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Integration among unequals: How the heterogeneity of European varieties of capitalism shapes the social and democratic potential of the EU

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MPIfG Discussion Paper 12/5

Integration among Unequals

How the Heterogeneity of European
Varieties of Capitalism Shapes the Social
and Democratic Potential of the EU

Martin Höpner and Armin Schäfer



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Abstract

At first glance, the social purpose and the democratic potential of the EU have made progress in the last 15 years. However, this impression is misleading. We argue instead that the social and democratic potentials of the EU are crucially shaped by the heterogeneity of European varieties of capitalism. First, we locate our argument in the integration literature and argue that political-economic heterogeneity shapes not only intergovernmental bargains but also the opportunities for judicial integration. Second, we document the heterogeneity among European varieties of capitalism and how it has increased with each round of enlargement. Third, we show how the heterogeneity of political-economic interests has led governments to opt for autonomy-protecting solutions whenever European initiatives have targeted highly sensitive institutions that constitute their different political-economic regimes. Fourth, we also show that, despite this, the European Court of Justice (ECJ) has often overruled such autonomy-protecting measures by extending the reach and scope of the European fundamental freedoms. We conclude, fifth, that the asymmetry between market-enforcing and market-restricting integration is not likely to disappear in the near future, and that the heterogeneity of European varieties of capitalism limits not only the social but also the democratic potential of the EU.

Zusammenfassung

Auf den ersten Blick scheinen sich die sozialen und die demokratischen Potenziale der EU in den vergangenen fünfzehn Jahren vergrößert zu haben. Doch dieser Schein trügt. Denn diese Potenziale werden in erheblichem Maße von der Heterogenität der europäischen Spielarten des Kapitalismus geprägt. Diese Argumentation verorten wir zunächst in der Integrationsliteratur und verdeutlichen, warum die politökonomische Heterogenität der EU-Mitgliedsländer nicht nur die Ergebnisse intergouvernementaler Verhandlungen, sondern auch die Möglichkeiten der judiziellen Integration beeinflusst. In einem zweiten Schritt dokumentieren wir die politökonomische Heterogenität der EU und ihre Zunahme im Zeitverlauf anhand von Daten. Drittens zeigen wir, dass die Mitgliedstaaten häufig autonomieschonende Lösungen wählten, wenn europäische Initiativen auf die Transformation politökonomisch sensibler Institutionen zielten. Viertens führen wir vor, wie der Europäische Gerichtshof (EuGH) genau diese autonomieschonenden Lösungen immer wieder konterkarierte, indem er die europäischen Grundfreiheiten immer extensiver interpretierte. Im Ausblick verdeutlichen wir, dass die Asymmetrie zwischen marktschaffender und marktkorrigierender Integration auch in Zukunft nicht verschwinden wird, und legen dar, warum die politökonomische Heterogenität nicht nur das soziale, sondern auch das demokratische Potenzial der EU prägt.

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Integration among Unequals: How the Heterogeneity of European Varieties of Capitalism Shapes the Social and Democratic Potential of the EU

1 Introduction: A political-economy perspective on European integration¹

One and a half decades have passed since Lisbet Hooghe and Gary Marks wrote their seminal article “The Making of a Polity: The Struggle over European Integration” (Hooghe/Marks 1999). Hooghe and Marks argued that with the Single European Act and the Maastricht treaty the European Union² had entered a phase of struggle between two competing projects: regulated and neoliberal capitalism, both being championed by different coalitions of member states, national and international interest groups, and European institutions and organizations. They also observed that the politics of European integration had changed. The struggle over Europe’s future had become politicized and could no longer be fought by technocrats behind the public’s back. In short, Hooghe and Marks described an integration phase in which both European social and economic governance and the legitimacy of European decisions appeared in a new light.

Much has happened since then. European integration has witnessed an unforeseen dynamic. The treaties of Amsterdam (in effect since 1999), Nice (since 2003), and Lisbon (since 2009) have introduced important institutional reforms, and since the eastern enlargements of 2004 and 2007 the EU now consists of 27 members, with more candidates awaiting accession. These changes have also affected the social and democratic potential of the EU. At first glance, the democratic quality of the EU seems to have increased with these reforms. For example, the Lisbon reforms have strengthened the European Parliament (EP), the only directly elected EU institution. Nowadays, the EP co-decides practically every European budget item, even in policy fields such as the common agricultural policy where this had not been the case before. Another democratic innovation is the European Citizens’ Initiative (ECI). Now one million citizens from at least one quarter of the EU member states are allowed to invite the European Commission to put forward proposals for legal acts.

1 This paper presents a further developed version of an argument that we first introduced in Höpner/Schäfer (2010, 2012). We would like to thank Alexandre Afonso, Hans-Peter Kriesi, Fritz W. Scharpf, Daniel Seikel, Kathleen Thelen, Benjamin Werner, Arndt Wonka, and Nick Ziegler for their helpful comments.

2 To simplify matters, we will use the term “European Union” (EU) throughout, rather than differentiating between the European Economic Union (EEU), the European Community (EC), and the EU.

The social purpose of European integration has been strengthened, too. With the Lisbon reforms, the European Charter of Fundamental Rights has become legally binding. The Charter encompasses social rights, such as employees' consultation rights and the right to strike. In addition, Article 3 of the Treaty on European Union (TEU) states that the EU shall work for "a highly competitive social market economy, aiming at full employment and social progress." And according to Article 152 of the Treaty on the Functioning of the European Union (TFEU), the EU "recognizes and promotes the role of the social partners at its level, taking into account the diversity of national systems. It shall facilitate dialog between the social partners, respecting their autonomy." Many more references to the social purposes of the EU in European primary and secondary law could be mentioned. Taken at face value, it seems that the project of regulated capitalism has made considerable progress over the last 15 years.

In this paper, we will argue that this impression is misleading. In fact, since "The Making of a Polity" was written, the asymmetry between market-enforcing and market-correcting integration has increased rather than decreased, and although the rights of the EP have been strengthened, EU democracy is still unlikely to emerge. We contend that the heterogeneity of European varieties of capitalism limits the social and democratic potential of the EU. In doing so, we bring together two strands of literature that rarely meet: integration theory and comparative political economy.

In order to arrive at our conclusions, we follow Weiler and Scharpf in analytically distinguishing between two different forms of integration: *political integration*, brought about by intergovernmental bargains, and *judicial integration*, which derives from the Commission's and the ECJ's interpretation of European law.³ Political integration can serve either the regulated or the neoliberal project. If political unanimity existed, political integration could in principle harmonize social policies and transfer competencies to the European level by, for example, establishing European-wide codetermination rights or building a European social security system. In contrast, integration through law mainly works to enlarge the scope of individual – mostly economic – rights and to abolish national regulations that potentially restrict the free movement of capital, goods, services, or persons. In the case of anti-discrimination, judicial integration also widens the scope of individual social rights.⁴

In this paper, we show that the heterogeneity of European varieties of capitalism affects political integration and judicial integration differently. Heterogeneous member states will find it difficult to harmonize regulatory standards or to agree to redistribution.

3 See Weiler (1981) and Scharpf (1999). We use the terms "judicial integration" and "integration through law" interchangeably.

4 Caporaso and Tarrow (2009) have argued that the ECJ case law on anti-discrimination and on transnational access to the member states' social security systems provides European integration with a social, "Polanyian" drive. Our interpretation fundamentally differs from theirs. Compare the details in Höpner and Schäfer (2012), in which we discuss not only the ECJ's case law on the fundamental freedoms but also its jurisprudence on anti-discrimination.

National welfare levels and institutions have grown more diverse with each round of enlargement. In core areas of national production and welfare regimes – such as codetermination, capital taxation, and labor standards – political integration has often resulted in deadlock and prolonged negotiation has not given way to harmonization but instead to the protection of national autonomy. At the same time, the political-economic heterogeneity of member states has increased the opportunities for integration through law, since the ability of governments to correct Court decisions depends on political agreement. In many cases, this would have to be based on unanimous decision. Supermajoritarian political decision rules in combination with highly diverse production and welfare regimes provide ECJ judges – compared to national constitutional courts – with an exceptionally large room for maneuver. The ECJ has skillfully used this room for maneuver to enlarge its own competencies and the scope of EU law. If the heterogeneity of European varieties of capitalism was less or even absent – i.e., if European integration took place among equals – not only the opportunity for political integration but also the ability to politically control judicial integration would improve. In other words, the “joint decision trap” (Scharpf 1988, 1999: Chapter 2) takes effect twice: it renders political integration exceedingly difficult and, at the same time, facilitates judicially enforced market integration.

We elaborate the argument by proceeding as follows. In section 2, we briefly revisit “intergovernmentalist” and “supranational” integration theory and develop our theoretical argument in more detail. Section 3 documents the heterogeneity of European production and welfare regimes. Section 4 discusses three cases where political integration has either proved inconclusive or safeguarded national autonomy: the struggle over the European Company Statute, corporate tax harmonization, and the Posted Workers Directive. In all of these cases, subsequent ECJ decisions unsettled political compromises and advocated a degree of liberalization that had not been achievable through political agreements. The different dynamics of judicial and political integration worked to the detriment of regulated capitalism and in favor of its neoliberal counterpart. We conclude in section 5 by discussing how member state heterogeneity affects not only the social but also the democratic potential of the European Union.

2 Member state heterogeneity in the light of integration theory

Different varieties of capitalism coexist within the European Union. National interests with regard to the speed and scope of European integration are therefore likely to differ. In order to locate our argument in the literature, we review how integration theory has incorporated this insight. We revisit three of the most influential strands of integration theory: neofunctionalism, classical and liberal intergovernmentalism, and supranationalism. The brief review reveals a paradox. We will argue that the growing heterogeneity of European member states has steadily increased the relative autonomy

of supranational agencies. However, neofunctionalists and supranationalists, who usually stress this autonomy, have paid only scant attention to the heterogeneous political-economic base of Europe. Intergovernmentalists, by contrast, emphasize the diversity of the member states' production and welfare regimes but question the autonomy of the Commission and the ECJ to propel European integration.

Since the 1990s, integration research has paid increasing attention to the small and politically unintended, but cumulatively transformative steps in which integration proceeds – much like early neofunctionalism with its emphasis on spillovers had done. In particular Haas (1958/1968) expected actors to redirect their expectations, interests, activities, and loyalties toward the European level over time. In his view, an expansive logic is systematically built into regional integration processes. Every redirection of actions toward the transnational level necessarily produces side effects that press for further transnationalization and for the transfer of competencies – “from coal to steel, to tariffs on refrigerators, to chickens, and to cheese, and from there to company law, turnover taxes, and the control of the business cycle” (Haas 1971: 13). Most notably, he expected nonpolitical, mainly economic transnationalization to spill over to political integration, as a consequence of which a “new central authority may emerge as an unintended consequence of incremental earlier steps” (ibid.: 23).⁵

The spillover hypothesis has some intuitive plausibility when integration proceeds among equals. But should not functional spillovers be decisively weakened or blocked entirely under conditions of political-economic heterogeneity and, therefore, diverging interests among member states? Haas actually accounted for the fact that political-economic regulations among the (from today's point of view, relatively homogenous) “Europe of the six” differed in many respects. However, he expected functional spillovers to override such diversity. In fact, in the presence of diversity, supranational regulations may become even more likely. For example, governments may push supranational agencies to legislate in order to overcome competitive disadvantage, as the Belgian government did in 1954 to offset its stricter working time regulations (Haas ([1958]1968: 90).⁶ In such situations, diversity may serve as an engine, rather than a barrier, to spillover.

In his alternative interpretation, Hoffmann (1966) by no means denied that functional spillovers might trigger incremental, politically unintended integration steps “from below.” However, he insisted on a logical hierarchy of integration forms, consisting of an

5 In his later writings, Haas distanced himself from his earlier unidirectional view on integration and argued that both integration and disintegration pressures coexist, the latter deriving from “pragmatic-interest politics” (see Haas 1967: 315).

6 Another example is the equal pay principle that had been included into the Treaty of Rome. France advocated inclusion of the principle because it anticipated competitive disadvantage due to the higher wage gaps obtaining between males and females in the other member states. This principle became the starting point for an extensive equal treatment jurisdiction on the part of the ECJ. If the differences between the member states had been smaller in the 1950s, the equal pay principle might not have been included in the first place.

intergovernmental logic at the top of the hierarchy and a neofunctional logic at the bottom. The neofunctional logic, Hoffmann argued, reaches its limits where – in modern game-theoretic language – zero-sum games between member states are concerned: “Functional integration’s gamble could be won only if the method had sufficient potency to promise a permanent excess of gains over losses, and of hopes over frustrations” (Hoffmann 1966: 882). As soon as potential integration “concern[s] issues that can hardly be compromised,” however, political integration is unlikely to occur. Therefore, integration dynamics are mainly determined by the goals, interests, and strategies of national governments, and the power constellations between them.⁷

For Hoffmann, the degree of diversity of national interests was crucial for understanding regional integration. But, interestingly, he drew a clear line between economic and political integration and conceived political-economic matters as “low politics.” “[E]conomic integration,” he wrote, “obviously proceeds and the procedures set up by the communities press the governments hard to extend harmonization in all directions. With a common market and a joint external tariff the states cannot afford widely different wage, budgetary and monetary policies” (Hoffmann 1964: 1289). In this respect, Hoffmann’s interpretation differed little from Haas’s. Yet, the “diversity of national situations” was supposed to translate into blockades where “high politics” such as security and defense policies, foreign policies, and political unity were concerned (Hoffmann 1966: 876).

In the 1990s, Moravcsik revitalized Hoffmann’s intergovernmentalism by theorizing on the emergence of national integration preferences and by providing intergovernmentalism with an explicit political-economic foundation. He argued that national governments’ integration decisions should be analyzed by “assuming that each first formulates national preferences, then engages in interstate bargaining, and finally decides whether to delegate or pool sovereignty in international institutions” (Moravcsik 1998: 473). Government preferences reflect the objectives of the respective state’s most influential interest groups and are mainly economic in nature (*ibid.*: 24). Economic preferences need not necessarily relate to overall efficiency, but can also be rooted in distributional concerns (*ibid.*: 36). Accordingly, member states’ preferences will differ along the lines of sectoral competitive advantage, wealth, and regulatory standards (*ibid.*: 28). Moravcsik claimed that the distribution of such preferences among member states and the power relations between them determine the outcomes of intergovernmental integration bargains, affecting not only market liberalization, but also issues such as product regulation, social policy, and monetary policy (Moravcsik 1993: 485f.; 1998: 474).

7 Hoffman insisted on a wide definition of interests, not only determined by strictly material gains and losses, but also conditioned by traditions, experiences, and cultures. See, for example, Hoffmann (1964: 1256) on the “historical memories” of nations.

As long as the degree of integration achieved by intergovernmental bargains is the dependent variable, there is wide implicit or explicit agreement that political-economic integration research should proceed in the way Moravcsik suggested.⁸ However, “grand bargains” and political integration are only one part of the story – and perhaps no longer the most important one. In fact, “liberal intergovernmentalism” is less contested for its analysis of governments’ integration preferences, but rather for insisting on a strict dominance of intergovernmental over supranational integration modes. In order to understand the limitations of this perspective, we turn to the heterogeneous literature that aims at determining the size of the freedom of action of supranational agencies, which – for the sake of simplification – we subsume under the heading of “supranationalism.”

Supranationalists focus their attention on the small but cumulative steps by which gradual in integration proceeds and supranational agencies, without any government involvement, enlarge their scope of influence. In particular, supranationalists have discovered the ECJ to be “a strategic actor in its own right” (Mattli/Slaughter 1998: 177). They argue that integration through law has shaped the speed and scope of integration at least as much as political integration has. According to this view, judicial integration has to be understood as a self-perpetuating process in which three types of actors activate each other:⁹ first, national and transnational litigants who make use of the opportunities that the European legal system offers; second, national courts that are willing to bring the respective cases forward to the ECJ;¹⁰ and, third, the ECJ itself, which is characterized by a strong preference to “promote its own prestige and power by raising the visibility, effectiveness, and scope of EU law” (Mattli/Slaughter 1998: 180).¹¹ Integration, in other words, can be changed in speed and direction by shifting it to “a nominally nonpolitical sphere” (Burley/Mattli 1993: 69). Thus supranationalists argue that European agencies have both the power and opportunity to override the integration preferences of governments, and that progress in European integration has often resulted from the skillful use of this opportunity.

8 Several authors have deduced hypotheses on the nature of national integration preferences from insights of the comparative political-economy literature, such as, *inter alios*, Fioretos (2001), McCann (2010), and Menz (2003, 2005). The same holds true for research into the origins of the integration preferences of collective actors such as employer associations (see, for example, Callaghan 2010) and of individuals (see, for example, Brinegar/Jolly/Kitschelt 2004; Tiemann 2008).

9 See the contributions to the edited volumes by Sandholtz and Stone Sweet (1998), and Stone Sweet, Sandholtz, and Fligstein (2001). In addition, see Alter (2001, 2009); Burley/Mattli (1993); Mattli/Slaughter (1998); Pollack (1997); Weiler (1987, 2004).

10 Equally important, the Commission has the right to submit to the ECJ cases of potential failure of member state compliance with European law.

11 In the words of Schepel and Wesseling (1997: 177): “The main stake for the ECJ is to have its authority accepted and expanded. And for the ECJ to expand its authority is to expand the reach of EC law.” See also Alter (2001: 45) and Pierson (1996: 133). For sociological views on the sources and evolution of ECJ judges’ integration preferences, see Alter (2009: Ch. 4); Höpner (2011); Cohen (2007); Madsen/Vauchez (2005); Vauchez (2007, 2008, 2010).

Intergovernmentalists have, in turn, produced sophisticated arguments questioning the idea of a politically uncontrolled room for maneuver that the ECJ and the Commission use to speed up integration.¹² In principle, member states possess the means to emasculate agency drift because European agencies cannot enforce European law directly. Governments may collectively refuse to comply with European law or may formally override ECJ decisions by changing EU Directives or primary law.¹³ The ECJ's autonomy is therefore latently in danger.

Empirically, however, coordinated resistance to ECJ decisions is rare or even non-existent. Rather than raising doubts about the ability of member states to control supranational actors, Garrett concludes that agency drift does not occur in the first place: "A more powerful explanation for the maintenance of the EC legal system is that it is actually – and seemingly paradoxically, given its consequences for national authority – consistent with the interests of member states" (Garrett 1992: 556f.). And even if ECJ decisions lead to allegedly unintended losses of sovereignty, member states may weight these lower than the gains from the ECJ's effective solutions to monitoring problems, from ensuring the credibility of European commitments, and from mitigation of incomplete contracting (Garrett/Weingast 1993; Garrett 1995: 172). In this perspective, therefore, "unintended" losses of sovereignty do not exist at all.¹⁴

However, the assertion that the Court's ability to ignore government preferences is not unlimited does not in any way prove that its room for maneuver is negligible or even absent (Pollack 1997). In practice, coordinated resistance to the ECJ is far more difficult than intergovernmentalists are ready to admit. First, the law serves not only as a "mask" but also as a "shield" of politics. Judicial independence and the rule of law are hardly questioned in modern democracies. Therefore, strategic and coordinated noncompliance is generally not perceived as a legitimate option (Mattli/Slaughter 1998: 181).¹⁵ Second, due to the numerous veto points operating in the European political system, formal ex-post correction of ECJ decisions is hard to achieve. Reaching political agreements in the EU is difficult and time consuming, and when unanimity is required, the resistance of a single member state can be sufficient to prevent action. As a consequence, the Commission and the ECJ can exploit disagreement among member states (Pollack 1997: 129). Third, ECJ judges and national governments differ with respect to their time

12 However, they agree on one crucial point: supranational agencies, just like governments, are strategic actors (Garrett 1995: 172).

13 Collective and individual noncompliance must not be confused. Individual non-enforcement frequently occurs and does not hurt the ECJ. Coordinated noncompliance, however, would severely damage the functioning of the European legal system, a scenario that the ECJ should seek to avoid (see Garrett 1992: 558).

14 This argument has far-reaching consequences for other debates in integration theory. For example, the European legitimacy deficit is much smaller than some argue if agency drift does not exist (see Moravcsik 2002).

15 The costs of noncompliance are even higher in situations in which governments would have to defect from cooperating not only with the ECJ, but also with national courts that brought the respective cases before the ECJ.

horizons. Since the full impact of ECJ decisions is often felt not in the short, but in the medium to long term, politicians may avoid the costs of noncompliance or of ex post corrections (Pierson 1996: 135–136; Alter 2009: 118–121). And, fourth, direct influence over judges' behavior is an equally difficult task: ECJ judges cannot be dismissed during their six year terms and, even more importantly, decisions are taken secretly and no minority opinions are published. It is therefore impossible for national governments to single out the behavior of individual judges (Pollack 1997: 117; Mattli/Slaughter 1998: 181f.).

This state of the integration debate is where we locate our argument. We agree that the likelihood of coordinated resistance among member states crucially shapes the ECJ's freedom of action to carry out judicial integration. At the same time, there are good reasons to believe that the ability of member states to control supranational actors is less effective than intergovernmentalists claim. Even if we take this into account, a puzzle remains to be solved. Attempts to formally override ECJ decisions as well as coordinated noncompliance are virtually non-existent, rather than just unsuccessful. If ECJ decisions violate member states' integration preferences as systematically as supranationalists maintain, why do the member states not try to control the Court?

We suggest that one answer to this question lies in the political-economic heterogeneity of Europe. In order to evaluate member states' preferences vis-à-vis judicial integration, we need to assume a two-dimensional rather than a one-dimensional conflict model. The first dimension is the well-known conflict between integration and sovereignty, the dimension in which the member states' (as well as the supranational agencies') integration preference is located.¹⁶ Integration through law often has systematic consequences for the division of labor between the market, on the one hand, and collective regulation, on the other. We expect member states to evaluate their likely gains and losses in this dimension as well, and to weight losses of sovereignty against potential political-economic gains. The resulting preferences necessarily differ with respect to anticipated welfare transfers and asymmetrical needs for institutional adjustment. Of course, this by no means postulates that preferences are *internally* homogenous in the respective member states (a point on which both liberal intergovernmentalists and supranationalists agree). Given the strict consensus requirement for treaty amendments, the likelihood of constitutional override of ECJ decisions is very low in situations in which the respective decisions asymmetrically target different European varieties of capitalism. As a consequence, the freedom of action of supranational agencies to widen the range of application of European primary law should grow as political-economic heterogeneity mounts. In other words, the heterogeneity of European varieties of capitalism is among the determinants of the potential for judicially driven integration.

16 Here we follow supranationalist insights and assume that both the Commission and the ECJ have a strong integration preference. Note that we locate the supranational agencies' preferences in this dimension rather than in the second (political-economic) dimension. In other words, we do *not* assume that European judges or Commissioners have a preference for neoliberal policies.

This implies that not only intergovernmental but also supranational integration theory requires a comparative political-economy foundation. The heterogeneity of European varieties of capitalism shapes *both* the likelihood of reaching intergovernmental agreements *and* the ability of member states to politically control integration through law. As a result, the dynamics of political and judicial integration differ – with consequences for the projects of regulated and neoliberal capitalism. While the former project has to come to terms with diverging interests, the latter project benefits from interest diversity – as the empirical examples provided in section 4 will illustrate. Before we explore the integration dynamics in three policy fields in more detail, we will document the heterogeneity of varieties of capitalism within the European Union and discuss how it has evolved over time.

3 The diversity of European production and welfare regimes

We have argued that the existing literature does not fully reflect the fact that today European integration takes place among unequals. Political integration has to come to terms with differences not only in wealth and productivity but also in taxation and welfare spending. Perhaps even more importantly, the political-economy literature has identified important *institutional* differences that set apart national production and welfare regimes – even among relatively wealthy industrial democracies. In the European Union, we not only find several “worlds of welfare capitalism,” but also different forms of corporate governance and of industrial relations (Esping-Andersen 1990; Hall/Soskice 2001; Amable 2003). In this paper, we do not enter the debate about how many production or welfare regimes exist within the EU. Instead we document in this section the heterogeneity of welfare and productions regimes in the EU-27 and argue that convergence is not likely to occur any time soon.

Table 1 displays a number of indicators that seek to reveal both material and institutional differences among the member states. We have collected indicators that are frequently used to identify differences in welfare or production regimes. Countries are listed in the order of their entry into the EU, and summary statistics are provided for the six initial members (EU-6), the group of West European states (EU-15), and for all current member states (EU-27). In general, the founding members score not only higher on almost all indicators, but differences are also smallest within this group. Belgium, Germany, France, Italy, Luxembourg, and the Netherlands constitute a comparatively homogenous group of countries. If they were the only member states, a harmonization of tax and social policies would seem conceivable. However, this does not hold for either the EU-15 or the EU-27.

Table 1 Differences in national production and welfare regimes of the EU-27

	A	B	C	D	E	F	G	H	I	J	K	L
	GDP per capita	GDP per capita	Hourly labor costs	Social expenditure	Total taxes	SSC	Corporate tax rate	Union density	Employer organization	Collective bargaining coverage	Codetermination	Market capitalization
Belgium	32,200	32,200	32.6	30.1	44.3	31.5	34.0	54.1	72.0	96.0	1	–
Germany	30,400	30,400	27.8	28.7	39.3	38.3	29.8	20.7	63.0	63.0	4	37.6
France	30,400	30,400	31.1	31.1	42.8	37.7	34.4	8.0	78.0	95.0	2	–
Italy	26,300	26,300	–	26.6	42.8	31.3	31.4	33.4	51.0	80.0	1	30.1
Luxembourg	80,500	–	33.0	20.4	35.6	28.3	28.6	40.4	78.0	60.0	3	192.3
Netherlands	36,200	36,200	–	29.3	39.1	37.1	25.5	21.5	85.0	82.0	3	–
EU-6	39,333	31,100	31.1	27.7	40.7	34.0	30.6	29.7	71.2	79.3	2.3	86.7
Coeff. Var.	0.47	0.10	0.07	0.13	0.07	0.11	0.10	0.50	0.16	0.18	0.47	0.86
Denmark	42,400	42,400	34.7	29.1	48.2	2.0	25.0	69.4	52.0	82.0	3	–
United Kingdom	29,600	29,600	26.4	26.4	37.3	18.3	28.0	29.0	40.0	33.5	1	124.5
Ireland	40,900	40,900	–	18.2	29.3	18.2	12.5	35.3	60.0	–	1	26.8
Greece	21,300	21,300	–	24.2	32.6	37.5	24.0	23.0	70.0	85.0	1	33.4
Portugal	15,700	15,700	11.3	25.4	36.7	32.5	26.5	18.1	58.0	62.0	1	–
Spain	23,900	23,900	16.4	20.9	33.1	37.1	30.0	14.6	72.0	80.0	1	85.8
Austria	33,800	33,800	26.3	28.5	42.8	33.6	25.0	31.7	100.0	99.0	3	28.2
Finland	34,800	34,800	27.9	26.2	43.1	28.0	26.0	71.7	70.0	86.0	3	–
Sweden	35,400	35,400	33.3	30.7	47.1	23.9	26.3	75.0	55.0	92.0	3	–
EU-15	34,253	30,950	27.3	26.4	39.6	29.0	27.1	36.4	66.9	78.3	2.1	69.8
Coeff. Var.	0.41	0.23	0.26	0.14	0.13	0.33	0.18	0.57	0.22	0.22	0.51	0.81

Czech Republic	14,200	14,200	7.9	18.7	36.1	44.9	19.0	21.0	32.0	44.0	3	22.8
Cyprus	21,700	21,700	12.5	18.4	39.2	19.7	10.0	62.1	57.0	75.0	-	42.2
Estonia	12,000	12,000	6.6	12.4	32.2	36.6	21.0	13.2	25.0	22.0	1	-
Latvia	10,200	10,200	4.4	12.2	28.9	28.3	15.0	16.1	25.0	20.0	1	-
Lithuania	9,600	9,600	5.1	13.2	30.3	29.7	15.0	14.4	20.0	12.0	1	-
Hungary	10,500	10,500	7.1	22.3	40.4	34.1	20.6	17.8	40.0	35.0	3	22.5
Malta	13,800	13,800	8.2	18.1	34.5	17.9	35.0	57.0	63.0	57.0	-	48.6
Poland	9,500	9,500	6.8	19.2	34.3	33.1	19.0	14.4	20.0	35.0	3	33.9
Slovenia	18,400	18,400	12.1	22.8	37.3	37.6	20.0	41.3	40.0	100.0	3	23.9
Slovakia	12,000	12,000	6.4	15.9	29.1	41.0	19.0	23.6	30.0	35.0	3	5.7
Bulgaria	4,500	4,500	1.9	15.0	33.3	24.3	10.0	21.3	-	-	-	17.3
Romania	6,500	6,500	3.4	14.0	28.0	33.3	16.0	33.7	-	-	-	7.2
EU-27	24,322	22,161	16.7	22.15	37.0	30.2	23.2	32.7	54.2	63.8	2.1	46.0
Coeff. Var.	0.64	0.51	0.69	0.27	0.15	0.30	0.31	0.59	0.39	0.43	0.49	1.00

Sources and definitions

GDP per capita at current market prices, PPS in Euro; Eurostat (2010a: 97).

Total taxes (including SSC) as % of GDP, 2008; Eurostat (2010b: 290).

SSC = Social Security Contributions as % of Total taxation, 2008; Eurostat (2010b: 313).

Social expenditure in % of GDP, 2006; Eurostat (2010a: 336).

Corporate tax rate: Adjusted top statutory tax rate on corporate income, 2010; Eurostat (2010b: 136).

Hourly labor costs in industry and services of full-time employees in Euro, 2007; Eurostat (2010a: 309).

Collective bargaining coverage: Percentage of employees covered by wage agreements, 2006; ETUC (2010: 5).

Union density: Percentage of union-organized labor in the entire labor force (excluding retirees), 2006; ETUC (2010: 4).

Employer organization: Percentage of the labor force whose employers are members of an employers' association, 2006; ICTWSS database (Visser 2009).

Market capitalization as % of GDP, annual data, 2009; Eurostat: <http://appsso.eurostat.ec.europa.eu/nui/show.do>.

Board level codetermination: 1 = no codetermination to 4 = at least 1/3 of the seats are held by employees; Höpner (2004: 40).

A glance at the overall wealth of member states does not seem to confirm at first sight that the initial member states form a homogenous group (column A). However, if we neglect Luxembourg – whose GDP per capita is almost twice that of the second richest state – a different picture emerges (column B). The other five founding members are by far the most coherent group in terms of wealth. Enlarging the Union has meant increasing differences in wealth. Leaving Luxembourg aside, GDP per capita is still nine times higher in Denmark than in Bulgaria and almost three times higher in the EU-15 than in the ten post-socialist countries. If we turn to labor costs, even bigger differences exist. Hourly labor costs are 4.5 times higher in the EU-15 than in the NMS states save Cyprus and Malta (column C). These differences constitute a strong incentive for the citizens of new member states to enter the labor markets of the old members¹⁷ and make the territoriality of labor standards a highly contested issue (Afonso 2012).

As is well known from the comparative literature on welfare states, European countries differ in their spending on social policy (column D). While some countries allocate more than 30 percent of GDP to social protection, others spend less than 20 percent. With the exception of Ireland, however, the EU-15 countries tend to be big spenders, whereas the new member states clearly spend much less on social protection. As a result, the EU-27 is notably more diverse than the old EU-15. Member states also differ in the way they generate revenues. While total taxes (including social security contributions) in relation to GDP are in reality not that far apart, even among the ten post-socialist countries notable differences in taxation levels exist (column E). While Hungary collects 40 percent of GDP through taxes – a higher figure than that of Germany, Luxembourg, or the Netherlands – Romania, Slovakia, and Latvia's overall taxation amounts to less than 30 percent of GDP. Since taxation and spending on social protection tend to co-evolve with a country's standard of living, these differences might decrease over time.

Even if this is true, however, considerable differences in the *structure of taxation* are likely to persist. Welfare states within the EU are financed in different ways. For example, all EU-6 countries belong to the group of Bismarckian welfare states, which rely heavily on social security contributions to finance social protection (column F). Yet, this does not hold for either the Anglo-Saxon or the Scandinavian countries, which rely more strongly on income taxes. New member states again form a heterogeneous group in themselves – some of them fall into the Bismarckian camp, but others do not. Similarly, member states follow different strategies in corporate taxation. While smaller states use low nominal tax rates to attract foreign direct investment, larger member states are less inclined to do so (see section 4, Political integration and national autonomy). Accordingly, notable differences in statutory tax rates for corporate income exist (column G). Given these dif-

17 In 2008, 1.4 million EU citizens migrated to another member state (excluding returning nationals). The largest shares of migrants come from Romania, Poland, and Bulgaria. In the same year, Germany received more than 300,000 EU immigrants, and Italy, Spain, and the UK roughly 200,000 each. 84 percent of all immigrants in 2008 were of working age (15–64) with a median age of 28 years. Data source: Eurostat (2011).

ferences, any attempt to harmonize taxation or the financing of the welfare state seems a daunting task – even among the EU-15 countries. Had the political will existed, a harmonization of social policies could have been conceivable among the founding member states, but this option seems no longer available (Scharpf 2002: 645–648).

One of the core insights of the comparative capitalism literature is that national production regimes differ in the degree to which economic action is coordinated, both between and within companies. Institutional differences – in labor markets, vocational training, corporate governance, or financial regulation – facilitate different strategies of firms. Strong trade unions and employer organizations have been identified as core elements of coordinated market economies. However, if we look at recent figures for union density, many CMEs today look more like liberal market economies (column H). Germany and the Netherlands, for example, have weaker trade unions than Great Britain or Ireland. In general, substantial differences in union strength exist within the European Union – no matter whether we consider only the initial six member states or the EU-27. Employers, in contrast, are much more highly organized in Western European than in the NMS states (column I). Similarly, collective bargaining coverage is – with the exception of Great Britain – fairly encompassing in EU-15 countries but much less widespread in most of the states that joined the EU in the 2000s (with the notable exception of Cyprus, Malta, and, above all, Slovenia) (column J) (Afonso 2011).

Another aspect that defines CMEs is the need for management to consult with employee representatives. Within the European Union, there exists no uniform model of board level codetermination, even within the initial member states (column K). In Belgium and Italy, supervisory boards do not include any employee representatives, whereas they hold half the seats in Germany. Interestingly, some of the post-socialist countries have established fairly far-reaching codetermination rights, whereas the Baltic states have not. Finally, those countries for which data are available differ markedly in the cumulated worth of companies listed on the stock market (column L). While the market capitalization in Luxembourg and Great Britain is well above national GDP, it is almost negligible in Slovakia or Romania. In general, the diversity of national production regimes exceeds that in welfare regimes. Institutional differences cut across old and new member states alike. Given these differences, it seems hard to imagine uniform regulations or policies operating for all member states.

However, such a focus on cross-sectional data might conceal underlying processes of convergence. Some of the differences between member states might diminish as the Eastern European “dependent market economies” (Nölke/Vliegenthart 2009) grow wealthier or if welfare cuts in the richer states accelerate. Social expenditure and taxation levels could converge over time and therefore make it easier to agree on common standards. To deal with the possibility, Table 2 displays trends over time for six variables. It reports the mean for all 27 countries as well as the coefficient of variation as a measure of convergence. While the overall level of taxation, spending on social protection, and social security contributions as a percentage of taxation hardly change during

Table 2 Average trends in production and welfare regimes of the EU-27

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total taxes	37.7	37.3	37.6	37.1	37.3	37.2	36.6	36.3	36.3	36.4	36.9	37.0	37.4	37.0
CV	0.17	0.19	0.18	0.18	0.18	0.18	0.18	0.17	0.17	0.17	0.16	0.16	0.15	0.15
Social protection		24.8	23.7	23.5	23.4	21.3	21.5	22.0	22.3	22.1	22.3	22.1	21.5	22.4
CV		0.26	0.24	0.22	0.21	0.27	0.28	0.27	0.28	0.28	0.27	0.27	0.26	0.24
SSC	30.8	30.9	30.6	30.1	30.3	30.6	31.0	31.0	30.9	30.7	30.3	29.8	29.5	30.2
CV	0.31	0.30	0.30	0.30	0.29	0.30	0.29	0.30	0.29	0.29	0.29	0.30	0.30	0.30
Union density	45.3	43.5	42.1	40.0	40.5	37.9	37.3	36.1	35.6	37.6	35.8	33.3		
CV	0.47	0.52	0.49	0.49	0.53	0.54	0.57	0.57	0.56	0.57	0.59	0.60		
Bargaining coverage	78.4	77.9	78.5	71.5	77.3	74.4	69.1	71.2	65.4	72.7	72.7	62.6		
CV	0.22	0.28	0.24	0.33	0.27	0.32	0.38	0.38	0.42	0.37	0.37	0.45		
Corporate tax	35.3	35.3	35.2	34.1	33.5	31.9	30.7	29.3	28.3	27.0	25.5	25.1	24.3	23.6
CV	0.23	0.23	0.23	0.21	0.20	0.21	0.19	0.22	0.25	0.29	0.32	0.31	0.32	0.30

Sources: See Table 1.

this period, this does not hold for union density, bargaining coverage, and corporate tax rates. On average, these indicators have been declining over the last 10 to 15 years. However, even if trade union membership and statutory tax rates are declining almost everywhere, the *rate of decline* differs significantly, rendering countries *more diverse* at the end of the period than at the beginning.

This brief discussion shows that EU member states' production and welfare regimes have become more heterogeneous with each round of enlargement – and if the Balkan states and possibly Turkey or Ukraine entered the EU, disparities would further increase. At the same time, spending patterns and the institutional set up of national welfare states have not converged, while the diversity of collective bargaining institutions and taxation systems has even increased. According to these data, European integration will for a long time remain integration among unequals, which will make it difficult to agree on interventionist policies that apply to all member states. As a matter of fact, negotiations about the defining elements of national political economies have frequently run aground, as the next section shows.

4 Political and judicial integration under conditions of heterogeneity

At first sight, one could expect growing diversity within the EU to slow down *every* form of integration, both market-restricting *and* market-enhancing integration. If this were the case, there would be no link between the heterogeneity of national welfare and production regimes, on the one hand, and the projects of regulated and neoliberal capitalism, on the other. In a setting that exclusively depends on political integration, there is no reason to assume that the neoliberal project would prevail over the project of regulated capitalism. However, growing heterogeneity need not equally impede integration

through law. In fact, the necessity to settle conflicts that arise from cross-border transaction through adjudication could well increase as companies seek to exploit differences in wages, labor standards, or company law. At the same time, judicial integration cannot serve either project equally; it is capable of removing (potential) restrictions on market transactions at the member state level but can hardly impose new regulations at the supranational level.

In what follows, we focus on salient cases from a political-economy perspective rather than randomly selecting cases to assess the overall line of ECJ rulings. We do not claim to study a representative sample but rather those cases that impinge on national welfare and production regimes. Thus, the theoretical perspective of the paper motivates the case selection. We concentrate on a particular constellation that systematically occurs in quite different fields of integration.¹⁸ When European initiatives target highly sensitive institutions that are rooted in different varieties of capitalism, member states have often opted for the protection of their own regulatory autonomy. We show that integration through law has political-economic consequences precisely when it thwarts member states' political decisions *not* to integrate.¹⁹ Below, we look in detail at three areas that are among the defining features of national production and welfare models – codetermination, collective bargaining, and taxation.²⁰

Political integration and national autonomy

Political integration decisions become unlikely when the respective integration projects target the production and welfare regimes so asymmetrically that the outcome will be a divide between winners and losers (Scharpf 1999: Chapter 2). It is therefore not surprising that some areas such as social security, wage bargaining, or codetermination have turned out to be resistant to political integration. The same could be said about capital and income taxes and other sensitive political-economic areas. In such constellations, once initially ambitious harmonization projects have failed, member states have often chosen to preserve their regulatory autonomy. The defense of national prerogatives can take a variety of forms. In the simplest form, governments refuse to transfer competencies to the European level and instead insist on the principle of subsidiarity. In labor dispute law, by contrast, member states have inserted a barring clause in the European

18 Compare Höpner/Schäfer (2012), in which we also discuss the soft coordination of social policies and the “left-liberal” (Fritz Scharpf) line of ECJ case law on equal treatment. On soft coordination, see also Schäfer/Leiber (2009).

19 Integration through law not only corrects political decisions to protect national autonomy, but also changes the content of political integration by manipulating the member states' fallback options. On such constellations, especially in the field of European competition law, see the work of Susanne K. Schmidt, in particular Schmidt (2000, 2008).

20 The political salience of these issues helps to explain why not even “package deals” have been capable of overcoming stalemates.

treaties which explicitly states that the European level lacks the competence to regulate (TFEU 153, 5). In other cases, member states have passed Directives that aim primarily at protecting national autonomy. In the following, we will briefly review three cases in which, after a long political struggle, member states finally agreed on autonomy-protecting solutions. And yet these political agreements proved unsustainable. In section 4, Expanding markets, we will see that the European Court of Justice has effectively nullified these compromises by enlarging the reach and scope of the common market principles.

The first example is employees' board level codetermination. The regulation of the internal organizational structures of firms (corporate governance) belongs to the member states' competencies. Corporate governance forms differ widely between European varieties of capitalism. This is particularly true for board level codetermination: actual practices vary from half of the board seats being allocated to the employee side (which is the case in Germany) to no board level codetermination at all (as in the UK and Italy, compare column K of Table 1). Given this heterogeneity, it is not surprising that member states have never managed to agree on a common European codetermination model. Nevertheless, the issue of board level codetermination has appeared on the European agenda: the European Company Statute (*Societas Europaea*, SE) offers transnational companies the possibility to opt for a European rather than a national legal status. Although this statute does not entail any obligatory minimum standards or harmonization, but rather provides a legal option that no company has to adopt against its own will, it took governments more than 30 years to find a solution that would not threaten national codetermination practices.

Numerous proposals and models have been discussed and finally rejected since the Commission, on the initiative of the French government, began drafting a statute for the European company in 1966 (Windolf 1993: 144–147; Fioretos 2009: 1177–1182). The first draft proposed one-third participation of employees, based on the then existing German practice.²¹ The discussions over different versions of this proposal lasted throughout the 1970s, but it was all to no avail. The SE was finally removed from the agenda in the early 1980s. In 1989, the Commission put forward a completely redrafted Directive that offered the choice between four different SE codetermination models, which mainly coincided with German, Dutch, French, and Scandinavian practices. Although the SE remained an optional legal form and although the proposal left substantial choices between codetermination models, member states still could not agree. In particular, the UK government strongly opposed any European Directive that might serve as a “Trojan horse” for company level codetermination (Fioretos 2009: 1178). It took another 12 years before the Council finally endorsed a model that would not en-

21 German parity codetermination – i.e., half rather than one third of the supervisory board seats being distributed to the employee side – has existed since 1976 (with the exception of the so-called *Montanmitbestimmung* in the coal and steel sector, in which half of the supervisory board seats have been allocated to the employee side since 1951).

danger national industrial relations systems. The SE statute, passed in 2001, does not regulate worker participation at all, but only obliges managers and employees to enter a bargaining process with certain fallback provisions in the case of non-agreement between the negotiating parties.²² If an SE is founded by merging firms from codetermination-free countries, no board level codetermination applies. In short, decades of debate have led to a political compromise that has enabled the member states to protect their respective industrial relations systems (Callaghan 2011: 6).

The second example concerns capital taxation. In a common market, transnational firms can minimize their tax burden by transferring earnings and losses across borders without having to relocate production plants.²³ In order to maintain significant parts of corporate tax revenue, states have to offer competitive tax rates to firms, and they have an even stronger incentive to lower corporate taxes if their neighbors do so or if they expect them to do so. In principle, the European member states could put an end to this form of tax competition by harmonizing corporate tax rates and, indeed, discussions about such a move have been going on for decades. Genschel and colleagues distinguish two phases of the long history of failed harmonization attempts (Genschel 2002: 128–231; Ganghof/Genschel 2008; Genschel/Rixen/Uhl 2008). The first phase started with the so-called Neumark Report, written by a European expert group in 1962, and led to a Commission Directive proposal in 1975. In this phase, the discussion revolved around the idea of full harmonization. The member states' willingness to harmonize was, however, limited because the pressure was still marginal.

The second phase started roughly with the Single European Act (1986), which pushed for the transnationalization of firms and, as a consequence, created new opportunities for seeking tax arbitrage. Due to increased tax competition, a race to the bottom of nominal corporate tax rates set in (Ganghof/Genschel 2008: 59). But still no harmonization of corporate taxes could be achieved. Two factors made harmonization unlikely. First, the Commission changed its perception of tax competition and began to adopt a positive view of its impact on tax ratios and budget discipline (Genschel 2002: 207). Rather than aiming at full harmonization, the discussion began to focus on minimum standards and coordinated determination of the taxable base. Second, as tax competition grew, interest heterogeneity among member states grew as well. Not all member states were equal victims of tax competition. Ireland consciously used a low tax regime to attract FDI and, after Eastern enlargement in 2005, several accession states followed suit.²⁴ Among the various determinants of corporate tax strategies is country size. Small countries have a higher chance of profiting from tax competition because they have relatively few domestic tax bases to lose but relatively much to gain if they undercut their neighbors' corporate tax rates (Dehejia/Genschel 1998: 23–26). As a consequence,

22 Council Regulation 2157/2001 and Council Directive 2001/86/EC. See the details in Keller (2002).

23 A comprehensive literature review is provided by Genschel and Schwarz (2011).

24 See Figure 1 in Genschel/Kemmerling/Seils (2011: 591).

harmonization attempts have failed until today. We will see in section 4, Expanding markets, that the ECJ has become an active player in European tax policy, but rather than slowing tax competition down, ECJ case law has intensified competition.

Our third example is the Posted Workers Directive from 1996 (Council Directive 96, 71, EC). The similarities to the first example of board level codetermination are striking. Due to fundamentally diverging interests among member states, no harmonization of labor standards in the European Union has occurred so far.²⁵ In contrast to the political rhetoric in countries with relatively high labor standards such as Germany, governments perceive the spread of their respective standards all over the EU as unrealistic. Therefore, they focus on the protection of national autonomy to legislate and to impose their standards on market participants in their own territory. A potential threat to this autonomy is the transnational posting of employees. The less member states are allowed to impose national standards on posted workers, the more intense labor standard competition will become.

Eichhorst has provided a detailed analysis of the process that led to the 1996 Posted Workers Directive, a Directive that – similar to the European Company Statute – abstains from full harmonization and enables the member states to protect their respective standards (Eichhorst 2000: 143–297). The compromise was difficult to achieve not only as a result of the heterogeneity of standards but also because of different interests in protecting the respective standards. As Eichhorst shows, member states that received more posted workers than they dispatched tended to support autonomy-protecting solutions, in particular Austria, Belgium, Denmark, Finland, France, Germany, Luxembourg, the Netherlands, and Sweden. The UK and Portugal were most strongly opposed, while somewhat weaker opposition was prevalent in Greece, Ireland, Italy, and Spain (*ibid.*: 273f.). In the end, however, those who struggled for the strict protection of the territoriality of labor law prevailed.

Some aspects of the Posted Workers Directive that was finally passed deserve attention. The Directive imposes a double ban on discrimination: not only does it forbid member states to impose standards on posted employees that domestic firms need not conform to; it also forbids member states to deprive foreign employees of standards that domestic employees are entitled to. In other words, member states have not only the right, but also the obligation to impose their standards on posted workers (Streeck 2000: 30f.). In Article 3 (1), the Directive lists a number of areas in which member states have to ensure the application of the respective standards; among them are, for example, working time, health and safety, and pregnancy and maternity protection. Article 3 (7) makes explicitly clear that this list is not a closed list on maximum standards, but an open list: “Paragraphs 1 to 6 shall not prevent application of terms and conditions of employment which are more favorable to workers.” A further instance that will be important for our discus-

25 Compare the summary in Höpner/Schäfer (2012); Schäfer (2005) on the OMC; and Falkner et al. (2005: Ch. 2) on minimum standards in selected areas such as parental leave.

sion in the next subsection is that the member states expressed their intention to let the Posted Workers Directive be “without prejudice to the law of the Member States concerning action to defend the interests of trades and professions,” i.e., labor dispute law.²⁶

In some respects, the same conflict reappeared on the European agenda some years later when the Directive on Services in the Internal Market was negotiated in the 2000s (Directive 2006/123/EC). Again, the struggle mainly concerned the extent to which posted workers should be protected by domestic labor law. While the Commission favored strict adoption of the country of origin principle, the majority of the member states and the EP successfully struggled for the superiority of the Posted Workers Directive over the Directive on Services in the Internal Market (see Article 1 [6] of the latter Directive). As Copeland shows, the conflict lines between the member states clearly resembled a CME-LME divide, consisting of Austria, Belgium, Denmark, France, Finland, Germany, Greece, Italy, Portugal, and Sweden on the more “protective” side and the UK and Ireland, all Eastern European “dependent market economies”, and Luxembourg and the Netherlands on the other (Copeland 2010).

In sum, these examples illustrate that in areas in which full harmonization is impossible due to diverging political-economic interests, member states often opt for solutions that aim to protect their regulatory autonomy. We will now show that integration through law in all of the cases has unraveled these political compromises.

Expanding markets: Integration through law

In this subsection, we take up the three examples discussed above – codetermination, taxation, and the Posted Workers Directive – and show that the European Court of Justice has partially reversed hard-fought political compromises (Höpner/Schäfer 2012). In each case, the ECJ has expanded markets further than had hitherto been possible through politics alone. Integration through law continues apace, if not faster, in the light of growing heterogeneity, while political integration is being stymied.

Already in the 1960s, the ECJ ruled that European law provides market participants with individual rights vis-à-vis their member states (the *direct effect*) and that European law generally overrides national law (*supremacy*).²⁷ Due to these two principles, European competition law became a means to liberalize economic sectors for which it had initially not been made, namely third-sector areas providing public goods and services, such as telecommunications, energy, and transportation (Scharpf 1994, 1999; Thatcher 2007). It took, however, more than twenty years until the Commission began to set up treaty violation proceedings in order to break up state monopolies in third-sector ar-

26 The quote is from recital 22 of the Directive.

27 ECJ, C-26/62 (van Gend & Loos); ECJ, C-6/46 (Costa/ENEL).

eas. Until the mid-80s, an increasing number of areas were being discovered in which this body of law could be applied. At the moment, disputes on public banking, public broadcasting, and hospitals are pending.

In this section, we focus on another line of ECJ decisions: on the judicial expansion of the reach and scope of the European fundamental freedoms and the impact of this on sensitive national regulation areas. Initially, the “four freedoms” – the free movement of goods, capital, services, and persons – aimed at guaranteeing discrimination-free transnational access to markets. Since the *Dassonville* and *Cassis de Dijon* decisions, however, the Court has replaced the *principle of nondiscrimination* by the *principle of non-restriction*.²⁸ According to the latter, any national regulation that potentially restricts the transnational exercise of one of the four freedoms – i.e., any regulation that makes the exercise of one of the fundamental freedoms less attractive – violates European law, even if the regulation does not discriminate against foreigners, i.e., even if it is imposed equally on nationals and non-nationals alike. Such restrictions are only lawful if they pass a four-staged test, uniformly applied to the “four freedoms”: they must not discriminate against foreigners, they have to be justified by imperative requirements of the general interest, they must be suitable for securing the attainment of the objective, and they must not go beyond what is necessary.²⁹

This reinterpretation has far-reaching implications for the scope of market-enforcing integration. Interpreted as individual rights for uninhibited economic transactions, the four freedoms can now be used not merely to eliminate disguised protectionism on the part of the member states, but also to identify a wide range of member states’ political regulations as obstacles to European law. Furthermore, this line of ECJ rulings not only affects political regulation but also – due to the legal doctrine relating to the horizontal effect of European law – the actions of private bodies such as firms or trade unions. In the last decade, it has become clear that the fundamental freedoms are a powerful tool to push ahead with “integration through law,” capable of correcting political compromises.

Our first example of such judicial expansionism is the liberalization of corporate law. In the struggle over the European Company Statute, governments, as we have seen, have adopted rules that aim at preserving national codetermination practices. With a number of decisions, the ECJ has effectively undermined the ability of member states to impose uniform rules on companies located on their territory. Until the end of the 1990s, a general consensus existed that European law was not an obstacle to applying the so-called “company seat theory” or “real seat doctrine.” This doctrine stated that the legal status of a company was not based on the place it was established, but on the place where the actual headquarters were located. In other words, if the seat of a company was in Germany, its internal matters were governed by German law. Assuming that head-

28 ECJ, C-120/78 (*Cassis de Dijon*); ECJ, C-8/74 (*Dassonville*).

29 ECJ, C-55/04 (*Gebhard*).

quarter relocation costs usually outweigh the advantages of a more attractive corporate law, firms usually had no choice but to accept the respective body of regulation (Damann 2003: 611).

The ECJ overturned the application of the company seat doctrine in its rulings on *Centros*, *Überseering*, and *Inspire Art.*³⁰ In the view of the Court, the application of this theory violated the European freedom of establishment, and the judges saw no overriding reasons of general public interest to justify this violation. In particular, the Court ruled that European law allows for the establishing of foreign letterbox firms (in which the company seat has no practical meaning for the economic activities of the business). In practice, this implies that entrepreneurs now have the freedom to choose whichever legal form among the entire EU-27 states they deem appropriate when founding a company (Deakin 2009).

The freedom to circumvent national corporate law has consequences for employees' codetermination: when a company's seat is in Germany but it does not choose the German legal form, management board codetermination does not apply if the company has grown beyond the size of 500 or 2,000 employees.³¹ This is not just a theoretical possibility, as recent experiences demonstrate. The Court's corporate law decisions have led to a boom of firms with foreign legal forms in Germany. In most of the cases, the respective firms do not exceed the number of 500 or even 2,000 employees. However, codetermination is affected in an increasing number of cases. Sick finds that from December 2006 to December 2010 the number of cases relevant to codetermination (i.e., firms of more than 500 employees) increased from 17 to 43 (Sick/Pütz 2011: 35–38). In effect, the ECJ has transformed German supervisory board codetermination, generally perceived as a key element of Germany's model of capitalism, from an obligatory to a voluntary institution.

Our second example for the power of judicial integration concerns tax law, in particular the law on corporate income taxes. Politically, it has been impossible to harmonize corporate taxes, as we saw in the previous subsection. Nonetheless, some member states have sought to restrict companies' tax-avoidance strategies – the transfer of profits and losses across national borders to minimize the tax burden – in order to tame tax competition. However, in a series of decisions such as *Cadbury Schweppes* and *Marks & Spencer*, the ECJ ruled that the common market logic legitimized tax-transfer practices and that efforts to curb these were not justified by overriding reasons of the public interest.³²

30 ECJ, C-212/97 (*Centros*); ECJ, C-208/00 (*Überseering*); ECJ, C-167/01 (*Inspire Art.*).

31 In Germany, with its far-reaching codetermination legislation, supervisory board codetermination sets in when firms have more than 500 employees, and the ratio of employees' supervisory board seats increases from one third to a half of all seats when the number of employees grows beyond 2,000 employees.

32 ECJ, 196/04 (*Cadbury Schweppes*); ECJ, 446/03 (*Marks & Spencer*). *Cadbury Schweppes* concerned the British taxation of foreign sourced income; *Marks & Spencer* related to a ban on cross-border loss offsetting. For an overview on this line of ECJ case law, see Schammo (2008).

By handing down these decisions, the ECJ has fueled inner-European tax competition. The more heterogeneous the tax systems of the member states are, the more intense tax competition becomes, and the more unlikely it is that political harmonization efforts will succeed.³³ As a consequence, nominal tax rates are declining faster in the European Union than in the wider OECD.

As Ganghof and Genschel have shown, the competition to lower corporate taxes does not necessarily reduce tax revenue (Ganghof/Genschel 2008). So far, the broadening of corporate tax bases has prevented a dramatic fall of tax revenues. More important is the indirect effect of corporate tax competition on personal income taxes. Because firms can be used as tax shelters of personal income, the corporate tax rate has a shelter function for personal income tax (the so-called “backstop function”). As tax competition pushes nominal corporate tax rates down, the backstop function is undermined. In this situation, governments have two options: they can accept a widening tax rate gap between corporate tax rates and top personal tax rates, thereby opening up loopholes for top earners, or they can limit the progressivity of personal income tax. Corporate tax competition, therefore, constrains the progressivity of income tax and, as a consequence, member states’ redistributive capacity.

The ECJ decisions on *Viking*, *Laval*, and *Rüffert* – our third example – have recently received much attention because they were interpreted as landmark decisions on the struggle between neoliberal and regulated capitalism in the EU.³⁴ In the context of our discussion, two aspects are of particular importance. The first aspect is the re-interpretation of the Posted Workers Directive from 1996. Remember that Article 3 (1) lists a number of mandatory rules for posted workers’ minimum protection on matters such as pay, rest, and holidays, while Article 3 (7) explicitly states that this minimum protection in force in the host country shall not prevent application of terms and conditions of employment which are more favorable to workers (see the previous subsection). In *Laval*, however, the Court referred to the list in Article 3 (1) as defining the *ceiling* on the *maximum* standards that member states are allowed to impose on posted employees from other EU member states (see Kilpatrick 2009: 845–849). With this judicial re-interpretation, the Court effectively limited the host countries’ room for maneuver in preventing races to the bottom in the field of labor standards, a problem that is set to become increasingly prevalent as heterogeneity among member states increases.

A second aspect of this case is equally relevant for our discussion: the Court expanded the so-called horizontal or “third-party” effect of the European market freedoms to trade unions. In general, the third-party effect implies that European law not only

33 Genschel, Kemmerling and Seils (2010) provide empirical proof that the intensity of tax competition between European countries is greater than in the rest of the world. In this policy field, the EU does not shelter member states from globalization, but rather increases its magnitude.

34 ECJ, C-346/06 (*Rüffert*). In the *Rüffert* case, the ECJ declared a public contract bid in which the contracted companies were obliged to pay no less than the regionally customary wage as a violation of the freedom of services.

obliges member states but also private bodies (such as firms or trade unions) to refrain from actions that might restrict market freedoms. In the decisions on the *Viking* and *Laval* cases, the Court ruled that trade unions are obliged not to hinder or block transnational economic activity by collective action, such as strikes, unless the trade unions' demands were justified by overriding reasons of the public interest and passed the proportionality test (Joerges/Rödl 2009).³⁵ Until *Laval*, few observers would have argued that restricting disputes among the social partners was among the aims of the European fundamental freedoms (compare the barring clause in Art. 153 [5] TFEU).

The three lines of ECJ case law illustrate the dynamic of European judicial lawmaking. In the cases discussed above, the ECJ clearly overrode member states' attempts to shelter sensitive areas of national sovereignty from being transformed by European law. This outcome is puzzling as long as we treat the conflict between sovereignty and integration as the only decisive conflict axis. We assume that the ECJ has a strong integration preference. But since we also assume that all member states have a certain preference for the protection of their autonomy, it remains unclear why no countermeasures occur, especially in cases of high salience and politicization such as tax policy and labor law. The member states could, in principle, introduce treaty changes that limit the Court's autonomy by limiting the reach and scope of the fundamental freedoms. However, the ECJ's activism not only affects the conflict line between sovereignty and integration, but also the conflict line between market and state (and other forms of collective regulation). With its extensive interpretation of European law, the ECJ has weakened the redistributive capacity of the national tax systems, it has transformed employees' supervisory board level codetermination from an obligatory into a voluntary institution, and it has subordinated collective labor law under the European economic freedoms.³⁶ Along this line of conflict given the heterogeneity of European varieties of capitalism, the ECJ targets member states' preferences much more asymmetrically than along the conflict line between integration and autonomy, both in terms of transnational welfare redistribution and in terms of asymmetrical needs for institutional adjustment. Once we assume that the member states evaluate their gains and losses on both lines of conflict and weight their potential political-economic gains against potential losses of sovereignty, it becomes less surprising that we see no unanimous readiness to "curb" the Court's activities. Among the determinants of Court's freedoms to engage in ju-

35 The Lisbon Treaty has made the Charter of Fundamental Rights legally binding. Some have hoped that this in combination with Art. 152 TFEU – which states that the EU recognizes and promotes the role of the social partners (compare section 1) – may prevent the ECJ from applying the proportionality test to actions of the social partners. ECJ, C-271/08 (Commission against Germany), however, has proved such hopes wrong. Anything else would have been a surprise, since the ECJ had started to judicially develop European fundamental rights since the 1970s and had even recognized the right to strike as a European fundamental right in *Laval* and *Viking*. We thank Florian Rödl for pointing our attention to *Commission against Germany*.

36 We do not claim that all expansionist lines of ECJ case law have a liberalizing impact. On this, compare Höpner/Schäfer (2012), in which we also pay attention to the two "left-liberal" lines of ECJ jurisprudence on equal treatment and on the judicially enforced transnational opening of the member states' social security systems.

dicial lawmaking is the ability of potential “court curbers” to make resistance a credible threat.³⁷ But in the light of the diversity of the member states’ political-economic interests, the threat of constitutional override becomes so small that it can be virtually ignored by the Luxembourg judges. Integration through law, in other words, profits from the two-dimensionality of the European conflict structure.

The logic of this claim becomes evident when we turn back to the cases discussed above. Let us assume that, in all three cases, all the member states were ready to agree that the ECJ’s expansionist interpretation of the fundamental freedoms limited their political discretion by identifying “legal obligations or constraints not found in the treaty texts or supported by the intentions of their drafters.”³⁸ But why should low-tax countries such as Ireland protest when judicial lawmaking constrains member states’ ability to slow down tax competition? Why should the UK engage in protest against *Centros*, since the respective line of ECJ decisions helps to spread the British limited company across the European continent? And why should Eastern European countries and the UK curb the Court for *Viking*, *Laval* and *Rüffert*, given that judicial lawmaking brings about precisely the labor market and services liberalization that the respective countries had – unsuccessfully – fought for politically?³⁹

Our claim rests on the premise that the ECJ has enough strategic capacity to evaluate the likelihood of resistance against its case law. Note that this assumption does not imply any “hyper rationality” on the part of the Court. In order to accept our interpretation, it is sufficient to assume that the judges understand that the ECJ is insulated from the threat of constitutional override when expansionist judicial lawmaking targets member states’ preferences asymmetrically. Remember that the “supranationalist” literature on the ECJ has shown that European judges have skillfully avoided resistance to expansionist case law for a long time by, for example, exploiting the shorter time horizons among politicians (compare section 2): Historically, whenever ECJ decisions drove European integration forward, they usually involved no problematic consequences in the short run, implying that national politicians were likely to avoid the costs of resistance (Pier-son 1996: 135–136; Alter 2009: 118–121). Today, we observe that decisions such as *Laval* target member states much deeper and in the short run. In our view, the reason for this is not that the ECJ has lost its capacity for strategic caution. We rather think that the increased heterogeneity of the EU has further diminished the likelihood that, beyond individual noncompliance (which frequently occurs), the member states collectively will

37 Brunell/Stone Sweet (2010); Carrubba/Gabel/Hankla (2008); Dyevre (2010: 30); Kelemen (2012). Note also that both Carrubba, Gabel and Hankla (2008) and Stone Sweet and Brunell (2012) agree on this point, but disagree on whether the threat of override is credible in the case of the ECJ, thereby disagreeing on the scale of ECJ autonomy.

38 This is the definition of supranational judicial expansionism provided in Alter/Helfer (2010: 566).

39 As a matter of fact, Lindstrom (2010: 1312–1321) shows that conflict lines behind the observations submitted to the *Viking* and *Laval* hearings were exactly those that had been drawn during the struggles over the Posted Workers and the Services Directives (on the latter, compare section 4, Political integration).

fight back, and that the judges are aware of this. This point is of particular importance for the dialog between integration theory and political economy because it implies that the political-economic structure of the EU is one of the determinants of not only the intergovernmental but also the supranational integration mode's potential – with consequences not just for the struggle between regulated and neoliberal capitalism, but also, as we conclude in the closing section, for the prospects of European democracy.

5 Conclusion: How heterogeneity shapes the democratic deficit

The struggle over European integration does not take place on a level playing field. While the project of regulated capitalism has to overcome the joint decision trap, the neoliberal project proceeds even under conditions of heterogeneous political-economic interests. As a consequence, market-enforcing rulings dominate over market-correcting policies.

These imbalances harm democracy as “a system of popular control over governmental policies and decisions” (Dahl 1999: 20). For, in a democracy, citizens must be able to choose between representatives who differ in their ideological profiles. Although party platforms do not differ on each and every item, they nonetheless need to differ enough to make choices among them meaningful.⁴⁰ If a change in the composition of parliament does not translate into a change of, at least some, policies and if governments fail to be responsive to citizens' demands, electoral competition grows superfluous and democracy hollows out. In the European Union, for reasons we have explored in this paper, changing political majorities in the Council and the European Parliament often do not translate into policy change. Hence we contend that the effect of member state heterogeneity impinges on the EU's potential to overcome its democratic deficit.

Those who are concerned about the democratic deficit of the European Union often promote institutional reforms that would bring about a further politicization of EU politics (Follesdal/Hix 2006). The underlying assumption is that politicization will generate European parties, interest groups, and social movements that organize *across borders* and that will, in turn, instigate public debates and help to build a European demos.⁴¹ However, in the cases that we have discussed, the lines of conflict do not predominantly run along ideological lines. Instead, the quest for liberalization often pits member states with high levels of regulation against those with lower levels.⁴² Even in

40 This holds true for majoritarian as well as consensus democracies.

41 See, for example, Habermas (2001: 17): “Relevant interests formed along lines of political ideology, economic sector, occupational position, social class, religion, ethnicity and gender would moreover fuse *across* national boundaries.”

42 This is not to say, however, that national actors hold uniform positions. For example, Swedish employers supported Laval in its legal fight against the union's blockade of the construction site in Vaxholm (see Lindstrom 2010: 1314).

the European Parliament, national and ideological cleavages cut across each other when core features of national production models are concerned. Both the Services Directive and the Takeover Directive showed, for example, that the two large party groups were internally divided along national lines (Crespy/Gajewska 2010; Callaghan/Höpner 2005). Under the given conditions of the political-economic conflict structure in the EU, intensified politicization might neither give rise to transnational alliances nor shape a European demos but instead intensify struggles along national lines. The more intense and salient such conflicts become, the less likely will be the emergence of European parties that are coherent enough to offer distinguishable political programs to voters. If this is the case, increasing the power of the EP does not necessarily increase the democratic quality of European decisions.

Attempts to tackle the democratic deficit by further strengthening the EP might be misguided for another reason as well. Political integration depends on qualified majority – if not unanimity – in the Council and on absolute majority in the Parliament. These super-majoritarian procedures contribute to the imbalance between political and judicial integration. While political decisions have to overcome a high threshold, judges take decisions by simple majority vote. Given the difficulties of finding political majorities, the European Court of Justice hardly has to fear legislative override, which reduces the need “to mollify those political interests responsible for compliance and legislation” (Carrubba/Gabel/Hankla 2008: 449). Hence the European Union faces a dilemma. Since the “permissive consensus” has given way to a “constraining dissensus” and legitimacy can no longer be derived from elite bargains only (Hooghe/Marks 2009), there is a need to further strengthen democratically accountable bodies such as the EP. However, in a multi-veto political system, such reforms might render decision-making even *more* difficult and thus *exacerbate* the imbalance between political and judicial integration. Of course, one way to facilitate political decisions could be to lower the majority requirements in both the Council and the Parliament. If the main cleavage in the EU divided left and right, such reforms would seem conceivable. Just as, domestically, alternating majorities or, at least, changing power relations within grand coalitions would pursue different political projects. If, by contrast, the Danes had to fear that they would constantly be outvoted by the Germans, moving from a super-majoritarian to majoritarian decision-making modus might not be acceptable for Danish voters, as Weiler, Haltern and Mayer have aptly observed (Weiler/Haltern/Mayer 1995: 12–13).

Organizations such as the European Trade Union Confederation (ETUC) have recognized that European integration suffers from the asymmetry of market-enforcing and market-correcting integration.⁴³ They tend to assume, however, that the course of European integration would change appreciably if the political balance of power changed in favor of the proponents of regulated capitalism. But, as this paper has shown, this assumption may be overly optimistic. The years between 1997 and 2003 offer an in-

43 See, for example, the documents on the 12th ETUC Congress, Athens, May 16–19, 2011 (www.etuc.org/r/1657; access 26 May 2011).

structive case in point. In this period, left of center parties held, for the first time, a clear majority in the European Council (Manow/Schäfer/Zorn 2008). Yet this phase of social democratic majority did not lead to a notable reorientation of EU policies but introduced mainly symbolic changes. In 1997, governments agreed to insert an employment chapter into the Amsterdam Treaty, which gave rise to the European Employment Strategy and, later, to the Open Method of Coordination. While these initiatives stressed the need to balance equity and efficiency, governments were still unable to agree on binding goals for social and employment policies (Schäfer 2006). Most observers today consider the achievements of the OMC as modest. And more ambitious goals were not even tackled – even *prior to enlargement* and under unusually favorable circumstances.

Today, after enlargement, it has become even more unlikely that political majorities could change the economic and social course of European integration. Given the diversity of member state interests, political projects such as corporate tax harmonization or European-wide employees' codetermination rights have little chance of being realized. At the same time, a constitutional override of ECJ decisions such as *Centros* or *Laval* is no longer a realistic scenario. As a consequence, the EU cannot help governments “to recover in Brussels something of the capacity for intervention that they have lost at home” (Habermas 2001: 14) or even serve as a shield against globalization. On the contrary, empirical studies suggest that the EU intensifies tax competition and exacerbates income inequality (Beckfield 2006; Genschel/Kemmerling/Seils 2010). The fiscal pact and the excessive imbalance procedure that were introduced in reaction to the euro crisis limit governments' political room for maneuver even more (Scharpf 2011; Höpner/Rödl 2012). In short, there is hardly a credible project of the left now in evidence to transform the EU into a polity that embeds the market, promotes solidarity (within and across borders), and reduces social inequality.⁴⁴ Voters who favor market-correcting policies at the European level have little meaningful political choice either in national or European Parliament elections. In the light of these developments, it does not come as a surprise that those who fear that their skills will be devalued as borders disappear have a higher likelihood of supporting populist right-wing parties that oppose European integration *in toto*.⁴⁵

European integration has reached an impasse. Support for further integration is declining in many member states, and there are open conflicts among governments about how to deal with the financial and euro crises, enlargement, and border controls. “More of the same” will not cure the disease. For many citizens, EU politics still seem opaque

44 Hence we side with Bartolini (2006: 47), who argues that the “contradiction between the idea of public debates and political competition on alternative mandates and the confining conditions of the Treaties seems so obvious that it is difficult to understand how the thesis of ‘politicization’ can overlook this problem.”

45 See Kriesi et al. (2008: 4–7). Fligstein (2008) suggests that there is a political split between those who benefit from the opportunities of market opening and those who stand to lose from it. While the former group welcomes European integration, the latter group has grown skeptical of the project.

and inaccessible despite efforts to make them more transparent. What is more, nation states still attract most citizens' loyalty, whereas the willingness to step up redistribution across member states is clearly limited. One way to reduce the imbalance between political and judicial integration and, indeed, to shield European integration from the tide of nationalist sentiments, would be to protect national autonomy to a larger extent than is presently being done. Integration among unequals means that a rather diverse set of national welfare and production regimes deserve autonomy protection even if the respective institutions make the transnational exercise of the European economic freedoms, as the Court says, "less attractive."⁴⁶ But this implies that the ECJ would have to interpret the European economic freedoms more narrowly, i.e., the Court would have to gradually go back to the meaning that the European fundamental freedoms initially had. At present, however, there is neither indication that the ECJ might engage in such judicial self-restraint nor a realistic path to institutional reforms that would impose such restraint on the Court. The joint decision trap makes an agreement on institutional reforms just as difficult as an agreement on policies that incur costs from some but benefits for others.

46 Remember that every regulation that makes the exercise of economic freedoms "less attractive" is a restriction and, therefore, in potential violation of European law (compare section 4, Expanding markets). Clearly, this does not mean that the Court would have to accept national regulations that discriminate against foreigners. The principle of non-discrimination is compatible with national diversity, whereas the principle of non-restriction understands institutional differences as such as market barriers (see Höpner/Schäfer 2010).

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