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Phedon Nicolaides*

Cost of Regulation and Impact of EU Membership on Policy Enforcement

Recent public debate on the costs and benefits of EU membership has focused more on the costs and less on the benefits. This paper explores the benefits from improved regulatory or policy implementation and enforcement. If actual regulatory enforcement differs from the socially optimal level, membership of a regional bloc that strengthens accountability mechanisms can improve the quality of implemented regulation. However, if the regional bloc tends to overregulate, the overall increase in the regulatory burden, together with strengthened accountability, will move a country farther away from its socially optimal state. Membership of the EU is beneficial for countries with weak enforcement institutions, but it may worsen the welfare of countries with strong regulatory institutions. Infringement statistics indicate that no member state of the EU has a perfect record in implementation and enforcement.

The intention of the current UK government to renegotiate its terms of membership of the European Union and put the outcome to a referendum has re-ignited discussion on the nature and magnitude of the benefits and costs of being a member of the EU.

In July 2012 the UK initiated a “Review of the Balance of Competences” which is “an audit of what the EU does and how it affects the UK”.¹ The results of the review will be gradually published in the period from summer 2013 to autumn 2014. Several studies have already been published by various departments and services. On the whole, they conclude that the UK has experienced an overall net positive effect. Most of these studies focus on the gains from increased trade, investment, establishment and competition, largely as a result of measures aiming to remove vestigial barriers in the internal market.

Some studies also consider three other categories of effects:

- the UK’s budgetary payments and receipts
- the burden of regulation emanating from the EU
- the consequences of maintaining (or losing) influence in the Brussels law-making machinery.

The purpose of this short paper is to explain that there are other possible and non-negligible effects, the most important of which is the improved ability of a member state government to pursue optimal policies by being less vulnerable to capture by special interest groups and more effective in enforcing policies and regulations.

The EU affords a certain degree of protection of policy processes from undue political interference and contributes to the strengthening of domestic regulatory enforcement. The quality of policy formulation and implementation very much depends on how capable public administration and regulatory authorities are, how prone they are to nepotism and corruption, and how open and transparent public administration and public policy making are. The accountability mechanisms of the EU can have a positive impact on the quality of domestic policy making and enforcement. This paper also shows that this beneficial effect has to be counterbalanced against the negative impact of possibly excessive EU regulation. These membership effects go beyond the typical integration effects identified in textbooks and in the literature.

This paper extends the analysis of accountability mechanisms within regional blocs that I developed in previous

* Comments by Nadir Preziosi, David Rinaldi and Roxana Sandu on a previous draft are gratefully acknowledged.

¹ All publications can be accessed at <https://www.gov.uk/review-of-the-balance-of-competences>.

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work.² What is new in this paper is the consideration of the costs of deviating from the nationally optimal level of regulation against the benefits from increased accountability as a result of EU scrutiny. This trade-off suggests that EU membership produces mixed results, at least as far as regulation is concerned. Whether membership is beneficial or not very much depends on the propensity of the domestic policy processes and institutions to formulate socially optimal policies.

The paper starts by reviewing briefly the typical effects of integration and then considers recent empirical studies on regulatory costs and other attempts to quantify such costs. Then it develops a model for understanding how membership of a regional bloc such as the EU may affect domestic policy and regulatory implementation. Lastly, it examines the UK's record of complying with EU law over the past decade. Evidence from legal proceedings initiated by the European Commission against the UK suggest that UK compliance is wanting and that, in fact, the UK may have benefitted from being forced by a supranational institution to improve its enforcement practices.

The “typical” integration effects

The standard textbook on economic integration covers a range of possible effects resulting from elimination of the barriers to trade and investment.³ The typical effects mentioned are the following, although not all of them are analysed at the same level of depth and detail:

1. Trade creation effect – access to cheaper products;
2. Trade diversion effect – displacement of imports from the rest of the world by more expensive imports from partner countries; this also means that the partner countries experience an increase in their exports and, of course, income, at the expense of importing countries;
3. Terms of trade effect – ability of the partner countries as a group to influence international prices;
4. Economies of scale – the larger market leads to larger output and the reduction of unit costs;

5. Competition effects – reduction in the mark-up charged by former monopolists or oligopolists.
6. Dynamic effects – increase in the rate of innovation as a result of more competition;
7. Liberalisation of the movement of labour and capital – access to cheaper labour and capital;
8. Internalisation of cross-border externalities – reduction of the negative effects of domestic policies on partner countries through policy coordination;
9. Reduction of systemic risk;
10. Budgetary effects – financial contributions to common institutions and policies and receipts from common funds.

However, the experience of the EU has also demonstrated the existence of other effects such as:

1. Avoidance of regulatory discrepancies – approximation or harmonisation of national regulations, which reduces the cost of compliance with multiple regulations;
2. Avoidance of regulatory duplication – sharing of regulatory tasks that leads to lower compliance and enforcement costs;
3. Cooperation effects – ability to influence rules in partner countries and loss of national policy autonomy.

These effects are more difficult to quantify and on the whole have received less attention in the empirical literature. However, many legislative initiatives are indeed motivated by the objective of reducing regulatory discrepancies across member states.

Regulatory costs and UK views

Despite the plethora of reports that seek to measure the impact of EU-wide policies on the EU and on individual member states, there appears to be no comprehensive study on the costs of EU regulation.⁴ The Commission,

² See P. Nicolaidis: *Microfoundations of Policy Implementation*, London 2013, Routledge; and P. Nicolaidis: *Economic Integration and the Structure of National Institutions*, in: *Intereconomics*, Vol. 47, No. 3, 2012, pp. 165-169.

³ See, for example, J. Pelkmans: *European Integration, Methods and Economic Analysis*, London 2006, Pearson Education.

⁴ The OECD has done extensive work on measuring the cost of regulation in different countries and in different sectors. But there is still no comprehensive study on the costs of EU regulation across the board. See D. Parker, C. Kirkpatrick: *The Economic Impact of Regulatory Policy: A Literature Review of Quantitative Evidence*, OECD Expert Paper No. 3, August 2012, available at http://www.oecd.org/gov/regulatory-policy/3_Kirkpatrick%20Parker%20web.pdf.

perhaps, could argue that this may not be necessary, at least since the introduction of impact assessment, because the EU would not adopt new rules unless *ex ante* assessment showed that the likely benefits would outweigh expected costs.

Such a claim could be countered by at least two possible replies. First, demonstration of overall net positive effects does not prove that benefits and costs are equally distributed across member states. The existence of overall net positive effects can be consistent with a very skewed distribution of such effects, whereby some member states derive all the benefits while other member states incur all the costs. Second, impact assessment studies have often been criticised for their sloppy methodology and narrow scope.

An exception is Open Europe, a British think tank which has attempted to measure the costs of regulation in a series of published reports during the past five or so years. In a much-quoted report, it estimated the cost of EU regulation to the UK for the period 1998-2008 to be £148.2 billion, or about ten per cent of the UK's GDP.⁵ This is a very high number by any standard. If true, it would have been a serious indictment of the EU.

However, careful reading of the methodology of the report reveals the following. First, there is no definition of a counterfactual scenario. That is, what realistically would have happened if the EU had not adopted any regulations? Is it correct to assume that there would be zero UK regulation in the absence of EU regulation?

Second, and even more surprising, there is no consideration in the report of the possible benefits from regulation.⁶ It is as if regulation is adopted and enforced for the mere purpose of raising the costs of business. While all regulations necessarily raise costs, their primary objective is to bring about benefits from extra effort or safety. It is true that they do not always succeed, and even when they are successful, the benefits they generate do not necessarily outweigh costs. But it is a gross exaggeration to presume that regulations only result in higher costs. Another recent report for the UK Department of Business, Innovation and Skills (the government body responsible for trade and investment) has concluded that product regulation in the form of standards has a

beneficial effect both on product quality and on trade by easing the conditions of doing business abroad.⁷

Third, there is no consideration of the benefits to UK companies from improved access to the markets of other member states. The Open Europe report focuses on domestic costs and ignores the reduction in the costs of UK companies that do business in other European countries. Given that EU regulation has a harmonising effect, even if it raises certain costs, it necessarily reduces other costs because it obviates or lessens the need for compliance with different national rules. Again, not to take into account the very rationale for EU regulation biases the findings of the report.

In the context of the UK's Review of the Balance of Competences, a July 2013 report on the Single Market finds that "[o]verall, there is a clear view from the evidence submitted that UK firms gain from the Single Market in terms of access to EU markets. Most accept that a degree of Europe-wide regulation is essential in getting this to happen."⁸

But it is not just non-harmonisation of rules that may be a problem. Even where rules are identical, problems may arise as a result of sloppy, inconsistent, partial or faulty enforcement. The Single Market report observes: "Enforcement is also cited by many as an issue. Much of the evidence to this report suggests that there is a significant problem with enforcement across the Single Market, with standards being applied differently in different Member States."⁹

In a recent report, Copenhagen Economics claimed that the cost of non-implementation or incorrect implementation of EU rules may be as high as one per cent of EU GDP.¹⁰ The OECD has also reached similar conclusions in its various studies on regulation. More interestingly, it has identified a link between the quality of regulation and regulatory enforcement and long-term economic growth.¹¹

5 M. Persson, S. Booth, S. Gaskell, L. Mullally (ed.): *Out of Control? Measuring a Decade of EU Regulation*, February 2009, available at <http://www.openeurope.org.uk/Content/documents/Pdfs/outof-control.pdf>.

6 *Ibid.*, p. 11.

7 P. Swann: *The Economics of Standardization: An Update*, Report for the UK Department of Business, Innovation and Skills (BIS), 27 May 2010, available at <http://www.bis.gov.uk/feeds/~/media/ED32C-DA672764D7C8AC2F4E323581010.ashx>.

8 UK Government: *Review of the Balance of Competences between the United Kingdom and the European Union: The Single Market*, July 2013, p. 41. This report is one of 32 reports being produced as part of the Balance of Competences Review, which are available at <https://www.gov.uk/review-of-the-balance-of-competences>.

9 UK Government, *op. cit.*, p. 43.

10 Copenhagen Economics: *Delivering a Stronger Single Market*, Nordic Innovation Report, June 2012.

11 D. Parker, C. Kirkpatrick, *op. cit.*

The Single Market report also indicates that a sizeable proportion of those who submitted evidence believed that the UK was better at enforcing EU rules and that being subject to more consistent enforcement was a form of competitive handicap. “There is also a view that the UK plays by the book more consistently, placing UK firms at a competitive disadvantage to companies in other jurisdictions.”¹² The last section of this paper will show that the UK is indeed better than some member states in terms of enforcement, but it still lags behind others.

At the same time that the UK is undertaking its “Review of the Balance of Competences” in relation to the EU, it also has to respond to the various arguments and evidence put forth by the Scottish government in support of independence from the rest of the UK. In autumn 2014, the Scottish government intends to hold a referendum on possible independence. The various reports of the UK government on the likely effects of Scottish independence are available in a series entitled “Scotland Analysis”.¹³

One recent report in the series by the Treasury makes the following interesting observation:

That is why Scotland benefits from its position within the UK. Devolution provides Scotland with the power to make decisions on important policy areas, including health, education, environment and policing. However, most regulations which impact on businesses in Scotland – including, tax, company law, competition and health and safety – are currently reserved to the UK Government due to the benefits from having consistent rules across the UK. Chapter 1 demonstrated how having a level playing field in the UK has created a successful UK domestic market. Administering these reserved areas of policy at a UK level helps to create and maintain this level playing field. Devolution therefore gives Scotland the best of both worlds.¹⁴

In other words, it is acknowledged that a certain degree of harmonisation benefits the regions or countries that trade extensively with each other. It is also acknowledged that the institutional architecture or structure of regulatory authorities – whether they are single or multiple – does have an impact on the quality of regulation. The Scotland Analysis series explores some of the main

arguments for and against recent trends in merging regulatory authorities. Institutional design does matter to the quality of regulation and rigour of enforcement.

Budgetary costs vs. enforcement

Contributions to the budget of the EU are seen as costs. However, even net contributing member states benefit from more rigorous enforcement of EU laws. This is particularly important for the UK, because as will be shown below, most infringements of EU law and rules are committed by other member states. That is, as the Commission forces other member states to apply EU rules properly, the UK benefits by having easier access to the markets of those member states.

This is a point often ignored by studies on the cost of EU membership. For example, a report by Europe Economics refers to the UK’s budgetary share of the EU’s administrative expenditure but is silent on whether there are any benefits to the UK from the Commission’s monitoring of enforcement of EU rules by member states.¹⁵

Amount of regulation

There is also much discussion about the regulatory burden created by Brussels in terms of the sheer volume of regulatory acts. For example, it has been claimed that between 50 and 80 per cent of UK legislation originates in Brussels.¹⁶ What is implied is that the large number of legislative acts translates into large costs for business.

A cursory look at data from the Eur-Lex database indicates that in 2012, for example, there were a total of 1454 basic acts and 603 amending acts. The latter do not introduce new rules but adjust slightly or update existing rules. Of the basic acts, only 11 were directives which introduced new rules that required transposition by member states. The picture in 2011 was largely the same: 1712 basic acts, of which only 29 were directives, and 620 amending acts. In 2010 there were 1550 basic acts, of which 26 were directives, and 517 amending acts.¹⁷ On the basis of these figures, it is very difficult to understand the veracity and meaning of statements claiming that 50 to 80 per cent of national legislation originates in Brussels.

¹² UK Government, *op. cit.*, p. 43.

¹³ See <https://www.gov.uk/government/collections/scotland-analysis>.

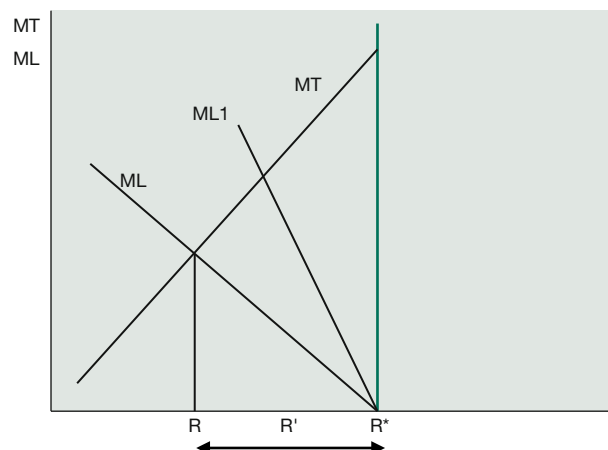
¹⁴ UK Government: Scotland analysis: Business and microeconomic framework, July 2013, p. 36, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/209891/13-635-scotland-analysis-business-and-microeconomic-framework.pdf.

¹⁵ Europe Economics: Optimal Integration in the Single Market: A Synoptic Review, Report for the Department of Business, Innovation and Skills, April 2013, pp. 73-74, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/224579/bis-13-1058-europe-economics-optimal-integration-in-the-single-market-a-synoptic-review.pdf.

¹⁶ *Ibid.*, p. 75.

¹⁷ The Eur-Lex database on legislation statistics can be accessed at <http://eur-lex.europa.eu/Stats.do?context=legislative&ihmlang=en>.

Figure 1
Regulation before and after lobbying



Source: Own elaboration.

A model of regulatory effectiveness

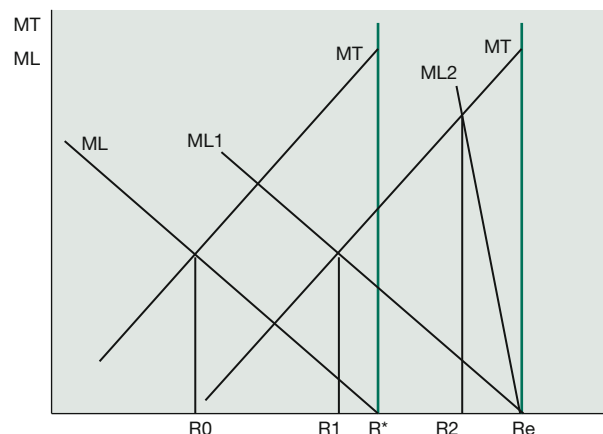
Assume that the optimal policy in a country can be defined as the value of a regulatory instrument, R , which maximises net social benefits, N . The net benefits are given by the difference between gross social benefits, B , and costs, C . In this setting, the optimal value of R^* is that which maximises $B - C$, so that $dN/dR = 0$ or $dB/dR = dC/dR$.

But suppose that businesses do not like regulation because it raises their costs. They lobby against it. However, lobbying is expensive and the amount of lobbying has to be considered against its effects, i.e. the extent to which it succeeds in reducing regulation.

Therefore, their optimal amount of lobbying is given by the difference between the costs they save from less regulation (which are their benefits), given by function T , and the costs they incur from lobbying, given by function L . If R' is the reduction in regulation they achieve, then $R = R^* - R'$ or $R' = R^* - R$. In other words, their objective function is to maximise $T(R') - L(R')$. The first order condition for minimisation is $dT/dR' = dL/dR'$.

It is assumed that the higher the R' , the higher the amount of benefits T , so that $dT/dR' > 0$. With respect to function L , it is assumed that the cost of lobbying is given by the function $L = L(n, r, R')$. Parameter n is proportionately related to the number of politicians that must be influenced (i.e. $dL/dn > 0$). Parameter r indicates the “efficiency” of lobbying. The lower the r , the less costly it is to achieve reduction of regulation by one unit (i.e. $dL/dr > 0$). This “efficiency” is inversely related to factors

Figure 2
Regulation before and after more onerous common rules



Source: Own elaboration.

such as how corrupt or transparent the political system is, how accountable the politicians are, whether regulations are set by politicians or independent authorities, etc. That is, the more corrupt or inefficient a system is, the lower the r .

After lobbying, national regulation changes to R' , which is equal to $R^* - R'$. Since the socially optimal regulation is R^* and since $R' < R^*$, it follows that lobbying lowers national welfare. The same conclusion would be reached if it were surmised that business wanted higher rather than lower regulation. This would be the case for rules that restrict entry, for example, in a sector or profession. Limiting entry would allow those who already operate in the sector or profession to earn rents above the competitive level.

Let us assume for ease of presentation that the T and L functions have the following format: $T = aR' - bR'^2$ and $L = nrR'^2$. This specification means that the marginal curves are straight lines and, therefore, easy to show diagrammatically (see Figures 1 and 2). The optimal value of R' is given by the maximisation of $T - L$ or the first order condition $a - 2bR' - 2nrR' = 0$. The solution to this equation gives $R' = a/(2(b + nr))$. Figure 1 shows the rate of regulation after lobbying. Given that the objective of lobbying is to reduce regulation from the socially optimal rate of R^* , the marginal T and marginal L lines are drawn from the axis R^* .

Now consider what happens to R' with small changes in n or r . By differentiating R' with respect to n or r , we can see that $dR'/dn < 0$ and $dR'/dr < 0$. An increase in n or r reduces R' .

This is important. An increase in lobbying costs (due, for example, to an increased number of political actors) or a reduction in the efficiency of lobbying (due, for example, to increased transparency or accountability) brings the country closer to its socially optimal level of regulation.

Impact of membership of a regional bloc on domestic regulatory effectiveness

Membership of the EU can have significant effects on the regulatory targets and structure of member states. It may enable them to raise the effectiveness of their rules (e.g. anti-money laundering) or force them to adopt rules they do not want (e.g. stronger worker rights).

The pertinent question for the purposes of this paper is how membership of a regional bloc affects the quality of domestic implementation and enforcement. There are three broad types of enforcement. First, a general regulatory framework is agreed to in Brussels and member states have to define instruments for its application (this is the case for directives). Second, specific rules are adopted by one or more EU institutions and member states have to apply them faithfully (this is the case for regulations or decisions). Third, member states have to explain and justify their policies even when they do not apply any specific EU rules (this is the case for macro-economic surveillance).

For all three types, it can be safely conjectured that greater involvement by the EU in overseeing the quality of domestic regulatory implementation and enforcement raises both parameters n and r and, consequently, makes it more costly to deviate from socially optimal policies.¹⁸ This effect on its own is beneficial. It is shown in Figure 1 by the steeper line ML1. The intersection of ML1 and MT gives a lower rate of R^1 or a smaller reduction in the optimal social rate R^* .

However, its actual impact very much depends on whether the rules decided upon at the EU level are indeed optimal. If they are not, it will be more difficult for member states to escape from sub-optimal rules and improve on sub-optimal policies. To the extent that good rules and policies are more likely to be stable and are easier to justify, mechanisms that increase the stability of rules and policies and strengthen the accountability of implementing and enforcing institutions should generate benefits for society. In so far as the EU makes regulations more stable and regulatory authorities more accountable, member states should become better off.

But let us consider in more detail what happens when a country has to apply EU rules and at the same time comes under the scrutiny of the EU. This is shown in Figure 2. Before the EU adopts any rules of its own, the domestic level of regulation is R_0 , which as a result of lobbying is lower than R^* . Now suppose that the EU legislates, and the common rule it adopts is more onerous. The higher level is R_e . Figure 2 shows R_e to the right of R^* . If the EU reinforces enforcement by member states, the ML line shifts to ML2. The level that is eventually enforced domestically is R_2 . This is indeed far higher than the optimal rate R^* .

On the other hand, if the EU does not affect the strictness of enforcement, the new level that is enforced domestically is R_1 . This is closer to R^* . Paradoxically, the country becomes better off from a higher level of regulation that is weakly enforced. This paradoxical result is the outcome of two opposing effects: the rise in formal regulation, R_e , and the laxness of actual enforcement. But the divergence between the formal and actual levels of regulation is beneficial to the country simply because the formal level differs from the optimal level, R^* . If the formal and optimal levels were the same, then lax enforcement would always lead to a lower level of welfare.

Some telling evidence

Is there any evidence that EU membership helps member states to improve their domestic enforcement? In other words, is the UK so good at determining and enforcing its own regulations that it does not need any outside assistance and therefore does not benefit from the accountability mechanisms of the EU? If it can be assumed that infringement proceedings initiated by the European Commission against member states correlate with the enforcement record of each member state, then the evidence suggests that the UK's performance is good, but not very good.

18 I am fairly confident it is safe to assume that EU membership raises the value of r . However, the impact on the value of n is not so straightforward. Certainly, there are more politicians at the EU level that have to be lobbied. The European Parliament has more members than any national parliament (e.g. 766 against 620 in the German Bundestag) and the Council has 28 different members. In addition, any legislative draft has to be based on a proposal by the Commission. It seems that it is more difficult to influence legislation at the EU than the national level. However, industries and special interest groups form pan-European coalitions. There are many lobbyists in Brussels. In this context, it is possible that a national organisation may increase its influence by working with other similar organisations at the EU level. For the purposes of this paper, I will ignore this possibility and assume instead that just because there are more MEPs than members of any national parliament, EU membership increases the value of n .

Table 1 shows how many times the Commission took action against the UK from 2003 to 2013 for failing to apply EU rules properly. In relation to Italy, which is the worst-performing member state, the UK performs well. In relation to Denmark, which is the best-performing member state, it performs poorly. Its performance is close to that of the Netherlands, another increasingly Eurosceptic country.

The numbers in the table have been generated as follows. First, all the infringement cases against the UK (and the other member states) for the period 2003-2013 were identified in the database of the Court of Justice of the European Union. Next, the reasons for the initiation of the infringement proceedings and the outcome – whether the Court of Justice ruled in favour of or against the member state – were determined for each case. We differentiate between infringements caused by failure to transpose on time and failure to apply properly or fully, as this is an important distinction. Failure to transpose on time may be caused by factors extraneous to the efficiency and accountability of domestic political systems. Perhaps the country was in the midst of a national election or there was an emergency that altered policy priorities. By contrast, failure to apply EU rules correctly, after they are transposed into national law, is more difficult to justify as not being caused by administrative and enforcement weaknesses.

The results, which are reported in Table 1, suggest that the UK appears to have a particular problem or administrative weakness on environmental issues. It cannot be that it is in the UK's interests to allow excessive pollution or pollution above the levels in other EU countries. It is more likely that administrative or regulatory weaknesses are the real cause.

It is worth noting a rather significant difference between the UK and the Netherlands. In the case of the UK, very few of the infringements were in the form of barriers or discriminatory rules against products or firms from other member states. In the case of the Netherlands, 17 (or 70 per cent) of the infringements concerning incorrect implementation involved violations of one or more of the internal market freedoms. Often they were in the form of discriminatory or excessive rules which kept firms and professionals out of certain sectors or professions. These violations hurt the Netherlands because they constrained competition, but they also harmed firms and professionals from other member states.

The scrutiny exercised by the Commission primarily aims to remove barriers and discriminatory policies. The examples of these two countries indicate that the

Table 1
Infringement proceedings: Commission vs. UK

August 2003 – August 2013

	Total infringements	Failure to transpose on time	Failure to apply properly or fully	Action dismissed (MS wins)	Other infringement
Environment	28	11	13	4	
Health/safety	6	-	3	3	
VAT	5	-	3	2	
Transport	4	4	-	-	
Other	11	4	4	1	2
UK total	54	19	23	10	2
Netherlands	40	7*	25**	6	2
Italy	133				
Denmark	11				

* 4 cases concerning environmental directives; ** 17 cases involving a violation of an internal market freedom.

Source: Court of Justice of the European Union.

scrutiny of the Commission also helps reluctant member states to implement rules and policies which are on the whole beneficial for them.

Conclusions

This short paper has explored the issues of cost of regulation and effectiveness in regulatory implementation or enforcement. It has been argued that when actual regulatory enforcement differs from the socially optimal level, membership of a regional bloc that strengthens accountability mechanisms can improve the quality of implemented regulation. However, when the regional bloc tends to overregulate, the overall increase in regulatory burden together with strengthened accountability can move a country farther away from its socially optimal state. This implies that membership of the EU is beneficial for countries with weak enforcement institutions, but that, in theory, it may worsen the welfare of countries with strong regulatory institutions.

As evidenced by the Commission's success in its infringement proceedings, no member state of the EU has a perfect record in implementation and enforcement. This suggests that as a matter of empirical record, all member states benefit from increased outside scrutiny. Yet, this does not mean that the actual benefits from improved implementation, due to the outside scrutiny, outweigh the costs of possible overregulation. In practice, EU membership has mixed effects.