (LMEs). This framework suggests that notwithstanding the general trend towards post-Fordist liberalization, significant differences in regulatory style continue to persist across Europe, partially driven by highly diverse production strategies that encompass different corporate interests in degrees of intra-company cooperation and coordination, skills distribution levels of employees, and the regulatory style of the labour market in general terms. However, one obvious point of weakness is the relative myopia of attempts to sketch a CME, given the bifurcation of labour markets and the more general ongoing steadily proceeding liberalization of these very models (Streeck 2009).

The pace and extent of disintegration, by which I refer to the dissolution of formerly more uniform and cohesive labour market structures into an atomized multi-tiered structure, is astonishing. The resultant dualization entails the segmentation of the labour market not only in the UK and other LMEs, where precarization, dualization and atypical forms of employment emerged from the late 1970s onwards and are well documented (Gamble 1988, Coates 2000), but, more strikingly, also in Germany and the CME category. Drawing on the UK Labour Force Survey, Goos and Manning

(2003: 77) show that though the proportion of top paying jobs in the UK increased between 1979 and 1999 (by 25% and 70% respectively in deciles 9 and 10), the same period also saw a significant rise (40%) in the proportion of jobs in the lowest paying decile. Concomitantly, between 1979 and 1993, the poorest decile experienced a real income decrease of 18 percent, whilst the richest decile experienced an explosive 61 percent rise (Macnicol 1998). The received wisdom of the German economy as being dominated by well-regulated and highly unionized industrial relations needs to be re-evaluated in light of the now readily apparent impact of labour market reforms and ongoing union weaknesses. Hassel (2011: 16-17) documents the use of marginal employment and fixed term contracts, especially in the service sector, which accounts for 80 percent of such marginal employment. Drawing on government data, she suggests that more than 20 percent of all jobs in the service sector are fixed-term contracts. With income inequality rising, nearly one third of recipients of long-term unemployment benefit are also in employment, spawning the phenomenon of the working poor. Part-time employment has doubled between 1991 and 2007, whilst the number of full time jobs has decreased by 20 percent. Fixed term contracts and contracts secured through work agencies amount to under 10 percent of the total labour force, though there are striking recent increases in absolute terms (Eichhorst and Marx 2009: 14). However, 22.4 percent of all employees received less than EUR 9.19 as a gross hourly wage in 2007. The percentage of employees thus covered by minimal wages only has risen from 14.2 percent in 1998 (Kalina and Weinkopf 2009: 2-3). Worryingly, not all poorly paid jobs are necessarily appropriately to be classified as low skill and many are held by clearly overqualified individuals, with 70.8 percent of employees in this category having undergone vocational training and 8.4 percent having obtained a tertiary education degree. 11.3 percent of all employees are foreign citizens. Between 1995 and 2007, real average wages in the low wage sector have actually decreased from EUR 6.03 to EUR 5.77 in West Germany and marginally increased from EUR 4.66 to EUR 4.69 (Kalina and Weiskopf 2009: 6).

Recent scholarship has all but neglected the neo-Marxist works of the early 1970s that postulated a link between migration and the “reserve army of labour” (Castles and Cusack 1973, Castells 1975). Engels had written in 1844 that

With such a competitor the English working-man has to struggle with a competitor upon the lowest plane possible in a civilised country, who for this very reason requires less wages than any other. Nothing else is therefore possible than that, as Carlyle says, the wages of English working-men should be forced down further and further in every branch in which the Irish compete with him. And these branches are many. All such as demand little or no skill are open to the Irish. For work which requires long training or regular, pertinacious application, the dissolute, unsteady, drunken Irishman is on too low a plane. To become a mechanic, a mill-hand, he would have to adopt the English civilisation, the English customs, become, in the main, an Englishman. But for all simple, less exact work, wherever it is a question more of strength than skill, the Irishman is as good as the Englishman. Engels (1844 [1943] : 94)

Inspired by the claim that migrant labour was consciously (ab)used to feed into substandard jobs, Michael Piore (1979) argued that the capitalist economies of the late 1970s were characterized by “dual labour markets” inasmuch as there was a permanent tier of poorly remunerated jobs attracting little or no prestige, often subject to bad or even hazardous working conditions. The

contemporary term “dirty, dull and dangerous” aptly summarizes the conditions found in this bottom tier of the labour market. According to Piore, this sector was a permanent structural component of the labour market, not a transitory or temporary phenomenon.

Drawing on the concept of the dual labour market, I argue that there is indeed a strong correlation between the manufactured disintegration of the labour market and migration. Labour migration is thus used both as an axe to crack open tightly regulated and homogenous labour market structures, permitting new substandard forms of employment *and* to people such new substandard tiers. The trend towards tertiarization, already evident in the 1970s, certainly dovetailed with this development, as newly emergent service industries proved more difficult for both unions and labour authorities to police effectively.

Concomitant with disintegration is the disproportionate effect of economic restructuring on settled immigrants, especially those working in relatively unskilled jobs (Dustmann, Glitz and Vogel 2009). This is borne out by the relatively high unemployment rates amongst UK ethnic minorities, as documented in the UK Labour Force Survey. Whilst in 2005-6 the rate was 3.8 for the white majority, it stood at 12.8 for Pakistanis, 19.4 for Bangladeshis, 11 percent for Black Caribbean and 11.8 percent for Black Africans. Though no similar data is available for Germany, 2007 EU Labour Force Survey data indicate that 19.24 percent of all resident non-EU citizens are unemployed as opposed to 7.76 native born (quoted in Kahanec, Zaiceva and Zimmermann 2010). Similarly, in 2009, the rate of economic activity for white Britons was 75.0 per cent, whilst for other ethnic groups this was 59.4 per cent (ONS 2010).

The disintegration of the labour market is accompanied by the (re-)creation of different groups entitled to different rights. Legality of employment, a common theme in the contributions to this special issue, obviously matters greatly, but less immediately apparent is the inferior status of EU citizens seconded transnationally under the auspices of the liberalization of service provision or “self-employed” as de facto subcontractors in this context. The transnationalization of production and corporate strategies and legislative changes aimed at reducing trade union influence and workfarism that links the receipt of transfer payments to generally poorly remunerated work activities are all important factors in the fundamental change of the legislative and political landscape. Such legislative measures were informed by an ideological shift towards neoliberalism, although the extent to which this ideology was embraced obviously varied across Europe.

### 3. THE CHANGING ARCHITECTURE OF THE EUROPEAN STATE

The architecture of the European state has changed radically when juxtaposed with the form and functions carried out by the postwar Keynesian welfare state. It was always misleading to conceive as the state as a neutral umpire between conflicting societal interests, but equally important is a clear understanding of what the internalization of neoliberalism and the embrace of authoritarian etatisme entail for the nature of the state and its population control policy. Such analytical confusion might be attributable to neoliberalism being conceived of as an ideology limiting the scope of the state:

A new ideology...must give high priority to limiting the state's ability to intervene in the activities of the individual. At the same time, it is absolutely clear that there are positive functions allotted to the state. [...] neoliberalism argues that it is competition that will lead the way. The state will police the system, it will establish the conditions favourable to competition.... Citizens will be protected against the state, since there exists a free private

market, and the competition will protect them from another.” (Friedman 1951, cited in Peck 2010: 3–4).

It is more helpful, however, to consider on the one hand, the more punitive elements of the neoliberalized state and its increasingly authoritarian nature. Earlier state theorists, including Poulantzas (2002), forecast a dichotomy between a liberalised economy and an increasing control and surveillance regime aimed at those considered deviant or somehow ill fit to contribute to the accumulation process.

“(I)t seems to be precisely this incapacity to make a clear distinction between ‘threats’ and ‘resources’, between the ‘dangerous’ and the ‘laborious’ classes or, to follow another sociologically successful dichotomy, between ‘social junk’ and ‘social dynamite’, which compels the institutions of social control to regroup whole sectors of the post-Fordist labour force as ‘categories at risk’, and to deploy consequent strategies of confinement, incapacitation and surveillance.” (De Giorgi 2006: 76).

Wacquant makes a similar argument that stresses the rise of the disciplining penal state, which renders what are often mere survival strategies into pathological and deviant behaviour, thus ‘penalising the poor’ (Wacquant 2009). But the state does not only contain a newly reinforced repressive role, it also contains an important ideological apparatus, which is involved in “ideological inculcation and transmission” (Martin, 2008: 183). Thus understood, the basic architecture of the European neoliberalized state becomes clearer. “[...] the state must not be considered as an intrinsic entity, but, as is also true for ‘capital’ itself, it must be considered as a relation, more exactly as a material condensation (apparatus) of a relation of force between classes and fraction of classes...” (Martin 2008: 307).

Three important arguments follow from this Poulantzian understanding of the state. The state is not captured by capitalist interests, but nevertheless strongly shaped by the ‘power bloc’, a congregation of influential political, social and economic actors. The state does retain a certain degree of autonomy, but it needs to be understood as the expression of economically driven struggles over political influence. Therefore, predominant and hegemonic classes will strongly influence public policy concerning population control and labour market regulation, with immigration policy presenting an obvious confluence of the two fields. In order to understand changes in migration policy, it is thus much more fruitful to study the position of economically dominant actors than to remain wedded to an ultimately short-sighted liberal pluralist paradigm. Secondly, though this article empirically focuses primarily on employers, not unions, the latter in part play a role in representing the labour aristocracy and acting as part of the ideological apparatus (Martin 2008: 186-219). It is thus misleading to assume either a highly active or an anti-immigrant status on the part of the unions, but more instructive to understand their interests as being shaped by defending the interests of their core clientele. This might entail accepting disintegration of the labour market as a lesser evil. Thirdly, the state needs to ensure its own underlying material resources and hence assure its reproduction over time. Immigration policy is thus always driven by the sometimes conflicting prerogatives of seeking to ensure a steady supply of a taxable labour pool and arresting costly demands by the new migrant population to services proffered and financially underwritten by the state. This includes directly repressive measures by the police, border police units and social services aimed at migrants and migrant populations. From this last point arises the interest in recruiting an easily manageable migrant population that can easily be slotted into existing production strategies and fit into either end of a bifurcated labour market.

If the reorganisation of the contemporary state has thus led to a gradual re-discovery of economic migration, this should come as little surprise. Weakening unions, more aggressive employers, labour market deregulation, and new corporate production strategies have red-drawn the contours of the labour market. Employers perceive of a need to solicit migrant labour, both because this helps promote and solidify a bottom tier of the labour market and because it broadens the size of the labour pool more generally and thus keeps wage increases in check. Indeed, real wages in Germany have stagnated since 1995, between 2004 and 2008 they have even declined slightly (Brenke 2009). In the UK, recent EU A8 immigrants earn 18% less than non-immigrants, suggesting a slight negative impact on wages in the bottom tier of the labour market (Blanchflower et al. 2007). The consolidation of a bottom tier in the labour market through liberalized labour migration is proceeding apace, yet it cannot simply be deduced from employer preferences.

In the following section, it will be empirically illustrated how the renaissance of labour migration in Europe since the mid-1990s (Menz 2008) and the rhetorical link between the “need” for such labour migration due to demographic pressures and labour market shortages thus needs to be understood as part of an active strategy by employers to create downward wage pressure, and establish and strengthen substandard tiers of the labour market. Understandably, such political activities by employers are not necessarily particularly popular. Consequently, political demands for liberalized labour migration are couched in terms of “competitiveness”, “labour market shortages”, or are portrayed as inevitable and without alternative in light of declining birth rates and rising life expectancy at birth throughout Europe.

#### 4. LIBERALIZATION THROUGH THE EUROPEAN BACKDOOR: SERVICE PROVISION

Though originally already contained in Art. 59-66 of the Treaty of Rome and one of the “four freedoms”, considerable legal uncertainty clouded trans-European service provision and it remained of little practical significance well into the 1980s. Historically relatively homogenous wage levels meant that transnational service provision was limited to instances of highly specialized niche providers. De facto, European service sectors remained well within the legal remit of national regulatory authorities and the often highly technical nature of applicable regulation deterred transnational service provision.

The Commission grew increasingly frustrated with this state of affairs. At the same time, the 1990s had witnessed a massive increase in transnational service provision, especially in the construction sector. The substantial wage gaps across Europe in this sector, which were first exploited by a Portuguese subcontractor of French construction conglomerate Bouygues in 1986 and reached epic proportions in booming Berlin in the mid-1990s.

Such transnationally active service provision, spawning “posted workers” from low wage countries such as Portugal and Greece to high wage destinations in northern Europe were welcomed by economic liberals, whilst critics perceived the emergence of islands of foreign law that imported Portuguese wages into Germany as a neoliberal nightmare. The posted workers were subject only to statutory laws of an *ordre public* character. This notably did not include wages in many countries, especially in the absence of a statutory minimum wage. The Single Market was spawning the bifurcation of the labour market in service industries, creating a bottom tier inhabited by EU citizens not entitled to standard national wages. A 1990 ECJ decision (*Société Rush Portuguesa Lda vs. Office National d’Immigration* 27 March 1990; C-118/89) opened up the way to national



response strategies. National re-regulatory strategies in a number of countries sought to establish some form of legally binding lowest wage tier, although in the Netherlands and Germany the re-regulation was so non-intrusive as to fail in arresting labour market bifurcation.

However, EU eastward enlargements in 2004 and 2007 re-ignited this problématique. Despite the imposition of temporary bans on labour mobility and service provision in all but three of the EU-15, the potential for competition via the wage factor re-emerged. Political debates focusing on social dumping very quickly were met by a number of practical developments that juxtaposed national regulatory regimes in wages and working conditions with European deregulatory tendencies. Companies availed themselves of new opportunities for transnational service provision with the explicit aim of lowering wages. In some cases, this entrepreneurial exploitation of wage gaps generated legal battles, but generally a predictable conflict between profit-driven companies and trade unions concerned with wage dumping and a downward spiral in remuneration and social protection levels ensued.

Thus, in Ireland, shipping company Irish ferries incorporated a Cypriote subcontractor, replacing existing employees with new staff from Latvia, remunerated at Latvian wage levels. In Sweden, a Latvian construction company active in Våxholm applied its home country regime in terms of wages and working conditions offered to posted employees in Sweden. In Germany, meat processing plants and construction companies found enterprising avenues for circumventing the temporary ban on service provision by employing nominally self-employed workers from Central and Eastern Europe (CEE) remunerated also at home country levels. In the absence of a statutory minimum wage, it proved possible to circumvent standard German wages, legally applicable only to businesses with membership in the German employer association, but not pseudo-independent subcontractors, of course.

Most controversially perhaps, the 2004 draft directive named after former Commissioner Frits Bolkestein (Commission of the European Communities, 2004. Directive of the European Parliament and of the Council on Services in the Internal Market. COM(2004) 2 final/3) would have enshrined the home country principle for transnational service provision, while forcing member states to open up significant segments of their economies to foreign competition, including areas traditionally regarded as *service public* such as health and education (Barnard 2008). While economic liberals, notably EU Trade Commissioner Peter Mandelson, warmly welcomed the, critics perceived of the “Frankenstein” directive as an incarnation of run-away neoliberalization, undermining fair wages and working conditions and pushing forward the doctrine of privatization by stealth. Such fears were nourished by the practical implications of the home country principle for host country wages, setting in motion a downward spiral. However, vociferous protest from the trade unions and a number of member state governments neutered the directive considerably.

Three recent ECJ judgments resurrected concerns regarding the clash between an essentially liberal Single Market project and national safeguards to protect labour markets (Höpner and Schäfer 2007). The 2007 *Viking* case centred on a strike by the Finnish Seaman’s Union against a Finnish company that operated its ferry services under the Estonian flag and labour legislation. This industrial action was considered by the court undue interference with the company’s rights under Art. 43 EC, preventing restrictions on the right of establishment. The 2007 *Laval* case mentioned above, involving Swedish union action against a Latvian company posting Latvian workers to a Swedish

building site and reimbursed at 40 percent below standard local wage rates was judged unlawful under Art. 49 EC on restrictions on the freedom to provide services. Finally, the 2008 *Rueffert* case overruled a decision by the German state of Lower Saxony to end a contract with a German firm employing Polish subcontractors. These employees received 46 percent less than the standards wages and the practice violated state law requiring contractors to adhere to regionally applicable collectively bargained wages. Nevertheless, the ECJ considered this decision a violation of Art. 49. In all three cases, the ECJ argued the regulations being sought by national actors were ‘disproportionate’ and ‘unjustified’.

## 5. EMPLOYERS AS ACTIVE ADVOCATES OF IMMIGRATION

Notwithstanding the political impediments to resuming labor recruitment (Messina 1990) and the obvious shortcomings of the guestworker concept of the postwar decades, European governments rediscovered labour migration in the early 2000s. Thus, between 1999 and 2006, the annual net flow of foreign workers into the UK rose from 42,000 to 62,700; in Germany it rose from 304,900 in 1999 to 380,300 in 2004 (OECD 2008: Table A.2.1.). This general trend holds true across European OECD members. There is no tangible sign of this course being abandoned, notwithstanding the changing economic fortunes evident from 2008 onwards. But who drives this change? Debates in migration studies seek to account for the “gap” between restrictionist rhetoric and slightly more permissive practice (Hansen 2002). This paradox has previously been partially accounted for by the activities of liberal courts (Hollifield 1992, Guiraudon 2000), though generally “prevailing scholarship...has been inconclusive with regard to the role and nature of domestic actors on national immigration policy-making.” (Lahav and Guiraudon 2006, 207).

Little scholarly attention has been paid to the role of employer associations (an exception is Cerna 2009), though organized business played a pivotal role in earlier Marxist-inspired analytical contributions (Castles and Kosack 1973, Castells 1975, Piore 1979). This is surprising, for it would seem *prima facie* fruitful to explore the role of these actors in understanding how and why national-level labor migration policy has come to be liberalized across Europe from the mid-1990s onwards, abandoning the previous restrictive approach introduced after the oil shocks of the mid-1970s. While the “gap” puzzle is still unresolved, it is worth noting that with respect to labor migrants, official discourse is strikingly less restrictive than regarding “undesirable” migrant groups.

### Developments in Germany

German employers re-discovered labour migration in the late 1990s. Especially influential was outspoken late 1990s BD! president Hans-Olaf Henkel. The employers saw the liberalization of labour migration both as a useful tool in securing greater competitiveness and as a mechanism of addressing alleged shortages of skilled employees, expressed particularly by the largest sectoral employer Gesamtmetall. Henkel himself was part of two government expert commissions on immigration and harshly criticized the Christian Democrats' rejection of explicit labour migration quotas geared exclusively at highly skilled migrants (Manager Magazin 16 October 2000). Convinced of the necessity to "compete for the best

brains" and "internationally mobile high flyers" to address "labour market shortages" and to ensure the continued "competitiveness of Germany as place to do business", BDA suggested changes to regulation, liberalizing economic migration, permitting both temporary and long-term migration flows, with minimal discretion for local and regional administrative interventions (BDA 2002) .

Not content with voicing their demands for liberalized labour migration through the expert committees, the employers also launched a vociferous and financially well-endowed public relations vehicle to popularise their demands for a general liberalization of the economy, including migration. Founded in 2000 by Gesamtmetall, the New Social Market Economy Initiative aims to influence public opinion and media reports (Leif 2004), drawing on an annual budget of 10 million euros. Immigration of "highly qualified foreigners" is one of its many proposals based on the "know how" and "contribution to economic growth" and "the future" that skilled migrants make (Initiative Neue Soziale Marktwirtschaft 2004, 2006).

These lobbying activities started bearing fruits in the 2000s. In 2000, the Red-Green government launched a temporary labour recruitment program for 20,000 highly skilled migrants, particularly in IT (the so-called "green card" initiative). The following year, Minister for the Interior Schily commissioned a report from an expert commission composed of academics, legal experts, the social partners and politicians from all parties, headed by moderate Christian Democrat Süßmuth. The "Law on the management and limitation of inward migration and the regulation of the residence and integration of EU citizens and foreigners" was finally accepted by the Bundestag on 1 July and by the Bundesrat on 9 July 2004, and came into effect as of 1 January 2005 (BGBl Part I No. 41 1950 of 5 August 2004). Art. 18 specifies that in processing an application for a work permit (henceforth linked to a residency permit), consideration should be given to the labour market situation, the fight against unemployment, and the exigencies of securing national competitiveness.

The employer association had been consulted throughout the drafting of the bill (interviews BDA, MinInt). Both BDA representatives within the commission strongly lobbied in favour of more "demand oriented managed migration" and less bureaucratic leeway for regional labour market administrations in the context of more "competition for the best brains", coupled with faster asylum decisions and more rigorously enforced deportations to "avoid any signal that could be understood in countries of origin that immigration for non-labour market related reasons will be expanded" (BDA 2002). Employers were particularly interested in highly skilled migrants, not least due to the positive experiences with the IT sector program, and contributed to the demand for an annual migration quota, based on a points system (interview BDA). Consistent lobbying led to the creation of migration channels for highly skilled high wage professionals in the new immigration bill, namely entrepreneurs investing at least one million euros and creating at least ten new jobs and carefully delineated categories of highly skilled migrants were permitted access, including teachers, scientists, and skilled managers earning in excess of 100,000 euros (all defined in Art. 19). In addition, foreign graduates of German universities were permitted to remain in the country for one additional year to search for employment.

By contrast, no categories were created for graduates of foreign vocational training schemes or labour migrants with general skills.

Following a meeting of ministers in Meseberg in August 2007, further business-friendly concessions were made effective as of November 2007, including facilitated access for highly skilled engineering graduates from central and eastern Europe, three year work permits for foreign graduates of German universities and the creation of a working group within the Ministry of Labor and Education charged with developing "a labour market-oriented management of migration", including the examination of a points-based system measuring qualification levels, age and language skills (Berliner Zeitung 6 and 25 August 2007). Vicechancellor and Minister of Labour Müntefering announced that there was no need for low skill labour migration, echoing the position of BOA. The employers enthusiastically welcomed the liberalization of access (BDA 2007a), and continued their advocacy of the "long overdue introduction" of such points-based system (BDA 2007b), pointing to Britain as a possible model (BDA 2007c, 2007d).

The Ministry of Labour drafted a bill on the "management of the migration of the highly qualified" during the summer of 2008. The key changes entailed were further reducing the annual income required for highly qualified migrants eligible for "fast-tracking" from EUR 86,400 to EUR 63,600, permitting labour market access for university graduates from the EU-8 accession countries, and creating a permanent council advising and evaluating labour market needs for skilled employees which would include a representative of the employers. It also facilitated labour market access for already resident temporarily "tolerated" refugees if they could demonstrate successful completion of a three year tertiary training program. The bill was accepted by the Bundestag on 17 November, by the Bundesrat on 19 December 2008.

Complaints over minor details notwithstanding and the absence of a comprehensive points-based system, the project was warmly welcomed by the employers (BDA 2008). The employers were successful in rhetorically linking competitiveness with the need for liberalized labour migration and in thus influencing public policy design.

#### Developments in the United Kingdom

In the UK, discourse that rhetorically framed migration as a vital in ensuring competitiveness played an important role in ushering in more liberal policies. Whilst employers played an active role in this process, the New Labour government of Tony Blair was active on its own. It wrapped its policy initiatives into the language of competitiveness, demonstrating that the discourse of linking migration with competitiveness was used by both business and governmental actors.

The beginning of this new turn towards "managed migration" and the discourse accompanying it, can be traced to 2000 (Balch 2009). The very phrase was used no less than 11 times in parliament by David Blunkett during his tenure as Home Secretary. That year, a major governmental review of international migration and its impact on the economy was conducted, influenced by pro-liberalization Minister for Immigration Barbara Roche, but also a Department for Trade Industry 1998 White Paper which first raised the possibility of lowering entry barriers for skilled migrants (Somerville 2007: 29-30).

A 1998 White Paper entitled "Our Competitive Future: Building the Knowledge-Driven Economy" by the Department for Trade and Industry questioned restrictive policy towards highly skilled migrants and entrepreneurs. The skill range covered by the work permit scheme was broadened beginning in 2000, at the same time formal requirements were relaxed to possession of a tertiary degree rather than a degree and work experience. Consequently, the numbers of work permit holders rose from 62,975 in 1997 to 137,035 in 2005. That same year, an "Innovator's Scheme" was piloted, supported by Minister of Immigration Roche who declared in an influential speech on 11 September 2000 that the "UK was in competition for the brightest and best talents - the entrepreneurs, the scientists, the high technology specialists who makes the economy tick" (Somnerville 2007: 29-31). The December 2001 Highly Skilled Migrants Programme (HSMP), complemented by the Innovators Scheme, first introduced an explicit point system, taking into consideration formal level of education, work experience, salary level, overall qualification and qualification of the spouse. Additional points were added for applicants in sectors with shortages - especially medicine - and, unlike the previous procedure, applicants themselves filed the application rather than their employer.

This rhetorical link between liberalised migration and enhanced competitiveness was to be found not only in employer pronouncements, but also in elite government circles. The Home Office's 2002 "Secure Borders, Safe Havens" argued that on balance the UK stood to benefit from global mobility, given that "our strong labour market acts as a magnet for those seeking better jobs for themselves ... Migrants bring new experiences and talents that can widen and enrich the knowledge base of the economy" (Home Office 2002, para. 1.13). Meanwhile, prime minister Tony Blair argued during an April 2004 speech at the CBI that "recognition of the benefits that controlled migration brings not just to the economy but to delivering the public and private services on which we rely" was needed.

Given the power vested in the executive in Britain's political system, the discourse produced was largely directed at the policy elite itself and successfully so (Balch 2009). The critical voices in the media and amongst the Conservative Party focused on alleged deficits in the control of asylum, but no signs of critical discourse regarding labour migration emerged, not even amongst the political opposition (Boswell et al. 2005: 21-23). The 2005 White Paper, its logic already apparent in its subtitle "Making Migration Work for Britain", based on a "flexible, employer-led" logic (Home Office 2005, 9), is highly representative of this rhetorical justification of relaxed immigration rules. "Managed migration is not just good for our country. It is essential for our continued prosperity", the paper claims, and proceeds to emphasize on 12 occasions that employers will be consulted or that the scheme is employer-led. In mid-2005 then CBI president Digby Jones stressed the advantage Britain enjoyed thanks to its flexible labour markets and pragmatic labour migration schemes, having earlier proclaimed that "capital can't afford to be racist for lots of reasons" (CRE 2003). A 5 January 2006 CBI policy statement (CBI 2006) similarly suggests that there was virtually no difference in opinion between government and employers:

"The CBI believes that migration is beneficial to the UK. Migrants have made an important contribution to the UK economy - bringing valuable and scarce skills that have benefited UK business and helped contribute to economic growth. Migrant workers are an integral part of the UK workforce and the CBI shares the Government's belief that a carefully managed migration policy can bring further benefits to the UK."

The employers welcomed this new turn towards liberalized labour migration due to concerns over labour shortages in a variety of economic sectors and in both high and low skill positions (CBI 2005). They assumed an active stance in advocating immigrants considered of economic utility (interview CBI). An interest in economic migrants pervaded all sectoral associations (interviews CBI, BHA). There was a particular interest both in very highly skilled service sector jobs, especially in finance, law, health, natural science research, and in low skill jobs in food processing, agriculture, gastronomy and construction and both regarding generalist and sector-specific skills (interviews CBI, BHA). In an interview, a CBI representative confirmed sectoral and firm concerns over poor "employability" of domestic workers in some sectors and highlighted the advantages of hiring "better trained" graduates of "continental vocational training schemes" and universities, despite their marginally higher average age (interview CBI). In 2005, CBI together with the union federation TUC and the Home Office published a joint position paper, emphasizing that "the skills and enthusiasm" (TUC 2005: 1) of new migrants was welcomed by all parties. Along with the unions and certain NGOs, the CBI is invited to the bi-annual "user panel" planning sessions of the Immigration and Nationality Directorate in the Home Office. Its representatives are also part of the employer taskforce group, which is responsible for providing policy suggestions to the Home Office's Border and Immigration Agency. Recommendations from this group have fed into the establishment of an Australian-style high skill migration program in February 2008 and the illegal working stakeholder group (interview CBI). Within this taskforce group, along with a trade union delegate, major internationally oriented businesses such as Shell, Ernst & Young, Tesco, Citigroup and Goldman Sachs are represented as well as sectoral employer associations in engineering, hospitality and employment services, alongside NASSCOM, the Indian IT sector chamber of commerce. Both formal responses to government initiatives and informal avenues to the Home Office are fairly well received (interview Home Office) and the CBI has positioned itself well to influence governmental deliberations. It is also part of the stakeholder panel of the Migration Advisory Committee, an academic expert body convened by the Home Office.

The turn towards liberalized labour migration, a policy stance embraced both by the New Labour government and employers, was supported by a discourse that portrayed migration as part of an inevitable attempt to retain international competitiveness. Whilst the 2010 Liberal Democrats-Conservative coalition government announced plans to reduce the numbers of non-EU highly skilled migrants immediately after coming to office in July 2010, internal dissent has already surfaced, with outspoken Liberal Democrat Business Secretary Cable sharply criticizing such cap as "damaging" (The Independent 18 September 2010), suggesting

an eventual compromise outcome. Though the temporary cap put in place may be extended, it seems unlikely that there will be complete reversal of previous migration liberalization initiatives. There was and is virtually no ideational difference between government and organized business in this process.

## 6. CONCLUSION: DISINTEGRATION AND BIFURCATION

Labour migration can be used as a strategy to establish and enhance the bifurcation of labour markets. In the bottom tiers of the labour market, substandard wages and working conditions apply. Consequently, labour migration can also be used as an efficient tool to pry open more homogeneous labour markets. This article has analysed such (ab) use of labour migration by employers, arguing that change from within even in coordinated market economies leads to a multi-tiered labour market structure, which holds obvious appeal to employers. Only the members of the core labour market still enjoy standard wages and working conditions. In the bottom tier, this is simply no longer the case. By marrying insights from migration studies and comparative political economy, this article demonstrates how labour migration, even if technically legal, can be utilized as a political tool based on power resources. It is striking that employer associations have re-discovered an appetite for labour migrants. The need for liberalized labour migration is portrayed rhetorically as being pivotal in securing and maintaining "competitiveness" and thus crucial to national security. Both in the UK and Germany employers enjoyed privileged access to policy-makers and succeeded in having their demands heard and incorporated into more liberal policy. However, considerably less efforts was required to convince the particularly economically liberal British government to take action. Privileged access to decision-makers by business interests in part reflects the changed architecture of the contemporary European state. Labour migrants are used in helping ushering in the disintegration and bifurcation of labour markets. This is true even of formerly organized and more coherent continental European labour markets, such as the German one. Though this article focused exclusively on legal forms of immigration, it is striking how limited access rights apply even to "posted" EU citizens, thus suggesting a mismatch between legal entitlement to employment and eligibility to standard wages and working conditions.

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## **Charlotte Rommerskirchen, 'The Difficulties of Fiscal Policy Coordination in Times of Economic and Financial Crisis'**

Ever since the emergence of the democratic welfare state with its unprecedented borrowing capacities and incentives, fiscal policy making has been haunted by a deficit and debt bias. It is this underlying assumption about the nature of those in charge of fiscal policy, which make the coordination of fiscal policy in a common currency union desirably. First, in order for monetary policy to be efficient and second to avoid exactly the beggar-thy-neighbor policies, both in a fiscally frugal and proficient sense, witnessed in the eurozone for the past decade. Moving to 1997 these concerns informed the blueprint for EMU's fiscal rules, specifically the Stability and Growth Pact, short SGP.

The poor performance of the Pact to curtail deficits has been notorious. Given the past record the European Commission was weary when the economic and financial crisis erupted. How to achieve fiscal policy coordination during the worst recession since the 1930ies if this has not even been on national agendas during the comparatively sunny period first decade of EMU? Unsurprisingly as soon as the scope of the crisis emerged, calls were heard to suspend not only the SGP rules, but also Competition policy which is a further potentially potent tool of the Commission to constrain public spending. With the majority of member states announcing considerable stimulus programmes ahead of any EU wide agreement, a EU level crisis action plan was agreed upon in December; the European Economic Recovery Plan, or short EERP. The plan essentially gives a carte blanche to national policy makers to spend their way out of recession Keynesian style, something that arguably most were set to do anyway. The guidelines how and when to spend it were purposefully vague, preferably ticking the boxes of timely, targeted and temporary in an official language that is reminiscent of consultancy speak. Notably, disagreements between member states over an EU-wide stimulus programme hampered attempts to forge a consensus for fiscal policy coordination. This discord did stem from the different national evaluations of the nature and scope of the crisis, as well as from widely differing fiscal stances which left national policy-makers with varying margins of maneuver.

Given that fiscal policy coordination was not working when it was concerned with curbing deficits prior to 2008, how then would it fare when all of sudden the message emerging from Brussels was; now you may actually increase your debt burdens? For the first time in EMU member states were faced with a situation where guidelines were vague, the SGP suspended, and national policy-makers expressively encouraged to run deficits. As a result member states spent as they pleased, some implementing substantial stimulus policies, others barely engaging in discretionary fiscal policy spending at all. This is one of the key lessons for fiscal policy coordination during the Great Recession of 2008-2009; fiscal policy coordination in EMU did not work, and it did not matter whether coordination was concerned with consolidation, or stimulus policies.

To understand this one has to look at an additional bias to the deficit and debt bias of contemporary policy making, - the hypocrisy bias. Virtually all member states like to sing the hymn of low deficit and debt burdens from the spreadsheet of stability culture. And if the economic climate and the

political one for that matter, seems opportune they might also act accordingly. Or at least pretend they do.

In a classic collective actions setting the two disagreements, first how to actually do fiscal policy and secondly how to talk about it, pose considerable problems. EMU states are heterogeneous as far as resources (in other words respecting the SGP and related rules is costlier for some member states than for others) as well as their interests (e.g. in France right now austerity is not as rigorous whereas it is very much so in Germany and Austria). This makes the success of collective action unlikely. Given the difference in thought or actual production and allocation functions of the cost and benefits of fiscal policy coordination, member states display a high degree of group latency, according to Mancur Olson (1963) one of the key features of collective action failure. The architects of EMU, saw this a long way coming and had the SGP purposefully set up to provide this very selective and separate incentive that is thought to induce group oriented behavior. Except for the fact that it was a weak instrument.

So how then to motivate this latent group and jolt it into collective action in the post-crisis context of fiscal consolidation and macroeconomic reform? Arguably the first answer is already becoming apparent and it is not found in the Treaty on Stability, Coordination and Governance, which is just the old rules dressed up in the sterner robes. Instead the real separate and selective incentive is exerted by 'market discipline' as bond market participants have awoken to the fact that EMU member states are very different indeed. In the turmoil of the Sovereign Debt Crisis with markets engaging in what some might describe as 'irrational exuberance' (Shiller 2000), consolidation of public finances in all EU member states has witnessed a tentative turnaround with an projected EU average deficit of 1.4 in 2014 (COM 2012).

Market discipline refers to the signals from the financial markets that - so the theory goes - can deter a borrower from maintaining an unsustainable path of borrowing, it is a police man against moral hazard problems described by the political economy of public deficits (Lane 1993). Looking at the development of long-term interest rate in the eurozone, the forces of market discipline seem to have been put into hibernation once states joined the euro which came to an abrupt end in 2009.

By eliminating currency risk and reducing transaction costs within the eurozone, the introduction of the new European currency has considerably strengthened European financial market integration. Not to bailout another eurozone member state is hence not also politically but also economically no longer an option. This poses a challenge; for market discipline to work, a modified Art. 125 has to stay in place. That means that muddling through towards fiscal union by agreeing on one bail-out after another, has the dangers of putting market discipline back into a slumber while not setting up binding rules and considerably taking fiscal policy making, and more to the point macroeconomic management, out of the hand of national policy makers.

Instead of relying solely on peer pressure and consequently intergovernmental agreements, market pressure may be the best sanctioning system available to achieve at least a minimal form of fiscal policy coordination. Notably coordination problems are not limited to the direction of fiscal policy (spend or save), but concern all agreements that constrain public spending. Unless EMU member

states converges in terms of their fiscal preferences, both in terms of political culture and economic reality, there is need to jolt this latent group via separate and selective incentives, and these are unlikely to come from within the group itself.

As a matter of course market pressure is not a panacea. The architects of EMU were skeptical of the effectiveness of market discipline in the first place and whether it could really induce member states to pursue sound fiscal policies. Not because they would not believe in the seriousness of the no bail out clause but because ‘market perceptions do not necessarily provide strong and compelling signals. The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive’ (Delors 1989). Looking at the devastating effects of the current Sovereign Debt Crisis the evaluation of the Delors groups reads like a writing on the wall. In this light, the various proposals (e.g. Favero & Alexandra 2012, Schelkle 2012, Curzio 2011, Phoebus 2011, Delpa & Weizsäcker 2010) to mitigate the ‘irrational exuberance’ of market participants whilst retaining their disciplinary function should be mandatory reading for all interested in the future of EMU.

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