National Identities and Common Policies
A case study of the European Union

Nationale identiteit en gemeenschappelijke politiek:
Een onderzoek van het beleid van de Europese Unie

Proefschrift ter verkrijging van de graad van doctor aan de
Erasmus Universiteit Rotterdam op gezag van
de rector magnificus
Prof. dr. F.A. van der Duyn Schouten
en volgens besluit van het College voor Promoties

De openbare verdediging zal plaatsvinden op
donderdag 3 juni 2021 om 10:30 uur

door

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geboren te Luxemburg, Luxemburg

Erasmus University Rotterdam

Promotiecommissie

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This thesis was written as part of the European Doctorate in Law and Economics programme

An international collaboration between the Universities of Bologna, Hamburg and Rotterdam.
As part of this programme, the thesis has been submitted to the Universities Hamburg and Rotterdam to obtain a doctoral degree.

To my parents

Acknowledgements

The present book concludes my academic education and journey as a PhD candidate. The work and dedication to this book have taught me a lot about economics, institutions and about myself. There are many to whom I owe gratitude for having enriched my experience as a PhD candidate, for having taught me valuable insights and views, and for having supported as well as motivated me.

I would like to extend my gratitude to Prof. Klaus Heine, who enriched and diligently supervised my research. It was not until I have met him that my research for the present book began to take shape. The numerous discussions and exchanges on economics and policy have taught me valuable lessons on how to apply economic theory to understand the world around us. I also wish to thank my advisor, Prof. Roger Van den Bergh, for his inspiring lectures, discussions and for his comments, which have always pushed my work in the right direction.

I would like to thank the RILE faculty at the University of Rotterdam, the faculty of the University of Bologna and the faculty of the University of Hamburg. In particular, I wish to thank Prof. Michael Faure, Prof. Louis Visscher, Prof. Luigi Franzoni and Prof. Christoph Engel for their comments, discussions and support. I am very much obliged to Elena Kantorowicz-Reznichenko, Jaroslaw Kantorowicz, Chris Reinders Folmer and Pieter Desmet for their continuous encouragement, enriching discussions and comments on my work. I wish to extend my gratitude to the administrative staff of the University of Bologna, the University of Rotterdam and the University of Hamburg. In particular, I wish to thank Marianne Breijer for all her support throughout the last years.

I am grateful for the company I have had from my fellow PhD colleagues, without whom the PhD experience would not have been the same. In particular, I wish to thank the following for their continuous support and friendship: Paul Aubrecht, Giulia Barbanente, Danny Blaustein, Goran Dominioni, Dirk Heine, Bryan Khan, Shaheen Naseer, Cintia Nunes, Alberto Quintavalla, Renny Reyes and Akiva Weiss. All of you have shaped this book and me – thank you for having been there. Very special thanks go to two great colleagues and friends, whose support enabled me to finish this book: Orlin Yalnazov and Jörg Peschner – thanks for the discussions and the feedback when I was finalizing this work – it would have been difficult to complete this book without you. I cannot forget about the person, who sparked my interest in Law and Economics during my Master studies, Prof. Wolfgang Weigel – thank you for your inspiration.

There are many more people who influenced my work and who motivated me. I apologize to those whom I did not mention here. I finish, by extending my gratitude to the most important ones – my family. My brother, his wife and kids – Gabriel and Amalia, thanks for all the cheerfulness. A very unique person to whom I am the most grateful is Sandra – thanks for all your love, support, understanding and patience. Finally, I wish to thank my parents for all they did for me – to them I dedicate this book, in loving memory of my dad.

Contents

List of Abbreviations

ALMPS	Active Labour Market Policies
AMECO	Annual Macro-Economic Database of the European Commission
CME	Coordinated Market Economies
CPR	Common Provisions Regulation
CSR	Country Specific Recommendation
EAFRD	European Agricultural Fund for Rural Development
EC	European Commission
ECB	European Central Bank
ECJ	European Court of Justice
EES	European Employment Strategy
EMCO	Employment Committee
EMU	European Monetary Union
EP	European Parliament
EPSCO	Employment, Social Policy, Health and Consumer Affairs Council
ERDF	European Rural Development Fund
ESF	European Social Fund
ESI	European Structural Investment Funds
EU	European Union
GDP	Gross Domestic Product
ILO	International Labour Organization
LME	Liberal Market Economies
MFF	Multi-annual Financial Framework
MME	Mixed Market Economies
OECD	Organization for Economic Cooperation and Development
OMC	Open Method of Coordination

PIAAC	Programme for the International Assessment of Adult Competencies
PISA	Programme for International Student Assessment
SGP	Stability and Growth Pact
SPC	Social Protection Committee
TFEU	Treaty on the Functioning of the European Union
UK	United Kingdom

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Chapter 1

Introduction

This study discusses the need and prospect of common European labour market and social policies and the impact of national identities on their political feasibility. The ties and interdependencies between European Union Member States have grown strongly over the last decades. The Member States share a common market. Cross-border labour in the EU has grown discernibly: the European Commission (2017a) reports that workers increasingly work outside of their country of citizenship. Although mobility remains low in absolute terms, especially relative to the USA, the trend is upward.

What of regulation? Many of the institutions that govern markets are directed at the EU level. Industrial relations remain a predominantly national concern. Although there have been some efforts to coordinate education and social dialogue at the level of the EU, national governments are still very much in charge. An EU whose focus lies exclusively on economics, with no regard for other state capacities, might cause friction between Member States. EU economies have different specializations, different degrees of competitiveness and different structures. Some labour markets are inclusive; others are not. Some innovate a lot, others, not so much.[1] Before the Great Recession of 2009, some Member States restrained wages. In others, wage growth outstripped productivity gains. Some have wage bargaining systems which allow for flexible adaptation to new realities and wage compression. In others, collective bargaining does not work like that. Such differences can amplify competitive advantages. Some commentators are of the view that differing levels of competitiveness cannot be easily reconciled under one common currency and therefore call for more support by the EU. The importance of the EU has increased, especially after the outbreak of the COVID-19 pandemic. The present study uses a law and economic approach to highlight the relevance of common EU laws and policies. The study discusses how cognitive biases of voters may pose potential hurdles to effective EU law making and provides suggestions to overcome these hurdles.

1.1 Background of the study

This study applies a law and economic approach to infer the optimal distribution of policies and law making between the EU and the Member States. This discussion has gained prominence, since the Great Recession. Scholars often exhort the virtues of solidarity in order to tackle the negative consequences of the latter (Nicoli, 2017; Risse, 2014). Proponents of common EU policies advocate a more social Europe and more risk sharing mechanisms, like common unemployment insurances. The idea is that, in times of economic crisis, the EU should support Member States to maintain macroeconomic stability (Krugman, 2013; Stiglitz, 2016). Other means for the EU to pursue macroeconomic stabilization relate to social and employment policies. In addition to macroeconimic stabilization, Stiglitz (2016) proposes a solidarity fund to support countries in distress. In times of economic distress, Member States need to be flexible.

[1] See chapter 4 for a discussion about different structural issues across states.

When unemployment surges, flexibility depends on labour-market structure and flexibility. Both Jean-Claude Juncker, European Commission president from 2014 until 2019, and Ursula von der Leyen, elected Commission president in 2019, favour common social and employment policies. Juncker promised to boost jobs and declared himself a fervent advocate of social fairness.[2] Von der Leyen, in her political guidelines[3] for her mandate as Commission president, gave a new impetus to this discussion. She proposed a European minimum wage initiative or an unemployment benefit reinsurance scheme. Contemporary policies are a product of history: they reflect national traditions and preferences over labour market and social policies.[4] This complicates the development of common EU policies, even though all acknowledge that a common framework can resolve collective action problems and thus benefit everyone.

Increasing integration has led to increasing movement across the EU and, with this, to increasing use of foreign labour. The movement of workers has made some states suspicious about unfair competition within the labour market and a potential deterioration of labour standards within the EU. Among others, ECJ decisions like the Laval case[5] illustrate the latent tension between market integration on the one hand and social and employment laws and standards on the other. Additionally, there is a suspicion that some countries set employment standards opportunistically, so as to attract foreign companies. A race to the bottom could result is self-evident.

Competition and specialization should increase efficiency and innovation, while depressing prices and, ultimately, maximising the gains of trade. These goals sometimes conflict with social aspects of labour-relation systems. There are also frequent frictions between

[2] https://ec.europa.eu/commission/sites/beta-political/files/juncker-political-guidelines-speech_en.pdf (last access: 17.02.2020)

[3] https://ec.europa.eu/commission/sites/beta-political/files/political-guidelines-next-commission_en.pdf (last access: 17.02.2020)

[4] See chapter 4 for an overview of the EU systems.

[5] Case C-341/05.

Member State economies, which are attributable to structural diversity. The European Commission strives to eliminate conflicts, safeguard standards and to establish a level playing field between the Member States.[6] Questions about the level of policy prerogatives are predestined for a law and economics analysis. Law and economic scholars draw on economic theory of federalism, which has done much to identify the criteria under which common policies can succeed (Hanke & Heine, 2016). In addition to this discussion, the present study also considers what laws are necessary to solve issues in the EU labour market.

Economists argue that the case for EU social policies is rather weak (Alesina, 2005c, Tabellini, 2003). Different countries have different social and economic models, reflecting different preferences about redistribution, labour market regulation and modes of decision making. This causes differing national political priorities, which hamper consensus or preclude it altogether. Furthermore, national and regional governments are 'closer' to citizens and can therefore assess the needs of the population better than a supranational entity.[7] These considerations provide some general, normative, criteria for centralization. For example, higher-level administration should take responsibility when economies of scale can be achieved, or when externalities can be internalized (Oates, 1999).

Such results typify so-called first-generation theories of the economics of federalism (Oates, 1999; 2004). Second-generation theories focused on political systems, institutions, and the incentives for decision makers (Oates, 2005). However, they neglect culture and territorial attachments. Economists, for the most part, do not differentiate

[6] See for example the discussion on the Posted Workers Directive in section 2.6. Another, more recent example is the Transparent and Predictable Working Conditions Directive (Directive (EU) 2019/1152), which grants workers, among others, rights to receive information about their employment before starting a new position.

[7] According to these models, electorates want to see their preferences satisfied and vote accordingly (Osbourne and Slivinski, 1996).

between the state as an administrative body and the state as representing a collective of people sharing an ethnic and civic background. In many theories, a nation is considered as an administrative entity, without reference to historical developments and cultural patterns. For example, in describing the optimal size of nations, Alesina et al. (2005) explicitly use the terms 'nation', 'state' and 'country' interchangeably to describe a sovereign state, with its administrative functions.[8] However, the non-administrative traits of a nation can have psychological impacts on voters, politicians and their decisions. Administration aside, the state provides non-pecuniary incentives and disincentives, which economic theories neglect. Accordingly, these theories fail to account for the impact of national and territorial identities on common policies. Non-rational behaviour has been shown to impact economic decisions and it can be assumed that it will also impact federal systems (Heine, 2018). First generation theories provide answers to normative questions about the centralization of public goods - what policies and laws should be decided and implement by a central authority. Second generation theories provide answers about the optimal implementation of public goods - what is the optimal design of laws and policies so that they will be respected by citizens as well as their representatives. Both theories are based on the assumption of rational decision makers, but behavioural economics has demonstrated that individual decision making deviates from rational behaviour. Accordingly, the economics of federalism also merits to be supported by a behavioural approach (Heine, 2018).

Many economic theories highlight that non-pecuniary incentives impact decisions. In economics, rationality means that individuals are fully aware of their desires, that they rank each desire according to fixed preferences and that they possess the cognitive capacities to satisfy them. In actuality, rationality is bounded, owing to limited cognitive abilities (Kanemann, 2003). Economists have also argued that individual behaviour

[8]See Alesina et al. (2005), p. 3., where this is stated explicitly.

is guided by social norms, such as a preference for equity over welfare maximisation (Fehr & Schmidt, 1999). These norms relate to the social context in which people interact, which implies that the importance of norms varies in different contexts (Akerlof & Kranton, 2010). Heine (2018) discusses that as a consequence of the behavioural economics research stream that a behavioural approach to federalism economics must follow. Such an approach needs to be informed by empirical insights about individual behaviour in the respective context. This study explores empirical insights from the international relations literature to define such a behavioural approach and thereby aims to contribute to the development of a third generation theory to federalism economics.

In July 2019, the Commission President Ursuala Von der Leyen, promised to table several initiatives to make Europe climate neutral, to make it fit for the digital age and to guarantee each and every European a decent living, thus protecting the European way of life. Such initiatives have become even more urgent in the the aftermath outbreak of the COVID-19 pandemic. It increased the urgency for new EU policies and support to its Member States. Proposals of laws to guarantee a decent minimum wage could affect traditional national systems. However, different electorates view such policies differently. Preferences of wage regulations are heterogeneous and this makes it complicated to find common policies. The national practices of wage setting also shape the views on how things should be done, and they shape common attitudes and expectations. Hence, common practices and institutions form the basis of a collective identity. Collective identities define selfhood. They can even prescribe behaviours. Psychological and economic experiments have shown that an unremarkable common trait (a marker), if shared by a group of individuals, suffices to generate in-group favouritism: individuals act more favourably towards group members than toward outsiders. In an economics experiment, Chen et al. (2009) built groups based on a similar taste for art, and showed in-group favouritism. In the international relations literature, nationalities are seen as such markers. The present study adds to the law and economics literature about the optimal design and implementation of federal structures, by extending the behavioural assumptions of the rational actors model with insights from identity economics. The international relations literature provides concrete insights, which will be among others used to this end.

A marker, providing for a group identity is national identity. A national identity constitutes a category and citizens feel a stronger sense of solidarity towards compatriots than towards citizens of other countries. Risse (2016) highlights that nations are 'an imagined political community - and imagined as both inherently limited and sovereign'.[9] They are imagined because, even in the smallest nation, no individual can know all their fellow nationals (Anderson, 2006). By establishing physical boundaries and borders, nations define citizens and 'outgroups' (Fligstein et al., 2012). Differentiations of this kind form the basis of collective identities, which are a categorization of social identities (Kohli, 2000). Collective identities are strategies that groups adopt to differentiate themselves from other groups. Considering the insights from social psychology and identity theory (Tajfel & Turner, 1986), nationality can have strong implications for (political) decisions and views. This facet of identity has so far been overlooked in economics. Yet, such identities may provide a further source of incentives to voters and politicians to take certain actions rather than others. This in turn can impact the design of law and policies.

A national identity can be defined as a collective identity with a territorial reference point. The EU, together with its policies and institutions, can be perceived as a threat to national and regional identities. Accordingly, support for the EU depends on the compatibility of national (or regional) identities with an EU identity, and the EU's

[9] See Anderson (2006), p.6.

values and norms (Brigevish, 2016; Mols, 2009). This mode of analysis provides a better understanding of the impact of nationalism and national identities on EU policies, as well as viable adaptive action. The incorporation of such ideas into federalism economics can augment their explanatory power.

Nowadays, the Member States' economies are strongly interwoven. The EU Parliament reports that in 2016 64 % of all EU-28 goods exports went to other EU Member States.[10] Considering that Member States export about 46.8 % of their total production,[11] a considerable share of demand for individual Member States' products depends on other Member States. Recent estimates indicate that citizens across the EU have, on average, a net benefit from the access to the internal market of about 840 Euros per year. At the same time, EU Member States compete against each other in this market and have to offer their products at the lowest possible prices. Unit labour costs, the costs for labour per unit produced, are among the main determinants of competitiveness. Unit labour costs are determined by wages and productivity.

Wages and productivity differ across Member States.[12] Before the introduction of the euro, some economies used currency devaluation to improve price competitiveness and to stimulate demand for their products and services. Other Member States kept inflation low and their currency strong, in order to forestall wage increases.[13] Member States also exhibit different degrees of flexibility in the labour markets to adapt wages and to adapt to changing economic realities in times of economic downturns. Moreover, different Member States have different employment frameworks, which can lead to frictions in the internal labour market.

[10] https://www.europarl.europa.eu/thinktank/infographics/tradeflows/public/inside.html (last access: 12.03.2020)

[11] Eurostat indicator (tet00003) 'Exports of goods and services as a percentage of GDP, value fr 2016.

[12] See Chapter 2 for a more thorough discussion of the respective mechanisms described in this paragraph.

[13] As it was the case in 1990s in Germany, for example.

Several problems result. First, for the less competitive Member States, market integration and free movement may amplify their disadvantages – labour, as well as other factors of production, flow to the more competitive Member States. As resources dwindle, pressures mount. Thus, the single monetary policy removed one lever through which Member States could enhance their competitiveness. Economic integration added to the strain. The Great Recession and its shock amplified the difference. Given the economic interdependencies between the Member States and given that the EU is sometimes better-placed to act, its mandate in labour and fiscal policy should be expanded. How shall the EU institutions further develop the EU legal framework to reduce frictions and improve its reactivity against adverse economic developments? This study aims to identify specific areas in which expansion is necessary, with the aid of the economics of federalism. It will then go on to explain how national identities may impact integration and the establishment of common laws.

The present study is a study of the impact of national identities on social and employment policies in the EU. To this end, it will first provide an overview of developments within the EU since 2008, so as to locate the relevant policies within the general macroeconomic policy framework of the Union. The study will then discuss how national identities are related to different aspects of these policies. The initial analysis proceeds along the lines developed in the previous literature. Since current theories do not allow for an analysis of national identities, the book also develops a theoretical framework that introduces behavioural, national-identity components to the economics of federalism. Hence, the ambition of the present book is two-fold. First, it overviews potential EU labour and social policies and supplies new policies with an economic rationale. Second, the book develops new economic theories while reassessing the predictive usefulness of the old. Thereby, the present study provides new insights and a new framework to law and economics scholars studying the optimal design and implementation of federal structures. It will apply this to EU laws and policies and provide insights relevant for EU labour law and social policies. At the same time, the application to EU laws allows to test the framework. The outbreak of the COVID-19 pandemic has shown that the respective questions are still of particular importance.

1.2 Research questions

Any cooperation in the policy realm between countries, regions or municipalities faces basic obstacles, such as differing agendas, views, institutions and views on what is acceptable. These factors determine the political acceptance of policies. The cultural, political and economic diversity of Europe can inhibit the creation of common policies within the EU.[14] Simply put, differing cultures explain different institutions, as well as different political and economic outcomes. This, in turn, calls for different political responses, and the different political responses obstruct consensus among countries.

It is trivial economics that policies should be implemented in areas where the potential benefits are high and where there are no (or only few) differences in political views. Considering the diversity of national social models, economists would argue that social policies should be shaped predominantly at the national level. The EU, however, has enacted many social policies and laws. Some observers are of the view that its involvement in this area is too extensive (Alesina et al., 2005c). At the same time, anti-European sentiment and Euroscepticism are surging. In Law and Economics, debates about European policies revolve around the economics of federalism (Van den Bergh, 2017). These theories rest on the assumption that voters, as well as politicians, are driven by the maximization of pecuniary benefits. Thus, economic theory sees the borders of juris-

[14]Measures of heterogeneity, linguistic or ethnic, were found to be related to be negatively related to the provision of public goods. See Spolaore (2013) for a review.

dictions determined by a trade-off between heterogeneity of preferences and efficiency gains from the size of the jurisdictions, due to economies of scale for example.[15] In this analysis, culture, values and norms, forming the basis of national identities, are only taken into consideration implicitly. Historical conflicts, as well as ideological and political considerations, other than purely economic interests, are left out. This poses a challenge to law and economics scholar of nationalism. A methodology needs to be developed allowing to relate the analysis about the impact of national identities to the existing literature. The present book answers the following research questions: How can national identity be integrated into an economic theory of centralization? Can this analysis explain any potential discrepancies between normative prescriptions for the allocation of policy prerogatives in the EU and their actual allocation? Considering national identity, how do the predictions of economic theory change? In light of such considerations, would differentiated integration be a more viable approach for the EU?

To answer these questions, the book proceeds in several steps. The primary aim is to provide an overview of the composition of the EU and to assess the usefulness and necessity of EU-level social and labour market policies. Can they be justified as a matter of economic theory? To answer this question, the second chapter supplies a general schema of EU integration, the compatibility of the different Member States' economies and potential frictions between the Member States. This discussion will be illustrated by reviewing the Great Recession and its triggers. Chapter 2 will discuss the role of the EU in smoothing potential incompatibilities. Secondly, the chapter will review the importance of employment and social standards in EU policies and their maintenance in the internal market.

After introducing the economic theory of public finance, the third chapter will discuss

[15] Jurisdiction describes here the territory in which a government exerts power.

different branches of public policies: macroeconomic stabilization, redistribution and resource allocation. Next, the chapter introduces EU social and employment policies and compares them to the prescriptions of the public finance literature. The focus will be on the policies which the second chapter identifies as being of high relevance to the present book: (i) EU spending on social policy, (ii) social policy coordination and (iii) employment law. The two underlying questions of that chapter are: (i) Can EU social and employment policy be justified by economic theory? (ii) How can policies be agreed and implemented effectively and efficiently? The analysis will show that the benefits and costs of common policies – and with these the likelihood of their creation - depend to a large extent on existing institutional frameworks and the political streams of the Member States. In order to get a grasp of preferences over such policies, chapter 4 reviews existing national institutions and structural issues. From that, the analysis derives a description of the preferences of a representative citizen over employment and social policies. Chapter 4 aims to highlight commonalities and differences between Member States on these dimensions. These insights will then be used to discuss national interests in chapter 5.

Chapter 5 analyses the political economy of cooperation between countries. The central question of the chapter is this: what makes common policies and institutions politically acceptable and sustainable? The question is addressed from the prism of public choice theory. The analysis is applied to the EU policies reviewed in chapter 3. A game theoretical approach is adopted to define self-enforceability. Finally, some discrepancies between the economic theory and actual policies are presented, and some explanations are advanced.

The analysis of Chapter 5 discusses the explanatory power of existing economic models and reveals some of their limitations. This discussion calls for a new generation of economic models to enable an analysis of the impact of nationalism on centralisation.

To inform that model, chapter 6 reviews the literature on nationalism and identity economics literature. The latter underlies the methodological approach followed in chapter 7.

Chapter 7 finally derives a behavioural model of federalism, which is based on the model of chapter 5. This model formalises the impact of nationalism on centralization within the EU and on the stability of supranational institutions more generally. The results are then compared to the results of the baseline model in order to highlight the advantages of the former. It is then applied to EU social and employment policies. Eventually, this theory will explain the need for differentiated integration. This chapter follows the call for a behavioural approach to the economics of federalism (Heine, 2018).

Chapter 8 concludes by discussing the broader implications of the theory for EU integration – what are the implication of national identities on EU policies and would multi-speed Europe fare better than what we have now?

This study has been written before the outbreak of the COVID-19 pandemic. The importance of the related political and socio-economic developments have made it necessary to put the results of this study in perspective of these new developments. To this end, an epilogue reviews the economic developments following the epidemic and discusses the national and European political reactions. It highlights the role of national identities and values and how the pandemic has changed the Member States' positions vis-a-vis common policies.

1.3 Methodology and concepts

The study undertakes a case analysis of European integration to discuss the benefits of cooperation and the circumstances in which it can be achieved. It takes a law and economics approach and applies economic concepts to discuss the need for - and potential of common EU policies and law. A broad view is taken of European integration, which is understood as political cooperation between EU states to create a common market as well as political institutions. The analysis may also refer to common policies, as parts of this integration process. The term 'policy' is at times used to describe legislative acts, such as Directives or Regulations, as well initiatives under which public funds are invested into different forms of capital. It becomes clear that the creation of a common market has put companies from different EU countries in stronger competition with one another, which has implications for social policies across Member States. The term 'social policy' describes the enactment of workers' rights and the maintenance of income security which, by increasing skills and through redistribution, promotes social inclusion and a minimum standard of living (Daly, 2017; Wagner et al., 2006; Midgley, 2009). Across the EU, the policies of different countries are characterized by values, such as democracy and individual rights, free collective bargaining, market economy, social welfare, equality and solidarity (Barnard et al., 2012). The commitment to these values is denoted by the term 'The European Social Model' (Mosher et al., 2003). Given that the focus and concepts used differ across chapters, the following section reviews the concepts on a chapter-by-chapter basis.

The second chapter will discuss common EU policies and the relevance of social policy within the EU. The chapter is a review of academic and policy literature on the EU and the EMU. It discusses the balance between EU economic and social policies. The chapter will summarize some criticisms of EU integration. It will first show that the EU is composed of diverse economies. As noted earlier, different labour market institutions, such as employment laws, allowing for different degrees of wage restraint, necessitate different monetary and fiscal policies and lead to different trade balance outcomes. The chapter will review the literature and show the interlinkages between different national economies. It discusses how incompatibilities between Member States' economies may amplify economic shocks. The chapter will review different proposals to overcome the short-term effects of shocks, as well as the causes of long-term unemployment and low growth. The chapter also shows what role the EU plays in safeguarding social and employment standards within the Member States, through EU law. The chapter outlines the literature on the economics of federalism, on which the following chapters will draw. In that literature, the essential arguments for the centralisation of common policies, are externalities and interdependencies. The discussion suggests that, within the EU, the case for social policy is limited. Although the number of policies is increasing, EU integration seems to favour economic policies and sound public finances over social policies. The chapter will highlight EU policies, which can broadly be related to the three activities of the government identified by Musgrave (1959): economic stabilization, redistribution and resource allocation. The policies which are studied belong to the realm of EU social and employment policies and these will be introduced in chapter two and be further discussed in the subsequent chapter. Chapter 2 shows that structural policies are needed to increase labour market flexibility and economic competitiveness. This study acknowledges that across the EU the economic downturn(s) over the years 2008 to 2013 has been a double dip recession, with an improvement of the economic situation over the years 2009 and 2010, followed by an economic downturn over the years 2011 to 2013. When discussing the economic crisis, starting in 2008, chapter 2 and subsequent chapters refer to the great recession between 2009 and 2013.

The EU coordinates national policies under the process of the European Semester, a macroeconomic policy coordination cycle, and the Open Method of Coordination (Harcourt, 2013; Zeitlin, 2009). Coordination here denotes the discussion of policies within different EU fora, as well as the development of recommendations by the EU. The analysis will also refer to social investments, which include unemployment and social benefits, as well as investments into labour market policies and other projects intended to increase welfare of the citizen who are not employed or in any other economically productive engagement. Broadly speaking, such public spending falls under the remit of fiscal policy. However, the distinction between fiscal and social policy is drawn, as the analysis mostly focuses on spending related to social policy. Additionally, the analysis includes a discussion of employment and social legislation (Directives and Regulations) related to the labour market or the welfare state.

The third chapter will deepen the theoretical discussion introduced in chapter 2. It proceeds in several steps. It will first outline basic concepts in traditional public finance and then link them to centralization. This will equip the analysis with the necessary normative framework to identify the conditions under which centralization becomes desirable. That analysis is then transposed to specific issues within the EU.

Chapter 4 provides a framework to assess economic and political interests at the national level.[16] This chapter draws on the political economy and institutional economics literature about labour market and economic institutions, the so-called varieties of capitalism literature. This chapter provides a stylized topology of EU member states, alongside an analysis of macroeconomic indicators, such as productivity and the labour market. This topology describes the similarity between Member States in labour market policies, structural issues, as well as labour market institutions, the welfare state, and others.

[16] Chapter 4 is based on a co-authored working paper, entitled 'Institutional determinant of Skills Matching'.

The chapter provides the foundation for chapter 5, which attends to the political economy of centralisation. The results of chapter 4 provide an illustration and description of a stylized citizen of the respective Member States.

Chapter 5 relates to the political economy of centralization. It will discuss the behaviour of governments and the decision-making process leading to efficient and stable centralization (or its failure).[17] The chapter will draw on models of centralization which take a game theoretical approach in order to establish the basic conditions for stable centralization. The chapter will model a representative democracy and highlight how the preferences of citizens have to be pooled in order for centralization to occur and for self-enforcing supranational institutions to emerge. The predictions from the model will be compared to EU redistribution policies, the coordination of national policies and EU (labour market) regulation. This chapter will pin down the effect of political interests on the centralization of common policies, and in particular their effect on EU policies related to employment and social affairs.

The theoretical predictions of the federalism economics are not always in line with political reality. Heine (2018) discusses that behavioural economics repeatedly has shown that individual behaviour does not always follow the assumptions of the rational actors model. Yet, such insights have yet to be reflected in the federalism economics. To this end empirical evidence needs to be gathered to inform the discussion. To this end, anecdotal as well as scientific evidence presented throughout the study will highlight one explanation for the mismatch – national identity. Chapter 6 reviews literature from the field of international relations to inform the discussion. It will provide a definition of nationalism and national identity and discuss how they affect individuals. The chapter will then relate the literature on nationalism to the literature on identity economics.

[17] See Loockwood (2006) for a review and comprehensive definition of the literature.

This will frame the incorporation of national identity into the political economy model from chapter 5. In turn, this permits an analysis of the effects of nationalism on centralization. A recurrent motif concerns the allocation of policy powers across levels of governance. Following the economic literature, this is conceptualised as a choice between assigning policies to a centralized government or to a local agency (Inman & Rubinfeld, 2017). The aim is to uncover the consequences of national identity for the design of common policies. In the analysis, national identity is defined as an 'individual's intensity of positive attachments to his or her nation'.[18] Thereafter, the focus is narrowed down to a specific territory. Such territorial identities, may develop as 'people who already share a common location establish a social network'.[19] There are several layers of territorial identities: they can be regional, national or European. Each of these levels can affect the likelihood of identification with a group defined at another level (Mols, 2002).

Nationalism has been described as a cultural narrative which highlights the factors that keep the individuals belonging to a nation together, while separating them from others. Commonalities include historical background, religion, beliefs or views on the economy and the political system (Fligstein, 2008). Kelman (1997) defines nationalism as the ideology that provides the justification for the creation of a state that accommodates a group of people. National identity is this group's definition of itself qua group, that is, the individuals' perception of being bound together by enduring characteristics of the kind just enumerated. Nationalism and national identities can be conceptualized on a civic or on an ethnic basis (Fligstein, 2012; Reeskens, 2010). If common historical roots, ancestry and native culture are emphasised, then identity takes on an ethnic conception. If, conversely, a common political entity with homogeneous laws is emphasised, then

[18] Carey (2002), p. 391.
[19] See Hechter (2000).

one speaks of a civic conception of identity. Depending on the conception, different behavioural effects are observed – a civic conception of identity is more inclusive than the ethnic conception. The analysis in chapter 7 refers to the civic conception of national identities. It portrays national identities as a bundle of shared national traits, values and norms, that is, formal and informal institutions, which are part of a national identity.

Chapter 7 will outline a third-generation, behavioural theory of federalism economics. Building on the review in chapter 6, it will extend the model of centralization presented in chapter 5. In essence, an identity component is added to the utility of the model's political decision maker. Combining models of centralization with identity economics, chapter 7 will identify mechanisms which play a role in centralisation decisions and policy design. Those mechanisms will then be compared to the actual policies of the EU. The previous chapters supply a theoretical framework, based on which earlier policy developments are studied. That theoretical framework is used to discuss the new Commisson's plans.

1.4 Contribution to the literature and policy relevance

In her political guidelines, Von der Leyen proposed to make the European economy greener while increasing competitiveness, ensuring high employment and a level playing field between the member states. This requires new technologies, necessitating investments into research and new skills. Some countries may find it easier to adapt their economies than others. The pursuit of these goals is thus also likely to pose challenges to economic and social cohesion. While the 'Green Deal' focuses on climate neutrality, Von der Leyen also proposed initiatives to ensure decent incomes and to create unemployment benefit reinsurance schemes.

This study will use economic theories to discuss the role of the EU in this endeavour, especially in light of nationalistic tendencies. Political discourse has recently begun to acquire increasingly populist-nationalist overtones, with national interests prioritised over those of neighbours. Populist and right-wing parties have become more popular in many EU member states, like Italy, Hungary, and Austria, among others. In December 2017, the Austrian conservative party ÖVP formed a coalition government. This study uses economic theories to account for these nationalist tendencies and to explain their impact. A central issue is the extent to which identities affect the feasibility of common policies and the conditions for their enactment and the present study takes an interdisciplinary approach to explain how national identities impact EU policy making. Over the last decade, this has become particularly relevant.

In 2017, the European Commission published a reflection paper on the future of the EU,[20] describing several scenarios for its future. Some of the scenarios envisage differentiated integration, whereby some Member States agree to do more together, while leaving other States out of these common policies. Other scenarios involve carrying on with the policies the way they are handled now. Another scenario could be that the existing policies remain untouched and that those who want more do more, while other Member States are left with the existing polices. An additional option could be to do much more together. Which one of these is the most viable option in the context of increasing saliency of national identities? Across its chapters, the study will discuss the implication of the respective theories for existing EU policies. These policies relate to coordination, cohesion and minimum employment standards and the respective laws. The present workwill discuss the insights for such policies and discuss their relevance. In particular, the concluding chapter will discuss whether a more differentiated approach to integration could be viable. The epilogue provides an additional discussion of the

[20] See European Commission (2017b).

need for common EU policies in light of the outbreak of the COVID-19 pandemic. It discusses the political economy of common EU measures to stabilize the economy in light of the results of the present study.

The analysis is based on the economics of federalism, which provides a framework to find an answer to these questions. Accordingly, when there are inter-jurisdictional inefficiencies,[21] a central authority should regulate the activity in question in order to internalize its costs or benefits (Olson, 1969). This is the focus of traditional, first-generation theories of fiscal federalism. They evaluate multi-level governance institutions in terms of their impact on efficiency and distribution.[22] The government is treated as a benevolent institution which seeks to maximize social welfare. The theories emphasize the role of public sector

Modern, second-generation theories assume that decision makers are self-interested and that political institutions might initiate goals which are not in line with the maximization of citizen's welfare. Second-generation theories attempt to specify a constitutional design which incentivises decision-makers to adopt welfare-maximizing policies. An appropriate design can contribute to the solution of a fundamental dilemma: the government must be strong enough to protect and enforce property rights, while committing not to encroach them and to safeguard free markets (Weingast, 1995). Sufficient powers must be allocated to the local government to make policy. At the same time, the central government should have sufficient power to safeguard free movement, as well as a commitment not to bail out the local government. These are some of the conditions for federalism to be market preserving and self-enforcing. Free movement implies that the local governments have to accommodate the preferences of their electorate, while

[21]See Inman et al. (2014).
[22]See Oates (1999, p. 1137).

decentralization reduces the influence of the central government and incentivizes both levels to maintain functional markets. To this framework, the present study adds a theoretical layer, to take into account the impact of national identities, to get a better understanding of EU politics when applying federalism economics.

The EU comprises diverse national economies, which are now governed by a single monetary regime. Some argue that the financial crisis and the economic downturn that followed were caused by this diversity. The great recession starting in 2008 showed that some Member States need to become more competitive. At the same time, systems competition between Member States to might lower social and labour standards. Some centralized policy is thus needed. The study will discuss these issues. Comparing existing policies to the normative and positive prescriptions of the economics of federalism, different chapters will assess whether EU initiatives in the social policy realm are justifiable. They can stabilize macroeconomic outcomes and maintain social and employment standards through appropriate EU laws. Their effectiveness, however, is limited by underfunding. As will be seen, one of the potential causes is a lack of solidarity between the citizens of different Member States. One conventional explanation for underfunding and inefficient laws revolves around divergent preferences and strategic behaviour. The acceptability of policies and institutions depends on the benefits from integration (Hooghe, 2004), which are usually higher when the proposed policies or institutions resemble the incumbents. Cultural, linguistic and ethnic differences have often been linked to preference heterogeneity, political dissent, and integration failures.[23] More recently, Alesina et al. (2017) found that cultural heterogeneity within some EU Member States is higher than that between Member States, considering cultural core values. They therefore suggest that it is not (only) preference heterogeneity which hampers common EU policies, but also nationalism.

[23]See Spolaore, 2013 for a review of the discussion.

The foregoing review serves to show that although federalism economics provides explanations to many of the development in EU politics, aspects such as non-pecuniary incentives are not taken into account. Identity, and national identity in particular, provide incentives beyond purely material gains. Therefore, the present work studies the potential impact of nationalism and how it impacts EU policies. It aims to understand how it affects EU policy-making. Nationalism is the cultural narrative of a nation – and national identity is the group's definition of itself, based on this narrative. Identification with a group engenders a cognitive process whereby individuals are compared to one another and assessed on specific attributes, with a view to being assigned to different groups. This assessment can affect the behaviour of an individual, depending on group allegiance and proximity to other groups (nations). As a result, individuals become more or less willing to accept some policy outcomes. Social psychology has shown that social identity affects preferences over redistribution (Shayo, 2009), tax compliance (Hartner et al., 2010) and cooperation within and between groups (Chen et al., 2002). Economists have studied this for different contexts.[24] However, identity has not yet a strong theoretical foundation in federalism economics. Therefore, the main contribution of the present study is to extend current economic theories to take into aspects related to identity. The study thereby aims to add to a third generation theory of federalism economics (Heine, 2018). By applying this framework to EU policy, the study contributes to discussion on differentiated integration and highlights how national identities impact EU policy, in particular those related to employment and social affairs.

From a methodological standpoint, the question is how to integrate these insights into the theories of federalism? What behavioural assumptions should be used to extend the rational choice model? Within the theoretical framework, freedom needs to be restricted, while tautology must be avoided. Therefore, the methodological question is

[24]See for example Akerlof and Kranton (2005; 2007; 2010), Shayo (2009); Chen et al. (2009).

how to enhance the existing frameworks without surrendering their predictive power or logic. Identity economics blends insights social psychology with the theories of fiscal federalism. Akerlof and Kranton (2000) have developed a method to determine how social context impacts individual decisions. Standard utility functions are enhanced by identity utility. This allows reasonable inferences to be drawn about the ways social categories impact individuals' perceptions and decisions. By using identity economics, this study extends the model of federalism to explain the effects of nationalism on EU policies and institutions. The analysis will show the conditions under which nationalism impacts centralization.

1.5 Limitations of the study

The foremost aim of this study is to explain the impact of nationalism on EU policy design from an economic perspective. In other words, the study will provide a behavioural approach to federalism. The discussion of EU policies should be considered a case study. The study does not aim to be a comprehensive analysis of EU social policy, but (i) to identify relevant problems within the EU and (ii) to show how theoretical insights can solve them. To this end, the study applies economic theory to analyse EU employment and social law, without aiming to establish an exhaustive overview over the development of that EU policy realm. The repsective discussion should be considered as case studies to illustrate and develop the theoretical framework.

The analysis is mostly theoretical. It does not aim to quantify the potential benefits of policies, an exercise which is as complicated as it is inaccurate. For this reason, the approach here is welfarist, in line with the law and economics tradition. The analysis will then go on to discuss the political feasibility of theoretically beneficial policies. According to economic theory, a central government may encroach on local agencies, which is inefficient. As the goal of the analysis is to discuss the allocation of policy prerogatives at the central level, this problem falls beyond its scope.

Chapter 2 aims to provide a broader picture of the issues uncovered by the Great Recession. It is not intended as an exhaustive review of the literature on the monetary and the economic union. An institutional view on the macroeconomic conditions within the EMU is taken, and social and employment policies are positioned within. The study does not discuss the development and completion of the EMU, but aims to provide general insights on EU policies and laws related to macroeconomic stabilization and the labour market. Chapter 2 reviews macroeconomic theory to provide a general picture of the EU context and different interrelations. This overview does aim to be exhaustive. The literature discusses the need for many other kinds of reforms, related the product market, among others. For reasons outlined above, the review here will focus on social and employment policies. One goal of the study is to investigate how national identity impacts the formation of common policies. Another goal is to determine whether identity can explain the observation that EU employment policies are in excess of what economic theory deems efficient. The study highlights a few potential policy options. However, it does not reflect on the ideological discussion about the desirability of market regulation. The analysis assumes an ordoliberal view, according to which there should be free market competition, but public authorities need to frame it. Much of the discussion in Chapter 2 implicitly reflects these views. However, the trade-offs between austerity and public spending are not discussed in detail. The study also does not discuss optimal currency theory. The aim is to give a brief overview of policy where the EU could make a positive impact, discuss the logics of integration from an economics perspective, and show how identity can change outcomes.

Chapter 7 draws on identity economics in order to discuss how psychological borders may impact the creation of common policies. To do this, it draws on the literature on nationalism and international relations to explain and define the specifics of national identity. The thesis does not give a comprehensive review of that literature. The goal is not to explain where national identities come from, but rather to discuss their effects on political decisions in the context of EU policies. The cases studied and the model analysis focus on interactions between a closed group of states. To underpin the analysis, chapter 6 reviews concepts related to national identity and social psychology. Following the approach of Akerlof & Kranton (2000), the framework is highly interdisciplinary and therefore not all the theories can be reviewed in detail. Such an approach sometimes makes it necessary to simplify and the discussion of chapter 6 does not claim to be an exhaustive review of the literature related to identity. It is a selection of approaches suited to analyse the questions at hand.

Chapter 7 starts from the premise that national identity, inclusive of familiarity with institutions, is first acquired in childhood. In line with traditional public finance literature, the study assumes that individuals within a country have a similar understanding of and preferences about its institutions.[25] Based on this assumption, the chapter analyses the likelihood of political coalitions. The analysis does not inquire whether or when a citizen is likely to identify with her or his home country or with the EU as an entity. Furthermore, it does not discuss how politicians satisfy electorates and foreign partners in two-level games. [26] To focus on the logic imposed by identity economics, the analysis assumes that a political representative aims to satisfy his or her electorate at home. What the chapter does study is the impact of identity on the bottom-up allocation of policy prerogatives. However, it does not specify the effects of identity on top-down decision making.

[25]For example Tiebout (1956).
[26]Putnam (1988).

It will become apparent from the literature that the identification of a person with a group emerges in relation to another, outside group. In the model, this outside group will comprise various combinations of EU Member States. The analysis does not consider relations with third countries or foreign policies. Representatives are modelled as citizens who grew up and socialize in a single jurisdiction. As will be underlined in chapters 6 and 7, this affects the representatives' perception of institutions. However, the analysis assumes, in line with the mainstream literature, a certain degree of homogeneity within national populations. Hence, it does not reflect the effects of migration and does not discuss traits which are closely related to the population within a country. The analysis and discussion focus on the decisions of the Member States, taken by politicians which represent their voters. In particular the discussion about post COVID-19 politics discusses the implications of the present research for the decisions of the Member States in the European Council. Other interest groups, representing industries, as well the EU bureaucrats also have an impact, but these groups are not explicitly taken into account in the present analysis.

Chapter 2

United in diversity - common policies and national social models

2.1 The potential for common EU labour market and social policies

The European Union can rightly be described as a place of diversity, with different cultures, ideas and traditions. It gathers different national economic and social models and it promotes many different common policies and goals. One of the major goals is the creation of a common market for goods and services, in which individuals can move freely. European integration started as an economic project, as part of the wider effort to ensure peace on the European continent. The creation of the European Economic Community EEC within the framework of the Treaty of Rome in 1956, was aimed at building the foundation of an internal market and the elimination of barriers to trade, such as customs duties. In addition, the four freedoms were established within the EEC, so that restrictions on the free movement of goods, persons, services, and capital were gradually eroded. A common competition policy was established, and state aid was prohibited (Chalmers et al., 2010). Overall, the dominant goal of the Communities was the creation of the common market. Policies, such as common environmental policies, social policies, budgetary policies or justice and internal affairs, were side effects of the overriding pursuit of market integration (Hix, 2007). The common environmental or social policies were designed to accompany the process of market integration, to correct market failures and to compensate the losers from integration. One such tool was the cohesion policy. National economies were opened up to global, international, competition.

The political institutions created at the EU level have mostly supported the goal of market making, whereas the governance of industrial relations remained the exclusive preserve of national administrations. One may speak of a selective centralization of institutions, following a liberal market-making ideal (Streeck, 1998). Some economists are of the view that there have been too many attempts to establish common EU policies in the field of employment and social affairs. Considering the bureaucratic capacity, budget and legislation of the EU in the field of social and employment affairs, Alesina et al. (2005a) find that there is too much involvement by the EU, compared to normative standards derived from economic theory. In essence, these views hold that EU Member States have strong welfare states, which reflect specific and divergent preferences over social and employment issues. Given these divergences, the EU should refrain from policy making in these fields. This arguably oversimplifies the matter. Integration creates new needs, which can justify the creation of common employment and social policies. This is true in particular in the case of the EMU. Nation-specific institutions, such as those that govern labour markets, allow for different degrees of wage flexibility and lead to different degrees of competitiveness. Therefore, different countries have different requirements concerning monetary policies. This in turn means that under a single monetary policy, either national labour market institutions need to be adapted or alternative EU policies need to be created.

Market interactions take place on a European scale. Market integration entails difficulties for national governments to implement and uphold labour standards, but it also limits their ability to do so (Scharpf, 2002; 2010). The Europeanization of the goods market opened the national economies to systems competition. National governments must now compete in a manner similar to corporations. The prospect of attracting economic activity leads Member States to create a favourable business environment. Low taxes and permissive labour standards can and do result.[1] As far as labour standards are concerned, this competition could lead to a race to the bottom that would, in theory, culminate in the decimation of the welfare state. In this case, economic theory would suggest that intervention by a supranational authority would be justified. Although common employment standards and social policies could be justified, EU integration appears to have emphasised economic stability over the maintenance of social standards. National governments must maintain stable and healthy public finances in order to avoid sovereign default and facilitate interventionist policies in times of stress.

The introduction of the common currency was accompanied by rules, such as those contained in the Stability and Growth Pact, which aim to safeguard public finance. These rules limit a government's budget to 3% of the national GDP and its overall to 60% of its GDP.[2] Fiscal discipline is there to ensure Member States' solvency and self-sufficiency.[3] The introduction of these rules limits states' manoeuvrability in times

[1]For a discussion on tax competition see (Zodrow et al.,1984; Bucovetsky, 1991; Wilson, 1991; Kanbur & Keen, 1993) and for a review on labour standards see for example Deakin & Wilkinson (1994).

[2]For further details, see European Commission (2017c).

[3]The Pact was complemented by further regulations, the so-called Sixpack, which introduced further

of economic downturns, as they cap the amount of new debt a government can issue. These rules have not been matched by increases of the EU's capacity to implement social policies (Scharpf, 2002). Especially in economic downturns, a government needs room for manoeuvre in order to invest and stimulate the economy.

The following chapter discusses two issues - (i) the compatibility of different types of national economies, as well as ways to address incompatibility, and (ii) the maintenance of minimum employment and social standards in the internal market. Concrete problems, related to the EMU, to labour standards, and to the compatibility of different systems will be discussed in detail. Once the essential features of the problem are in place, this chapter will proceed to economic theory, which sheds some light on the main normative issues. What transpires is that social and employment policies at the EU level are not at all without merit. The chapter will further discuss political interests and show that despite merit, the political cost of such measures might be prohibitive.

2.2 Diverse national economies under single policy regimes

The EU comprises diverse capitalist systems. Different Member States have different systems of industrial relations, which comprise affairs as varied as collective bargaining, the regulation of wages, mandatory working-conditions standards, and the input of social partners in matters of policy and regulation.[4] Some countries struggle in terms of competitiveness, while others have achieved higher productivity growth that allows for wages to grow faster without jeopardizing competitiveness. While diversity has always been at the very core of European integration, the 2008-2013 crisis made it clear that a single monetary policy cannot fit all Member Stats.

specific rules and monitoring frameworks. For the monitoring aspects, see section 2.6.

[4]For a detailed review of different national social dialogue systems see European Commission (2016c).

Johnston & Reagan (2018) see institutional and trade-related explanations for the Eurozone's dilemma. According to the institutionalist[5] view on the Eurozone crisis, wage bargaining institutions in Northern, corporatist Member States have tended to contain labour cost increases and thus inflation, maintaining competitiveness vis-a-vis foreign companies. In Southern and Eastern EU countries, which lack such traditions, wage growth was less influenced by concerns of global competitiveness. With wages growing faster than productivity, domestic products became more expensive relative to competing products from abroad.[6] This resulted in persistent current account deficits in countries that imported more services and goods than they exported. Graph 2.1 shows the development of compensation in typical current account surplus countries, such as Germany, Luxembourg or Austria, versus current account deficit countries, such as Spain, Portugal or Greece for example.[7] The graph shows that nominal compensation increased more in the deficit countries which, owing to international price levels, caused the competitiveness of these economies to decrease.

As Johnson et al. (2018) put it, bilateral nominal exchange rates disappeared with the creation of the EMU, and with it its moderating effect on countries' diverging inflation performance and real exchange rates, as discussed in box 2.1. The European Central Bank (ECB) targets price stability, with an official inflation target 'below 2%' per year for the entire Eurozone.[8] As Member States' competitiveness varies, a general target may not suit all Member States' needs.

[5]See Hall & Soskice (2001) for a review and Hall (2017). For a discussion of the explanations of great recession from the viewpoint of the institutional economists see Johnston & Reagan (2018) and Stockhammer & Ali (2018).

[6]This summarizes the argument brought forward by the institutionalist literature. See Hall (2017), but also Thimann (2015) who takes a broader view at these issues.

[7]The graph is based on figure 1 in Thimann (2015), where it is shown that the overall divergence between wages and productivity was higher in current account deficit countries as compared to current account surplus countries.

[8]According to the official press release: https://www.ecb.europa.eu/press/pr/date/1998/html/pr981013_1.en.html (last access: 15.05.2019

Box 2.1: Currency valuation and Macroeconomic performance

To sell national products in international markets, national producers must compete on price. Theory[a] suggests that depreciating the domestic currency would cushion the low competitiveness of national producers to some extent by making domestic products less costly from foreign countries' perspective. To demonstrate, imagine that e denotes the nominal exchange rate of a domestic currency, expressed in a foreign country's currency units. Let P be the domestic price level and P^* the foreign price level. Then $e_r = e \cdot \frac{P}{P^*}$ describes the real exchange rate of the domestic economy, relative to the foreign country. The real exchange rates is an often-used indicator for competitiveness as it describes how much of their own products foreign countries' citizens would have to give up in exchange for one unit of a certain domestic product. If P grew faster than P^* due to higher domestic inflation then e_r would increase, indicating a loss of competitiveness because people in foreign countries would have to pay more of their own production to receive one unit of the domestic product. However, as domestic products are denominated in domestic currency, a currency devaluation (i.e. lowering e) would cushion the effect on e_r. As part of (or with close ties to) the Eurozone, no such move would be possible as e is exogenous from any single country's perspective. Persistently low competitiveness (an increase of P relative to P*) would persistently push e_r upwards, causing what scholars call internal devaluation. The concrete manifestations of that devaluation include declining global market shares and job losses in domestic industries.

Optimal currency theory (Mundell, 1961) suggests that internal devaluation could be offset by similarities between national economies or by flexible factors of production.[b] If countries are similar enough, the exposure of different members of the currency area to exogenous shocks would be very similar and therefore one single monetary policy benefits all the Member States. Secondly, if factors of production are flexible enough, they can be applied where they are most productive. For example, if a shock causes unemployment to spike in one region, labour could migrate to more prosperous parts of the currency area. This would result in a decrease in unemployment in the disadvantaged area, while contributing to economic growth in the prosperous region. However, these criteria do not seem to be met in the EMU (Jager & Hafner, 2013). While Northern economies are characterized by a high degree of specialization, exporting a large share of their production, the Southern economies rely more on domestic demand in non-tradable sectors, such as construction, tourism, real estate or banking (Johnson & Regan (2018). Some Member States' economies proved to be more flexible with regard to wage restraint than others, a point to which this chapter will return shortly. Overall, flexibility across EU labour markets still is relatively weak: few workers work outside of their country of citizenship. Around 4 % of the labour force (either employed or looking for employment) were not living in their country of citizenship in 2018.[c] According to Kenen (1969), in such cases, the monetary union should be complemented by a fiscal union. Under a framework of this kind, negative externalities could be offset. Iversen et al. (2016) point that optimal currency theory is of little help to explain the creation of the EMU.

[a]See for example Dieckheuer (2001), p. 298.
[b]See Jager & Hafner (2013) for a more complete and detailed review.
[c]European Commission (2018) p.18.

In southern economies, currency depreciation supported the competitiveness of their economies, whereas depreciation did not fit the economic structures of the coordinated northern economies. Competitiveness in these countries is supported by wage restraint. Currency depreciation increases the prices of imports, which fuels inflation. This in turn leads to lower real wages and therefore workers have lower incentives to invest in highly

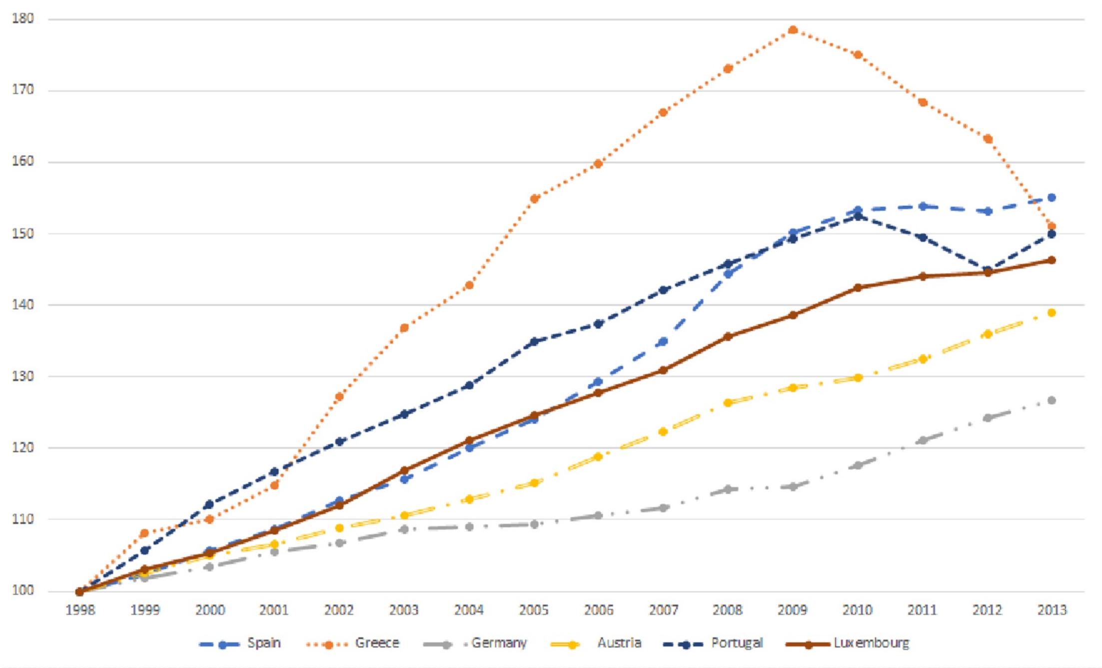

Figure 2.1: Nominal wage growth in deficit and surplus countries
Source: European Commission AMECO Database. Represents compensation of residents and non-residents working for resident employers. Compensation includes wages and salaries, as well as the employer's social contributions.

specialized skills. 'A basic asymmetry was built in to the EMU from its inception',[9] however it was assumed that countries would converge over time, which may not have happened (Stiglitz, 2016). Hence one of the key goals of the EMU, achieving and maintaining full employment in all Member States, could not be achieved.

Chapter 5 will take on the argument by Thimann (2015) that in order to overcome the frictions within the EMU, national institutions need to be reformed. These reforms relate to the markets for products, capital, as well as labour. For reasons outlined earlier, this study relates to labour market and social policies. These policies and related institutions are rooted in national 'traditions', which in turn remain enmeshed with nation-specific cultures. These institutions are difficult to change, and given that they form national social and economic models and therefore are part of national identities

[9]See Hall (2012), p. 359.

they increase the difficulties of finding consensus and creating stable EU solutions.[10] Alesina, Ardagna & Galasso (2008), in a review of the early discussion on the introduction of the single currency, mention that trade unions might need to replace the nominal devaluation of exchange rates to create slack for the affected economies. However, they conjecture that trade unions might not prove to be that flexible after all.[11]

In the first years of the EMU, current account[12] imbalances built up in the Southern EU economies. In short, these economies consumed more than they produced, the difference being imported from other countries.[13] That type of deficit needs to be financed either by foreign direct investments or by foreign debt. Capital imports, in the form of foreign direct investments can fuel growth, while debt financing can cause disturbances. In the periphery, increases in market demand in the early years of the Eurozone countries were seen as a sign of progress. The current account imbalance in these countries appeared to be related to increasing incomes. Capital flowed from capital abundant countries in the North to capital-poor countries in the South, which was thought to be related to lucrative investment opportunities in booming economies.[14]

However, capital was often invested in real-estate projects and consumption. Accordingly, there was no real productivity growth and no additional export capacities were added (Baldwin & Giavazzi, 2015). Hence, the boom resulted in excessive credit growth with ever more distant prospects of repayments.[15] Much of the debt of the periphery

[10] As will be elaborated in more detail in chapter 5.

[11] The arguments outlined above provide the more conventional narrative, aiming to understand the microeconomic determinants of the economic downturn in 2008 and the following years. Gros (2016) for example provides a more nuanced picture, suggesting that there were difference in domestic demand growth across Member States and that these might also relate to differences in productivity. He points to another reason for high wage growth: higher productivity fueled demand, thereby leading to tighter labour markets, due to higher demand for workers, which in turn fuelled wage growth.

[12] Which is the sum of all exports, net foreign income and net current transfers minus imports.

[13] See Baldwin & Giavazzi (2015) for a thorough discussion of the Eurozone crisis.

[14] Baldwin & Giavazzi (2015) and Baldwin & Gros (2015).

[15] For a more complete review of these processes, see Pierluigi & Sondermann (2018).

was held by banks based in core countries. With the onset of the subprime mortgage crisis, debt-risk premia increased. High interest rates aggravated the debt burden in Greece, and the Greek government for example had to be bailed out. For investors, this was an alarming signal and they began doubting governments' solvency. Soon, the risk premia for other countries' sovereign bonds increased sharply. Loans became prohibitively expensive for many countries, and borrowing ground to a halt (Baldwin & Giavazzi, 2015). With the important source of funding now dry investment in Southern economies' construction sector wound down and domestic consumption plummeted, depressing GDP and employment. In addition, some governments had to bail out their banks, further increasing public debt. After 2009, some governments eventually needed to be bailed out by third parties, such as the European Central Bank or the International Monetary Fund. This was the case for countries such as Greece, Spain, Portugal and Ireland.

The global financial crisis, having its roots in the subprime crisis, thus lead to a sovereign debt crisis. Investors became more cautious, leading to an increase in the interest rate, jacking up the cost of borrowing. This in turn lowered consumption and investments, and according to textbook macroeconomics, led to a falling gross domestic production. The coordinated market economies, where growth is led by exports, suffered from lower exports, whereas the southern economies suffered from reduced inflow of foreign capital (Iversen et al., 2016). Unemployment increased. GDP in the Eurozone fell, not only in the southern economies, but also in Germany, Netherlands and Austria. After the downturn, there were growth differentials between these regions - those with higher current account deficits grew slower. Current account differentials are related to competitiveness issues (Shambaugh, 2012).[16] Accordingly, the shocks can be considered

[16]Shambaugh describes the Eurozone crisis by three crises unfolding at the same time - a banking crisis, a sovereign debt crisis and a growth crisis.

asymmetric - some countries were able to recover more quickly as others.

During the great recession, the EU surveillance framework has been reformed to strengthen the observance of the fiscal rules, such as the Stability and Growth Pact (SGP). The latter is an agreement between the Member States, to ensure the stability of the monetary union. It is a monitoring framework for Member States to keep their public debts and deficits at 60% and 3% respectively. In addition, since 2013, the European Commission and the Council of Ministers regularly monitors the national budget proposals of the Member States. In case they exceed the agreed thresholds, recommendations and prescriptions for corrections can be issued (European Parliament, 2019a).[17] Member States hit hardest had to repay their debt and therefore needed access to credits. The banks' financial situation was dependent on the governments repaying their debts. However, given the bad ratings, the risk premia increased for governments and became prohibitively high, disrupting access of these governments to financial markets. Therefore, the IMF and EU intervened as lenders of last resort. The European Financial Stability Mechanism was created as a temporary facility was created in 2010, followed by the creation of the permanent European Stability Mechanism (ESM). Together with the ECB and the IMF, the ESM funds supported Member States in particular distress, such as Greece for example. The support was conditioned on the implementation and safeguarding of fiscal discipline in order to reduce public debt and restore national public budgets. Critics argue that these austerity led measures increase the lack of needed public investments, such as those into public infrastructure for example (European Parliament, 2020).

[17]This was introduced by the so-called two pack regulations: Regulation (EU) 472/2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability; and Regulation (EU) 473/2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area.

From the academic and policy discussion, the necessity of at least two reforms is evident. Firstly, the literature suggests that the sovereign debt crisis shows that institutional reforms, such as the introduction of a common banking union and further fiscal integration, are needed. The latter could take the form of additional revenue raising capacity to finance EU income support measures.[18] Secondly, despite positive general developments in the EU, unemployment in the southern economies has remained above pre-crisis levels.[19] Hence, Thimann (2015) stresses that the crisis is only over when unemployment falls to 'socially sustainable levels'[20] and therefore structural reforms which promote competitiveness and productivity are required. There are several reforms which Thimann considers worth considering. Such reforms could aim at the product market reforms to ease doing (starting) business, as as well improving labour - employer relations. According to his analysis, this would require adapting microeconomic institutions. As will be further explored and discussed below, these institutions cannot be easily changed. Therefore, Thimann proposes that the EU could play a supportive role, by providing technical assistance to the Member States in designing their structural reforms. The following section will discuss the nature of economic shocks and provide clarity over how to approach them, depending on their nature.

[18] See Iversen et al. (2016) for a discussion on the need for a banking union and Thirion (2015) for an overview these reforms including fiscal reforms. De Grauwe & Ji (2017) discuss the potential for fiscal stabilizers.

[19] https://www.iemed.org/observatori/arees-danalisi/arxius-adjunts/anuari/med.2018/Crisis_Shoutern_European_Agnieszka_Piasna_Medyearbook2018.pdf (last accessed: 16.02.2020).

[20] See Thimann (2015), p. 141.

2.3 Lessons from the crisis - containing future shocks

During the crisis, demand for national products and services dropped. This demand can be re-established through flexible national economic policies. Flexibility can refer to the mobility of labour or the flexibility of wages.[21] Hence, through the movement of labour from a region with high unemployment to a region with low unemployment, unemployment can be reduced in one region. If wages are flexible, these can be adjusted downward, which in turn will shift prices and increase competitiveness. De Grauwe & Ji (2017) highlight that responses to shocks, which can either be permanent or temporary[22], need to be adapted to the nature of the shocks.

Permanent shocks can be related to a permanent increase in productivity in one country, but not in another. Alternatively, they may be linked to changes in consumer preferences, leading to a permanent reduction of demand. In such cases, flexibility in labour and capital markets can cushion the negative effects. Moreover, wage flexibility can bolster the competitiveness of the regional (national) economy, thereby lowering the relative prices of products and stimulating demand. However, De Grauwe & Ji (2017) point out that flexibility is neither necessary nor universally desirable in a temporary shock. If lower demand in a region (or country) is related to the business cycle, the movement of workers could lower output and thereby exacerbate the downturn. Accordingly, temporary and permanent shocks call for two different responses. Responses to long-term shocks should aim to increase flexibility in the labour and product market (De Grauwe & Ji, 2017). This can be achieved through wage flexibility or through adaptation. In the view of De Grauwe & Ji (2017), short-term shocks should instead be met by stabilising aggregate demand through a common insurance function.

[21] See for example Vandenbroucke (2017a) and De Grauwe & Ji (2017) for a discussion.

[22] See De Grauwe & Ji (2017) for more details on this differentiation and explanation of the optimal currency theory.

One possible way of establishing a common insurance function can be further fiscal integration, or the establishment of a fiscal union. The concept of a fiscal union has many interpretations. It might entail the introduction of balanced budget rules, or shifting the power to levy and spend tax revenue to the EU level (Bargain et al., 2013). When taxing and spending capacities are allocated to the EU level and there is an increase in unemployment in one Member State that state would send less tax revenues to the EU, while receiving the same amount of benefits.[23] Thirion (2015) gives a detailed review of the different components and mechanisms of fiscal unity, which allocate fiscal spending powers and functions to the EU. Accordingly, a fiscal union could include, among others, a set of fiscal common rules, a banking union and a risk sharing mechanism. The function of a banking union is to monitor banks and to manage failing banks which might harm the public interest. A banking union could provide for burden sharing across Member States, reducing the deterioration of public finances (Iversen et al., 2016).

With highly integrated markets, the fiscal policies of one member of the currency union can affect demand in another, both positively and negatively. Alcidi et al. (2015), in a review of empirical research, show that increases in public expenditure in one country can have positive effects on output in other EU Member States. The size of this effect depends on the linkages between this particular country and other Member States, as well as on the business cycle. A risk-sharing mechanism can take several forms, such as common unemployment insurance or transfers from a centralized budget. One issue is moral hazard - in the presence of an insurance scheme, politicians might have lower incentives to implement unpopular (contractionary) fiscal policies in bad economic times. However, such a system could be linked to measures which have been found to be closely correlated with economic business cycles - the number of short-term

[23]Shambaugh (2012) provides such an example for the US.

unemployed, for example. Under specific triggers, such as an increase in unemployment over a specific period of time, funds could be transferred to a Member State in need.[24] These funds could be earmarked for unemployment benefits. Another option discussed by the European Commission (2013) would be to set up a genuine unemployment insurance, where individuals during employment pay contributions and receive benefits when laid off. The Commission (2013) estimates that such a mechanisms would not lead to permanent transfers between Member States, while it would stabilize output.

The European Commission has made several proposals on macroeconomic stabilization. One proposal envisaged to replace the ESM, which has been created outside the EU's legal framework, by a permanent European Monetary Fund to provide liquidity in case Member States lose access to the financial markets[25] (European Parliament (2019b). In addition, the EC proposed a European Investment Stabilization Function, which would grant loans to Member States, in case of crisis. These loans should have been used to make specific investments into their economy (European Parliament, 2019c). Such instruments are supposed to be complemented by a Budgetary Instrument for Convergence and Competitiveness (BICC), which should provide additional funds for structural reforms in the Eurozone.[26]

Some of the proposed solutions to overcome shocks, would all entail redistribution between states, or between citizen of different states. In the debates of the European elections, the topic of a common unemployment insurance gained some momentum again. The following sections will discuss that stabilization can have its merits, when properly designed. However, redistribution requires solidarity - the political acceptance

[24] See European Commission (2013b), p. 6ff for a detailed discussion of these triggers.

[25] It was also envisaged that this fund would be used to support national structural policies to some extend.

[26] https://www.consilium.europa.eu/en/policies/emu-deepening/bicc-faq/(last access: 20.11.2019)

of such mechanisms might not be easily established across Member States.[27] The next section will provide a synopsis of structural reforms that can tackle long-term economic downturns.

2.4 Competitiveness and common structural policies in the EU

The review just presented indicates that any solution to the resultant problems would have several components, of which fiscal integration is just one. Insurance mechanisms help overcome demand shocks, especially in the short run. Other responses relate to labour market policies which should increase competitiveness and potentially lead to a convergence of Member States' productivity. These policy responses enhance the economic performance in light of shocks sustained over longer periods. This policy reduces unemployment and reinvigorates demand for national products. One core issue is competitiveness of the countries, that is, the relative prices of national compared to foreign products. Competitive economies contest international markets by producing goods and services at prices lower than in other economies. Policies to achieve this are an additional tool to prevent the negative effects of economic downturns from unfolding. Thimann (2015) highlights several factors impeding competitiveness of national economies. On the one hand, there are structural barriers, imposing high costs for establishing and running businesses - inefficient bureaucracy, credit availability, or taxation are just a few factors he highlights. Other factors are high labour costs, employment protection as well as strict regulations in the goods market. One of the major issues is found to be high wage growth and bad employer-labour relations, which are weak in France and

[27] The aim of this section was to give a broad overview over macroeconomic stabilization mechanisms. The aim in the following chapters will be to uncover what the triggers for political acceptance of redistributive mechanisms are.

Greece, as compared to Austria and the Netherlands. Thimannn is therefore of the view that a lack of job creation is not related to a lack of demand - but that it is related to these barriers. As a rule of thumb, wage growth should be in line with productivity growth, in order to keep inflation at acceptable levels and produce at internationally competitive prices.

Box 2.2: Competitiveness and Macroeconomic performance

Competitiveness is a critical feature of national economies. It determines the relation between the prices of national and foreign products, and with it the orientation of a given economy. Competitiveness can be defined 'as the ability of firms to sell goods and services profitably in an open economy and to sustain market shares, domestically or abroad'.[a] Following this definition, competitiveness relates to low output prices, which can be the result of high productivity, low factor costs, or a combination of the two. Accordingly, competitiveness is the relation between relative costs and relative productivity. Costs, in the sense in the which term is used here, usually relate to labour costs, given that capital costs are relatively aligned in developed economies. Accordingly, low costs are related to low wage costs.[b] Productivity is the relation of factor output to factor input. It can be enhanced by technological progress and by improving the skills of the workforce. However, productivity gains through technological progress are limited by the skills of workers (Bakhshi et al., 2017). In order to apply modern technology in the production process, workers need to be able to use it. Therefore, workers' skills and technological progress are complementary in achieving productivity gains.[c] The other dimension of competitiveness is related to labour costs, of which wages are an essential component.

[a] See Thimann (2015), p.144.
[b] The sum of wages, social contributions and taxes to be paid by the employer.
[c] See European Commission (2018).

Member States differed in their responses to the crisis. Between 2011 and 2015, Portugal undertook labour market reforms. Often, the goal of labour market reforms is to increase flexibility within the labour market, by lowering employment-law protections or through the introduction of alternative forms of employment, with lower wages and lower job security (Hermann, 2017). In Portugal, severance pay was decreased and the definition of fair dismissal was expanded. Furthermore, the activation framework was modernized, i.e. the framework giving incentives to take up work and promoting employability. In this context, the reforms entailed a stricter application of the criteria for unemployment benefits, as well as more opportunities for training and other active labour market policies[28]. More generally, labour and product market reforms purport to increase flexibility and lower the price of labour. Gama et al. (2015) classify labour market policies into three main categories: (i) active labour market policies, which cover training, employment incentives or job search assistance; (ii) labour market regulation, such as dismissal rules or the maximum duration of temporary contracts; (iii) wage policy and (iv) unemployment benefits. The ILO estimates that more than 40% of labour market policies implemented between 2008 and 2013 in the EU were related to labour market regulation, whereas roughly one quarter of the policies were related to active labour market policies (ALMPS)[29]. They conclude that reforms and ALMPS only had a limited effect, and this could have been the result of relatively moderate expenditure on these reforms.

National social dialogue can support competitiveness in several ways. In many countries, social partners are involved in the design and implementation of education and training systems. In companies having a functioning social dialogue, workers are more likely to receive training (European Commission, 2019). In countries with a well-functioning

[28] For a more complete overview, see OECD (2017).
[29] See Gama et al. (2015).

social dialogue, the matching of persons with specific skills with appropriate workplaces is higher than in countries where social dialogue is less important (Rieff & Peschner, 2020). Social partners are also leading collective bargaining over wages. Wage coordination can also increase flexibility in the labour market, restrain wages and thereby support competitiveness. For example, in an economic downturn, coordinated wage bargaining, i.e. coordinating wages across and between industries, may increase flexibility by adapting wages and working hours. This in turn avoids the necessity to lower employment (OECD, 2004). Generally, the OECD (2018) reports better employment outcomes in instances of coordinated wage bargaining. Coordination refers to the degree to which small social partners groups, for example at the company or sectoral level, follow decisions made by major groups, such as governments or industry organisations (Visser, 2016). Deakin (2017) observes that during the crisis, most of the debtor states had only weakly coordinated bargaining. He argues, against this background, that there should be a common approach to collective bargaining. However, this requires interference with national collective bargaining institutions, which are rooted in national traditions. Therefore, interference might lead to strong opposition at the national level. However, in the framework of policy coordination, the EU could encourage and support Member States to adopt a more flexible wage bargaining system. This could be done in the framework of the European Employment Strategy (EES), where the EU provides the possibility for labour market and social policy coordination.

The goal of the EES is to provide mutual learning, common guidelines for improving national policies and to stimulate national reforms. The EES has been integrated in the European Semester, a cycle of macroeconomic policy coordination (Bekker, 2015). In the framework of this policy cycle, the European Council adopts country-specific recommendation (CSR) every year. Those address issues related to fiscal policy, macroeconomic stability as well associal and labour market issues. These recommendations highlight the need for reform.[30] For several countries, there have already been CRS relating to social partners and collective bargaining. The CSRs related to social dialogue and collective bargaining were rather cautious over the last years, which suggests that there is a reluctance by the EU Commission to tackle the issue of collective bargaining. A question, which remains is in how far would EU institutions be able to support effective collective bargaining and what its role could be? In the process of the policy coordination in the framework of the European Semester, the EU could support the Member States with room for mutual learning and specific proposals of how to adapt their national bargaining systems for example.

The New Economic Geography school predicts that economically strong regions can be more attractive to factors of production, such as capital and labour.[31] Agglomerations of companies around production centres have many advantages, among which shorter transportation paths and better access to concentrated human capital with industry-specific skills. This reduces the potential for labour shortages for the companies while boosting workers' immediate employment prospects. Furthermore, there are potential information spillovers between clustered companies, an advantage isolated companies might not have (Krugman, 1991). According to theoretical predictions, these factors increase the likelihood of company concentration in economically strong areas. Improvements in infrastructure and labour mobility can lead to a drain of workers, innovative industries and services from the periphery to the economic centres, thereby further decreasing economic activity in the peripheries. Economic growth within the periphery would decrease, which could be accompanied by a decrease in employment and economic activity.

[30] For a more in depth discussion of the Semester cycle, see section 5.5.1 and 3.4.

[31] See for example Krugman (1991) and for a discussion of these theories in relation to EU integration, see Wagener et al. (2006), p.500.

Given a decrease in economic activity, incomes in concerned regions would decrease as well, which would depress demand for services and products, with repercussions for richer regions as well.[32] Aside from the institutional differences enumerated earlier, economic performance is an important dimension on which integration can exert a negative influence. The centre-periphery divide was the reason for the introduction of a common cohesion policy. Cohesion policy in general, and social investments in particular, should reduce regional welfare disparities.

The cohesion policy regroups several funds, as will be explained in more detail in the next chapter. One of these funds, the European Social Fund (ESF), is tied to what one may call European social expenditure. Under the cohesion policy, regional disparities ought to be addressed through structural investments. These investments encompass, among others, infrastructure projects or human capital and skills. The ESF subsidizes projects related to life-long learning and the labour-market integration of refugees. According to recent model estimates[33], ESF investments can have substantial effects on productivity in the poorest regions. These investments could not only increase productivity and competitiveness, but also lower the divide between the centre and the periphery. However, for reasons best left for chapter 3, this is not always the case.

In the European Union (EU), as in the industrialized world as a whole, economies have been maintaining competitiveness through continuous capital investments. As described in more detail in box 2.2, competitiveness relates to low output prices, which can be achieved through high productivity or low factor costs. Labour has been substituted by capital where low labour productivity and rising labour-capital cost ratios induced firms to do so. Indeed, Thimann (2015) observes that there is a number of EU countries

[32] See Wagener et al. (2006), p.498f for a detailed review.
[33] See European Commission (2019a), chapter 3.

where unit labour costs have been increasing as productivity growth has been lagging behind wages. Companies have tended to displace workers by cheaper capital whenever technically feasible. In other countries, buoyant productivity gains have outpaced wage increases, dragging down unit labour costs, increasing competitiveness and creating new jobs.

Sources such as the European Commission's 2018 Employment and Social Development in Europe review (European Commission, 2018) find that whether technological change displaces labour or accelerates job production depends on the availability of skilled and qualified workers and on whether or not this human capital is used efficiently. When it comes to labour organization, the 19th century Industrial Revolution was basically a simplification of tasks that allowed for optimizing processes to be performed by highly specialized, yet low-qualified workers[34]. That is not true of modern technology. Technological change today is skill-biased: It favours workers with higher skills and qualifications[35] (Frey & Osborne et al., 2017) while allowing for routine-tasks to be outsourced from labour to capital. In other words, there is a strong complementarity between skills and qualifications. Physical investment is most likely to be complementary to job creation where workers are well-skilled and best prepared to work with the innovative capital that firms need to stay competitive (European Commission, 2018b). In short, it takes skilled labour for capital investments to generate new jobs. This serves to underscore the importance of European structural policies.

In light of developments such as globalization and digitalization, investment into skills and training have grown in importance. Unskilled labour is likely to be automated,

[34] See Frey & Osborne et al. (2017).

[35] A person's qualification level is seen here as her formal education according to the International Standard Classification of Education (ISCED), while skills are specific competencies she needs in order to perform her job, irrespective of formal qualifications. They include, for example, ICT proficiency, reading capacity, and social skills.

especially in manufacturing[36] In order to remain in the labour market, workers need qualifications. The European Commission (2018a) highlights that European students increasingly lack basic reading and mathematical skills. The socio-economic background influence not only educational attainment, but also labour market outcomes (European Commission, 2018). To break this vicious cycle, public investments in education and training are of the utmost importance, all the more so in disadvantaged regions.

Investment into skills boosts Member States' productivity - it allows to adopt new technologies and to the individual worker to produce more high value added products. It thus reduces the divergences that lay at the core of the last crisis. Investments of this kind make the recipient regions more competitive. This underlines the importance of the ESF. With the appropriate financial endowments, the ESF could also fulfil a stabilization function during times of crisis. In times of economic downturn, tax revenues are likely to be low, constraining fiscal policies. The ESF could bridge this gap. In this manner, it may also aid labour market policies, in addition to decreasing the core-periphery divide. As discussed above, high unemployment rates in some Members States can be reduced through movement of labour. Thimann (2015) further mentions that an attractive regulatory environment can improve the economic circumstances of a country. The problem that results is that in order to attract businesses, Member States, may lower employment standards. The next section will explain these issues in more detail.

[36] See European Commission (2018a) for estimates.

2.5 Systems competition and the race to the bottom

Under EU law, capital, services, labour and goods are allowed to move freely across borders. For instance, national governments must allow foreign companies to establish themselves in their territory and to provide services to the local population. It is a trite observation that firms relocate to countries with lower nominal wage costs. This means that, *ceteris paribus*, countries where higher wages and higher labour standards prevail are at a disadvantage, relative to countries where wages are low and labour standards are weak. If barriers to the free movement of capital, labour and services are removed, then competition between national welfare systems to attract industries is opened.[37] Assuming, it is thought realistically, that companies aim to produce in locations with low labour regulation, which reduces administrative costs, the elimination of barriers is liable to impel a race to the bottom in social and labour market standards. Firms may pursue several strategies to produce at cost-minimizing levels. On the one hand, they might produce in high-wage and high-productivity countries.[38] On the other hand, they might produce in low-wage countries using under-valued labour in under-regulated conditions. In case of the latter strategy, companies might in fact invest in countries with lower unit labour cost and more flexible regulations. Increases in the mobility of resources further encourages regulatory arbitrage. Countries with a more flexible regulatory framework and low wages have a competitive advantage, given their lower unit labour cost. Absent harmonisation, stronger labour standards might be undermined (Deakin & Wilkinson, 1994). Olney (2013) finds a negative relationship between foreign direct investment and labour protection standards and a positive relation between national and foreign labour standards. In other words, this study provides empirical evidence that labour standards of different countries are correlated and that labour are

[37] See (Deakin & Wilkinson, 1994).

[38] See also Sinn (2003) on systems competition in the EU and its potential effects.

lowered in order to attract foreign investments. This adds further credence to the race to the bottom hypothesis. On the other hand, neither Brown et al. (1996) nor Martin et al. (2001) confirm that labour standards affect international trade significantly. Davis and Vadlamannati (2013), however, find that there are interdependencies between the labour standards of different countries and that these standards appear to be correlated. The interdependence manifests more strongly when the analysis circles on enforcement instead of black-letter law.

Within the EU, the political debate about the race to the bottom relates to the posting of workers, among other things. Under the freedom to provide services, companies may post workers to another country in order to provide services there. This has caused political controversy since the accession of Portugal in the 1980's, when Portuguese workers were posted to France.[39]

The free movement of services also allows foreign producers and companies to provide their services abroad. Owing to disparities in working conditions and wages, companies in some countries can provide services in foreign states at a lower cost, relative to local companies. This leads to conflicts between foreign companies and employees, trade unions, and host-state governments.[40] The posting of workers is mostly an important phenomenon for only around a dozen Member States (European Parliament, 2016). The most important sending countries, in absolute terms, are Poland, Germany and France.[41] As a proportion of the domestic labour force in sending countries, the posting of workers was most important in Luxembourg and Slovenia. In absolute terms, the most important receiving countries are Germany, France and Belgium. As a proportion of domestic employment, Luxembourg, Belgium and Austria were the three main re-

[39] Wagener et al., p. 244.
[40] See Wagener et al. (2006), p. 244.
[41] See European Parliament (2016), data for the years 2010 to 2014.

ceiving countries. In the main, workers appear to be posted to neighbouring countries. The main sectors that employ posted workers are the construction sector and service sectors such as health, education, art or scientific research. Interestingly, the widespread assumption that the majority of the posted workers come from low wage country does not hold in practice. Only a third of the postings go from low- to high-wage countries (Batsaikhan, 2017). The European Parliament (2016) reports that one can differentiate between two models of posting. One is based on the comparative cost advantages of low-wage countries. A second model is based on skill shortages within the host country, which require highly skilled labour for specific tasks. Rates of pay and labour costs are irrelevant for this type of posted workers. The mode of posting which could result in a race to the bottom in terms of remuneration and wages is the first of the two, since it is motivated by wage differentials rather than structural considerations.

It is an uncontroversial proposition that goods and services should be produced where it is most cost-efficient to do so. There is nothing in economic theory to suggest that the free movement of labour ought to be curtailed. However, when certain practices lower labour and quality standards, government and EU-wide intervention can be justifiable. Although the empirical evidence about adverse incentives is not entirely conclusive, the potential of a race to the bottom remained a political issue. The introduction of common labour and social standards, for example, could further reduce perverse' incentives and create a level playing field for European workers and companies. Low-income countries have an advantage at present, since lower wages might be more attractive for companies. Why would the beneficiaries accept change? The next chapter will discuss the Posted Workers Directive, a policy which explicitly aims to prevent a potential race to the bottom.[42] That it was passed means that it was accepted by at least some lower-

[42]Directive 96/71/EC of the European Parliament and of the Council of 16 December 1996 concerning the posting of workers in the framework of the provision of services

income countries, as will be discussed in the following chapter. One hypothesis put forward to explain is related to social identity. This will be explained in more detail below.

2.6 Market correction in the EU

The preceding sections discussed various attempts to achieve economic integration and compared them to the creation of common labour and social standards. The text also put forward arguments in favour of EU-wide labour standards. The next section will identify some of the problems of this approach. The EU's early social policies in the seventies laid down minimum standards related to employment and the movement of workers (Barnard & Deakin, 2012). Those policies provided a floor of rights , based on which Member States could compete over factors of production. Welfare was supposed to follow economic growth, fueled by economic integration (Wagener et al., 2006). EU labour and social policy is outside the scope of traditional social policy, which specifies rights for workers and employers, such as the right to bargain collectively, or to enjoy rights to minimum wages or maximum hours of employment (Deakin & Wilkinson, 1994). Social and employment policy only has a marginal role in EU law (Barnard & Deakin, 2012). One constitutive part of 'Social Europe' is the ensemble of social schemes and policies which are vested with a cross-border element (Ferrera, 2017a). The EU's social policy regimes involve the promulgation of standards and the removal of barriers to free movement. It is primarily geared toward improving the functioning of the internal market (Daly, 2017).[43]

[43] For a discussion on national social policy, see chapter 4.

Box 2.3: Market Integration and Social Rights

The European Court of Justice's jurisprudence further shows that market integration, and more specifically the freedom to provide services, might clash with fundamental rights. Some observers are of the view that such rulings like Laval might undermine the ability of trade unions to protect the rights of workers.

One important ECJ case which illustrates this trade-off is the *Laval* case. In light of the Eastern European enlargement, Western trade unions were concerned that Eastern European workers would flood Western labour markets. Several Member States restricted the right of individuals to work in the West (Barnard, 2007). However, these restrictions did not extend to secondments. Additionally, these restrictions did not prevent Western employers from establishing themselves in the Eastern countries to take advantage of cheap labour.[a] Laval was a Latvian company, which owned a Swedish subsidiary, L& P Baltic Bygg. Baltic had a contract to refurbish a school in a suburb of Stockholm, which it sought to fulfill by posting 35 of its Latvian workers to Sweden. These workers earned 40% less than comparable Swedish workers.[b] Byggnads, a major Swedish construction trade union, wanted Laval to apply the Swedish national collective-bargaining agreement, which regulated a range of matters, including, critically, the payment of a 'special building supplement' to an insurance company to finance group life-insurance policies. After some negotiations, Laval eventually refused to sign the agreement. This led the Byggnads to call a strike, blocking the construction site and boycotting suppliers, which prevented the Laval workers from fulfilling their tasks. Eventually, all of Laval's construction sites were boycotted by other trade unions across Sweden. Laval brought proceedings before a national labour court claiming that the blockade and the industrial action were illegal. In a first-instance ruling, the court ruled in favour of the trade unions, on the grounds that the promotion of a national industrial agreement could not be seen as a breach of good labour-market practices. The blockade intensified and, eventually, Bygg went bankrupt.[c] On appeal, the Swedish court referred the case to the ECJ to clarify whether workers reliance on their right to industrial action conflicted with the free movement of services (Art. 56 TFEU). The ECJ held that the right to take collective action had to be acknowledged as a fundamental right that forms an integral part of the general principles of Community law and, further, that the right to take action against possible social dumping may be an overriding public interest. However, the industrial action aimed at securing employment conditions beyond the minimum established by law, which rendered the exercise of Treaty freedoms less attractive. Therefore, the ECJ held that the industrial action constituted a restriction on the freedom to provide services.[d] The European Trade Union Confederation (ETUC) was disappointed with the ruling because the ECJ found that the 'right to strike was a fundamental right, but not as fundamental as the right of businesses to supply cross-border services'.[e] ETUC further pointed out that the ruling could have negative implications for the ability of unions to protect workers' interests and that the objectives of unions might be undermined by the free movement of services.

[a] See Barnard (2007).
[b] For a more complete analysis of the case and its facts, see Barnard (2007).
[c] See Barnard (2007).
[d] See https://www.eurofound.europa.eu/observatories/eurwork/industrial-relations-dictionary/laval-case. (last accessed: 20.08.2018)
[e] See https://www.etuc.org/en/laval-case-vaxholm. (last accessed: 20.08.2018)

The EU has certain tools, such as the European Social Fund, to support national social policies. European funds, such as the ESF, can provide the necessary stimulus. By virtue of the co-financing structure of the fund, they incentivize further investments by national authorities. The Commission, together with the EU Council, has launched a series of initiatives to counter the social effects of the crisis in response to the backlash against austerity (Copeland et al., 2018). These include the Youth Guarantee and the Skills Agenda. But the budget for delivering such policies is relatively limited, compared to the national budgets for such investments. The foundational epoch of the EU was driven by market integration, that is, the completion of the internal market. The integration of social and economic policies was asymmetrical: more importance was ascribed to market efficiency than to social policies (Scharpf, 2002).

In fact, not only was there an asymmetry between the integration of economic and social policies, but the EU also appeared to curtail existing national social policies. Scharpf (2002) points out that European competition policy was extended to all national policies that could have had distortionary effects. Analyzing the timing and sequence of privatization taking place within the EU between 1980 and 2001, Clifton et al. (2006) find that many liberalization efforts within the transport and communications sector followed EU legislation aimed at reducing barriers to trade. The pace and rhythm of privatization was different in the different European Member States. In the Netherlands, Belgium and Spain, for example, the EC Directive on the liberalization of basic telephony (EC96/19/EC) appears to have been a major driver for the mass of public telecommunication companies.[44] According to Clifton et al. (2006), the liberalization of different air transportation markets across the EU is best understood as a response to the Single European Act, which called, among others, for a removal of barriers on free trade and the free movement of persons. As Scharpf (2002) points out, Member States ceded not only control over their monetary policy, but also the ability to buffer unemployment through expanding their public sectors. In addition, state aid cannot be used to support a distressed private sector.

At the same time, the EU has aimed to remain on the path of fiscal discipline since

[44] See Clifton et al. (2006), p. 746.

the introduction of the EU. The Stability and Growth Pact sets out rules that aim at price stability and job creation. Member States must maintain a healthy public budget and sustainable fiscal policies. At the same time, the Member States must take corrective action if public debt exceeds 60% of national GDP and if their deficit becomes higher than 3% of the GDP.[45] Member States are monitored within the European Semester. This process covers the coordination of structural reforms, fiscal policies and the prevention of excessive macroeconomics imbalances. The EES and the coordination of labour market and social policies are nowadays integrated into this cycle. During this cycle, the European Commission drafts the Annual Growth survey in autumn and publishes it at the end of the year. From the beginning of the following year until spring, this survey is analysed and discussed within the Council of the European Union[46] and the European Council.[47]. Around February, the European Commission publishes the Country Reports, which assess the social and economic situation in each country.[48] In early spring the Member States submit their budgetary plans and reform strategies. These are the so-called national reform programs. In spring (early summer), the Council of the EU adopts the country-specific recommendations, drafted by the EU. In this monitoring framework, some Member States may be reviewed in more depth, where it is warranted. The Council of the EU may then decide to recommend to Member States,[49] to rectify imbalances and enable the Commission to take further steps to enforce such rectifictations.[50]

Some authors studying the European Semester find that the process has become more

[45] https://www.consilium.europa.eu/en/policies/european-semester/european-semester-key-rules-and-documents/ (last accessed: 14.11.2018)

[46] Gathering of the national Ministers.

[47] Gathering the Heads of State.

[48] See https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/european-semester/european-semester-timeline_en (last accessed: 13.02.2019)

[49] https://www.consilium.europa.eu/en/policies/european-semester/european-semester-key-rules-and-documents/ (last accessed: 13.02.2019)

[50] For example under the excessive deficit procedure.

social over recent years, but the marketarian tendency continues to predominate. The European Semester streamlines the policy coordination process related to social and employment policies with other policy fields, such as education and fiscal oversight. Within this framework, national public finances, as well as labour and social policies, are reviewed and country reports on respective national developments are prepared. It is on those reports that the country-specific recommendations (CSR) are issued. These are the key tool of the Commission to influence social and employment policies at the national level. However, their adoption is not mandated by law. Copeland & Daly (2018) analysed 656 country-specific recommendations issued between 2011 and 2015, which can be related to social policies. They categorized each of the CSR and then classified each CSR as market correcting, market making, or somewhere in between. Their aim was to ascertain whether the process of the European Semester follows a liberal agenda, eliminating barriers to trade. They found some evidence to support this hypothesis. Accordingly, the CSRs appear to follow that ideological aim aim, with around 41% of the CSRs directed at market making, that is, the removal of barriers to trade, deregulation, and the reduction of non-market benefits. More than half of the CSR are a mix between market-correcting and market-making recommendations.

Those CSRs that have a market-making goal purport to unleash competitiveness. According to Copeland & Daly (2018) these CSRs recommend labour market desegmentation and reductions in pensions. Others relate to the wage-bargaining system and minimum wages, and recommend that wage growth should reflect labour productivity and competitiveness. Copeland & Daly (2018) conclude that the Europe 2020 strategy lead to a substantial change in EU governance and social policy. They find that the social policy of the EU aimed at stronger EU-level monitoring of the economic and financial performance of Member States, with the goal of achieving balanced national budgets. Accordingly, purely market-correcting mechanisms appear to be rather scarce as compared to market-making policies. Overall, social actors were able to strengthen market-correcting CSRs. However, the degree of 'socialization' of the semester process is not continuous, and it appears to be contingent on economic policies. Whether or not a more social trajectory will be adopted remains unclear, with Copeland & Daly (2018) arguing that the signals are rather mixed. Section 3.4 will discuss the role of the European Semester for employment and social policies and what role it could play for reforming national policies.

The common market was the EU's *raison d'etre*. So far, the discussion of the last two sections has shown that European integration is driven by economic concerns. Social policy has been lagging these marketarian developments. However, with increasing market integration on the one hand, and increasing globalization on the other, common social policies could alleviate this pressure on national economies. There is a further potential pressure from market competition on workers' rights, that is, the race to the bottom in social and labour standards discussed above. Some tools to alleviate the pressure of marker integration already exist at the EU level, such as the cohesion policy. However, the effectiveness of this policy is far from clear cut (Darvas et al., 2019). Moreover, these tools are outside the scope of the discussion of the measures to alleviate the negative effects of the crisis.

This section has shown that social affairs were and appear still to be secondary compared to economic policies, whatever the advantages of the latter. The next section provides a basic overview of the mechanisms and normative logic which underlie the formation of common policies, based on the economics of federalism.

2.7 The economics of federalism and the relevance for EU integration

The EU is a supranational organization rather than a federal entity. Still, the economics of federalism have proven very useful in analyzing the allocation of policy functions within the EU (Kelemen, 2007). Economic theories of federalism provide rationales for allocating functions to different levels of governance. In economics, the term 'federalism'[51] is used to describe public sectors which are characterized by multiple levels of governance, with each tasked with the provision of public services and entrusted with some degree of authority. One of the principal problems within the EU is the so-called assignment problem, that is, the decision about what responsibilities are to be assigned to the EU and to the national governments of the Member States. This choice is linked to a trade-off between maximizing the welfare of individuals within a jurisdiction[52] and minimizing inefficiencies that arise from inter-jurisdictional externalities.

A common argument is that public goods should be provided at different levels of government, depending on spatial patterns of benefits of the respective jurisdiction.[53] The principle of fiscal equivalence (Olson, 1969) holds that the circle of beneficiaries of a public good should coincide with the circle of taxpayers – those who pay should be able to decide about the form and use of the public good, while preventing others from free-riding. This provision of public good is optimal – externalities are internalized and the quantity of the public good is sufficient for citizens. A central government can achieve this, in case the provision of the public good entails externalities. Furthermore, centralized provision can result in cost savings, due to the exploitation of economies

[51] See Oates (1999), p. 1120.
[52] Jurisdiction is defined in the following as the area of competence of governance authority.
[53] See Oates (2005).

of scale and scope. However, a central government might not be able to adapt the good to different local tastes. Hence, in case no cost advantages accrue from centralized provision, then decentralized provision in line with difference in local preferences and tastes across jurisdictions would be preferable.[54] This is the so-called decentralization theorem, formulated by Oates (1972).[55]

The premise of second-generation theories federalism theories, that governments are self-interested imposes an additional complication. According to Bardhan (2002), there is sometimes a gap between the centre's commitment to finance projects and local government's commitment to deliver the services. One explanation circles around rent-seeking and capture by local pressure groups. Another emphasises that local governors must be responsive to their electorate and to federal governments at the same time, which is troublesome. Such misalignments might lead to strategic behaviour by political decision makers, as is evident from the tax competition literature (Wilson, 1999; Winner et al. 2014; Keen et al., 2012). In order to attract economic activity, local governments will enter a tax competition to underbid neighbouring regions, which forces them to decrease taxes, too. A race to the bottom results, limiting the public budget. An agreement to refrain from tax competition would make all the regions better off, but the promise of a higher tax base triggers strategic behaviour.

The EU is driven mainly by market integration. It is built on a system of multi-level governance where primary policy and legislative responsibilities lie with national (local) governments. Still, taxation policies in Luxembourg and Ireland suggest that policy makers act strategically. Rodden & Rose-Ackermann (1997) argue that incentives through the market do not necessarily have the same effect anywhere.[56] In the EU,

[54] See Oates (2008), p. 314.

[55] For a more recent discussion of federalism economics and its relation to the EU, see Inman & Rubinfeld (2020).

[56] The discussion Rodden & Rose-Ackermann (1997) evolves within the field of development economics.

some scholars are of the view there are too many social policies (Alesina et al., 2005a). According to the decentralization theorem, whenever efficiency gains are low and local preferences differ strongly, decentralized provision is preferable. This probably captures social policy and redistribution. However, some aspects of related policies and laws might be justifiable.

Given the strong links between the Member States' economies, public spending in one state can have positive impacts on another state. In a common currency union, the failure of one state can have negative effects of unforeseeable magnitude. Therefore, a common public spending - or insurance - function, which was discussed above, has a direct positive effect not only on the rescued country, but also on others. Hence, common spending exhibits positive externalities. The systems competition described above constitutes another externality. Theoretical considerations dictate that, by lowering labour standards, a government can attract economic activity to the detriment of neighbouring states. In other words, the state in question imposes an externality on others. Such externalities can theoretically be eliminated by creating one framework common to all the Member States involved. What is needed, in simpler terms, is that a higher-level authority, such as the EU, be entrusted with the promulgation of such regulations. However, for certain policies, this increases the likelihood that the publicly provided services and goods will not be to the liking of all the citizens within that jurisdiction. This trade-off between efficiency and the satisfaction of differing preferences is also central to regional integration and the decentralization of functions of the public sector[57] and determines the size of jurisdictions.

More fuel is added to the case for centralisation when economies of scale and scope stand to be realised. Earlier, it was said that the EU could act as a provider of skills

[57]For a review of the literature see Spolaore (2006).

initiatives in case of regional economic downturns, during which the governments cannot implement expansive labour market policies. A central authority designing and coordinating such active labour market policies, and managing their implementation, would capture economies of scale and scope better, relative to a situation in which their implementation is left to individual Member States. The reason is that, instead of twenty-seven administrations, only one body is responsible with the management of the policies in question, avoiding unnecessary multiplication of tasks. Costs could be further reduced through mutual learning between national administrations. The traditional, first-generation theories of fiscal federalism highlight the trade-off between satisfying divergent local preferences and internalizing externalities resulting from inter-jurisdictional interdependencies (Oates, 2005). These theories provide normative arguments related to the centralization of policies.

Preferences over public policies might differ across regions. These preferences are best known to local governments. A central authority would only be able to provide one single 'size' of public goods, which might not be to the liking of all Member States. Accordingly, policy responsibilities should be assigned to the lowest possible level of government (Oates, 1972). This allows the administration to provide public goods that are attuned to municipal preferences. However, this would lower the potential gains from economies of scale and scope, which are due to a large number of consumers. Delegation would also curtail the internalization of externalities. In short, one speaks of a trade-off between efficiency gains and heterogeneity costs, namely the satisfaction of individual preferences. The centralization of policies can lead to improvements, as long as the gains from centralization are higher than potential costs related to the uniform provision of the policy. The second-generation theories of the economics of federalism shift this trade-off to a trade-off between efficiency and political accountability.

In the context of EU policies, diverging preferences are often invoked as the reason for a lack of integration or the creation of common policies. The more preferences over a certain issue diverge, the more unlikely it becomes that an agreement on a policy can be found, particularly when such decisions have to be taken unanimously. Once the decision about a policy is taken, it applies in a similar manner to all Member States. And here lies the central problem of the decision-making within the EU. Depending on the voting-rule applied for different policies, heterogeneity of preferences will lead to a deadlock situation in which decision-making is basically blocked (Chopin & Lequesne, 2016; Schimmelfennig & Winzen, 2014). The downside of centralization of provision of public services and goods is that the level of uniformity increases, as the taste and preferences of the different Member States will not entirely be taken into account. Theoretically, these problems could be overcome if citizens could choose where and what quantities of public goods they would consume. This is for example the idea of Functional Overlapping Jurisdictions, where multiple jurisdictions offer similar public goods and citizens can freely choose from which jurisdiction to buy from (Casella & Frey, 1992).

Alternatively, centralization within a union of countries could allow for flexible arrangements, where some countries could choose whether to join a certain agreement or not. In the literature on EU integration, this is called differentiated integration. The former Commission President Juncker discussed different strategies for the future of Europe and how to achieve cooperation between the Member States. These description covered, among others, the option of *those who want more do more*. Such an approach can take several forms, depending on the degree of flexibility. Stubb (1996) provides a categorization of differentiated integration. This differentiation related to (i) the subject matter of the policy, (ii) its timing or (iii) the territory where the would operate. Conceptually an *a la carte* approach would allow different Member States to accept those some policies or regulations and opt out of others. Under a multi speed approach, some initially willing Member States would drive a common policy and others would follow later on, when the policy has become feasible. If integration takes the form of a variable geometry, there would be different integrative groups of countries pursuing more or less ambitious degrees of permanent integration.

Interest groups, as well as institutions, might distort the incentives of decision-makers, which would then wind up addressing concerns other than the trade-off between local preferences and inter-jurisdictional externalities. Political institutions and interest groups might lead decision-makers to take decisions contrary to the interests of their constituencies.[58] For example, the legislative process itself can result in inefficient outcomes, as delegates of local jurisdictions seek benefits for their own constituency (Oates, 2005). Inefficient spending and the misallocation of resources can be the result of strategic interactions within the legislature (Besley & Coate, 2003). Regarding regional projects, financed by taxes raised at the central level, there is a tendency to finance the cheaper projects and not those with the greatest benefits. The logic behind this apparent paradox is that the costs are shared by a majority, whereas the benefits accrue to a minority, so that only the cheaper projects will be voted for in a centralised legislature (Lockwood, 2006). These problems are exacerbated by regional tastes, which inevitably cannot be accommodated by uniform national policies, with political disintegration among the potential outcomes (Bolton & Roland, 1997). Hence, institutional arrangements, such as cost-sharing, and differing (political) interests and log-rolling may limit the number of regions or countries taking part in the formation of common policies. In other words, divergent preferences limits the size of the jurisdiction of the central authority. Considering these impediments to the efficient allocation of policy powers, some of the second-generation turned to a different question: what is it that leads decision makers to respect existing rules and institutions? In other words, what

[58]For a more extensive review of political economy arguments and centralization, see Lockwood (2006).

makes rules and institutions self-enforcing? This relates to the essential dilemmas of federations: what keeps the central government from overriding constituent units and, secondly, what keeps the states from free-riding or failing to cooperate with the other units (De Figueiredo & Weingast, 2005)?

The EU faces similar dilemmas (Kelemen, 2007), which involve centripetal and centrifugal forces. Centripetal forces relate to the potential danger that a central government, for example the EU, would encroach on the powers of the Member States. This, however, appears to be unlikely, given that the Member States define and decide on the powers of the EU authority. Centrifugal forces refer to the undermining of the powers of the central state and to the disintegration of Member States. A federal system must overcome both forces in order to survive. Market competition ensures that political actors take decisions which the economic actors are willing to fund. If politicians failed to do that, labour and capital would move to other states, which puts their re-election at risk. Weingast (1995) argues that well-designed constitutions, which he defines as institutions that govern political decision-making, are essential to commit states to economic and political markets. Accordingly, federalism limits the discretion of the government.

Weingast points out three conditions for federalism to become market-preserving, namely that (i) subnational governments have primary regulatory power, i.e. the subnational governments have the primary responsibility for regulation (ii), there is a common market, and (iii) the lower-order governments face hard budget constraints. Hard budget constraints mean that the central government can credibly signal that it will not bail out a state in case it goes bankrupt (Oates, 1999; 2005). The three requirements just outlined are characteristics of political systems, characterized by a hierarchy of governments and the institutionalization of the autonomy of each government, which make a federal system market-preserving. A political system characterized by this structure will ensure competition between jurisdictions and thereby give enough incentives to policy-makers to act in line with the needs and likes of their constituency. As Weingast (1995) points out, competition ensures 'that only those restrictions that citizens are willing to pay for will survive'.[59] These limits, to be effective, need to be self-enforcing - political actors need to have an incentive to abide by them. The folloying analysis will describe a bottom up approach to federalism and not deal with issues related to encroachment of a central government on local government. Rather it will discuss self-enforcing centralization.[60]

For other centralized policies, economic benefits could outweigh costs.[61] Therefore, the electorate should be willing to accept them. If the policy is to the liking of the constituency, then their willingness to pay is high enough. The resultant institutions would be accepted and remain stable. The EU's non-implementation of some social and employment policies has caused frictions between EU economic policies and national social models. It stands to reason that centralising social policy matters could be beneficial. The governance system could be designed so that its model would be self-enforcing[62] and beneficial to all the Member States. However, the preferences of the electorate are not always driven by purely economic motives; socio-cultural aspects play an important role (Kelemen, 2007). These aspects are the focus related to the research question of this dissertation, namely what is the impact of nation specific culture and national identity on the formation of supranational policies? Can this be achieved more easily by differentiated integration?

[59] See Weingast (1995), p. 5.
[60] This concept further developed in chapter 5.
[61] See also chapter 3 and 4.
[62] See chapter 5 for the definition of this study of self-enforcing

2.8 The role of social norms in EU policy making

Across Europe, there are different industrial relations models, which ascribe different roles to workers and companies in the political process. These models are rooted in historical developments and national traditions (Hall & Soskice, 2001). In simple terms, this means that people are used to the way certain issues are managed at the national level. For example, in some countries, such as Finland or Sweden, working conditions and wages are regulated through collective bargaining agreements, whereas such agreements are much less important in Eastern European countries. Institutions of this kind generate a set of common expectations and understandings, allowing actors to coordinate their actions (Hall & Soskice, 2001). This also means, that institutions are not stable - they evolve over time.

Reviewing a voluminous literature, Alesina & Giuliano (2015) conclude that there exists a feedback loop between institutions and culture. This means that cultural values influence, and to some extent determine, the construction of institutions. But, at the same time, institutions also influence individual attitudes. After German Unification, for example, East Germans were found to be more pro-government than West Germans, which was explained by indoctrination or induration (Alesina & Fuchs-Schündeln, 2007). The authors, however, also show that the two populations converged. From this, it can be concluded that existing institutions, such as norms guiding the behaviour of actors determining working conditions, can impact subjective electoral preferences and therefore complicate the creation of common EU policies.

National social models constitute political norms, 'prescribing' how policies are made. The European Commission (2016c) provides an overview of the role of social partners in the design of policies. This overview illustrates that the role of social partners is more important and formalized in some countries than in others, in spheres including but not limited to collective bargaining on wages and working conditions. The social partners take part in commissions related to new regulations, and thus participate in broader national political institutions. Such political institutions form part of national identities, through which individuals relate themselves to a larger group, the nation. National identities are constructed by political elites, who emphasize not only that citizens share political institutions, but also a common ancestral cultural heritage (Risse, 2015). National identities are collective group identities. According to social psychology theories, group identities impact individual behaviour. A central argument in these theories is that the greater the differences between groups and smaller the differences within groups, the stronger the collective identity of the group. Therefore, differences in norms and institutions may forestall solidarity and with the conclusion of efficient agreements.

The different national industrial relations systems across Europe impact preferences over specific policies. The existing institutions have an additional impact on individual behaviour, in that identification with a group results in in-group favouritism. In an ideal world, politicians represent the preferences of their constituency, which would impact the legislative process at the EU level. Taking a political economy perspective, the second-generation theories of fiscal federalism suggest that an institution's chances of survival are linked to the electorate's willing to pay for its continued existence. (Weingast, 1995). It follows that politicians should take decisions which benefit their electorate. One example, where politicians have to enforce a potentially detrimental, yet collective decision, is Brexit.

Dhingra et al. (2017), in a literature review, conclude that Brexit will have a negative effect on the welfare of the UK. Estimates from 2016 showed that Brexit could lower British GDP in the next four to fourteen years. Based on the seventh wave of the British

Election Study, Hobolt (2016) tests different theories on public opinion formation to explain the decision of the UK's citizens to leave the EU. She finds that the decision was impacted by education and income levels. In addition, Hobolt (2016) found that those with a strong British identity were more likely to vote Leave, whereas those with a stronger European identity were more likely to vote Remain. A national identity is a form of a territorial attachment. Economic and political integration necessitates a shift of identities to achieve a shift of allegiances from the national state to the European Union. This is confirmed by Alesina et al. (2017), who find that it is not necessarily divergence of interests or common values that undermine the efficiency of the political process in the EU. Instead, they identify nationalism as the culprit. Alesina et al. (2017) point out that, with regard to the EU, cultural differences fail to explain the rejection of common policies within the EU. According to their estimate, inter-country heterogeneity of cultural traits is not much higher than within country cultural heterogeneity. These results appear to confirm the view that 'territorial' identification is based on political principles. Such principles or values respectively, also are an important aspect within the EU, considering that Article 2 (TEU) states that: 'The Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities'. Such values form the basis of territorial identities.

A European identity can be considered as a requirement for adapting or changing loyalties and their political priorities (Castiglione, 2009). Furthermore, as a transnational identity, identification with the EU undermines territoriality and sovereignty. So, the process of identification and that of securing allegiances and loyalty is important. Castiglione (2009) points out that political loyalty needs some form of socio-psychological basis and a more concrete form of attachment. The identity-economics literature suggests that social identities influence distributive preferences (Shayo, 2009), that is, whether or not a poorer individual identifies with his or her nation might increase or decrease his or her acceptance of redistributive policies. Although the context is different, these results confirm to some extend the suggestions in Alesina et al. (2017), to the effect that national identity is liable to influence the popularity of supranational policies. Accordingly, Alesina et al. argue history or traditions lead individuals to identify with their nation, which could have undesired effects, including the failure of otherwise efficient agreements. On the other hand, identification can also support common policies.

Economic theory has put forward two generations of theories explaining the functioning of fiscal federalism. The first-generation theory provides normative explanations for common policies - how to maximize welfare? The second-generation theories describe why welfare sometimes goes unmaximized. They adopt a positive descriptive approach of political behaviour describing why decision makers might fail to do what is best. Group norms and attitudes can affect allegiances and thereby impact political behaviour, leading to suboptimal behaviour. Second-generation theories base their analysis on the assumption that individual behaviour is guided by pecuniary incentives. So far, these theories do not explain the impact of norms and values on individual behaviour. However, the problems raised above are to a large extent related to traditions and norms of solidarity. Therefore, to derive explanations of these issues, third- generation theories need to be developed. Chapters 6 and 7 will provide an approach linking the first and the second generations to a third generation - a behavioural approach to federalism.

2.9 Conclusion

This chapter reviewed the development of the EU, with a focus on social and employment issues. It raised several issues. Advanced economic integration, especially monetary integration, has resulted in an impasse, adding to the salience of new policy agendas. With the introduction of a single currency, Member States are now faced with a single monetary policy, which does not fit all national frameworks.

The chapter illustrated how economies are linked on several levels and uncovered several reasons why the EU should intervene in issues related to social and employment affairs. The EU is composed of countries which follow various economic and social models, which are not necessarily compatible. This may lead to differences in competitiveness whose solutions do not necessarily all fit under one single currency. During the Great Recession, inflexibility resulted in extended periods of low growth and high unemployment in some Member States. This revealed the need for reforms within these countries and in EU institutions. According to normative theories of federalism, the EU, as a supranational entity, should intervene in several cases, most importantly if activity in some Member States has repercussions on others, that is, if externalities can be internalized and economies of scale and scope be achieved by policies provided at the EU level.

In the review provided on the preceding pages, the normative criteria for an EU intervention appear to be fulfilled. Demand in one Member State is affected by public policies in other Member States. Furthermore, there are strong links between the national banking systems and banks in some Member State hold substantial foreign debts. Therefore, during the great recession, there should have been a shared interest across the EU in common macroeconomic stabilization and in re-establishing demand in these economies. Re-establishing demand during times of recession could, for example, be achieved through a common unemployment insurance mechanism at the EU level. However, this is only viable in the short run. In the long-run, high unemployment and low growth call for structural changes to boost competitiveness. This can be achieved by dedicated labour market policies and by increasing the flexibility of the systems used to determine wages. The EU could play a supportive role in the provision and organisation of these policies, and the following chapter will explain this role in more detail. By playing that role, the EU can and does cushion the centre-periphery divide, all while investing in skills. The discussion on the development of the EU has shown that EU integration is driven by economic goals and that social and employment affairs are mostly dealt with at the national level. Yet, there is coordination of social and employment policies and the next chapters will discuss the potential of this coordination to adjust collective bargaining systems to increase flexibility of wage setting for example.

Some Member States (or regions) have more competitive economies than others, which can attract economic activity from peripheral, regions to more prosperous, central ones, exacerbating the problem of the periphery even further. Therefore, investments into peripheral regions are important to increase cohesion between Member States. Such investments, especially into skills, are even more important in light of technological developments. While increasing competitiveness, it is important to maintain a level playing field between the Member States. This relates to a fourth issue discussed in this chapter, namely the maintenance of social and employment standards in the face of market integration, and especially free movement of capital and labour.

There seems to be a tendency in EU politics to favour economic policies over social ones. This owes much to the heterogeneity of electoral preferences and the low efficiency gains from common policies. Social policies relate to norms of solidarity, a bond which is enabled by common identity. The discussion in this chapter suggests that, in the long-run, policies related to structural issues - upgrading skills and increasing flexibility in the labour market - are of the utmost importance to ensure high levels of employment and well-being throughout the EU. At the same time, theory suggest that such policies are generally less likely to be implemented at the EU level. The existing theories appear to have only limited explanatory power. Therefore, an alternative theoretical approach will be put forward.

Chapter 3

European social policy - dynamics and economic rationales

3.1 The rationale of EU social policies

The previous chapter discussed different ways in which the EU can support Member States while they stabilize their economies, both in the short and the long run. The following chapter introduces the normative criteria for centralization, derived from economic theory. To illustrate these, the chapter outlines some specific EU social and employment policies, which pursue the goals introduced in the previous chapter. Advanced EU integration calls for increasing the flexibility of labour markets and creating a level playing field within them. Some observers even call for a European Social Union to include cross-border (pension) insurance schemes and redistributive mechanisms (Ferrara, 2017a). So far, EU social policy has been rather fragmented (Deakin, 2017) and it differs from national policy in that it lacks redistributive policies. The EU's initiatives in the field of labour market regulation and employment policies are related to the functioning of the internal market. The free movement of labour and persons are strictly auxiliary to that aim (Hix, 2007). Labour market regulation or social protection, for example, depend on national traditions and established views, which are differing. Given these differences, political acceptance of common EU policies might prove difficult.

Economists do not see a strong case for social policy to be devised at the European level (e.g. Alesina et al., 2005a). However, the previous chapter provided at least some evidence for the merits of that approach. The EU could support Member States to re-establish demand in the short term or to improve competitiveness of the national economies in the long-run. By providing for investments into labour market policies for example, the European Structural Investment funds could support Member States in economic distress to bridge times of hardship and add to the stabilization of the economies (Monti et al., 2017; Katterl A. & Koehler-Toeglhofer, 2018; Ecorys, 2008).[1] Fair competition in the EU market is a further issue in respect of providing services in different regions of the EU. Although, economic integration has been privileged over social and employment policies, the EU is not exclusively marketarian. As was highlighted in the previous chapter, different national preferences make it harder for the Union to advance social and labour-market policies. However, depending on their nature and design, some of those are likelier to gain traction than others. The following chapter will inform the discussion about how such policies emerge and whether or not these should be done according to a more differentiated vision or a so-called variable geometry. Doing more or less together, or shall those who want to do more, do more? The chapter will do so by introducing related normative standards derived from economic theory.

There have been social accomplishments at the EU level - the Posted Workers Directive addresses race-to-the-bottom concerns, whereas other measures aim to boost competi-

[1] As will be discussed further below, the existing funds are too small for doing so.

tiveness in specific regions.[2] The European Social Fund (ESF) support regional projects aiming at improving skills for example. This chapter will review some of the relevant policies and strategies. The intention is not to give an exhaustive review, but to provide an understanding of EU social policy and to contextualise that policy within the theories that were discussed earlier. More specifically, the chapter will show how these policies perform economically, and why some of them fall short of their stated objectives.

3.2 The economic rationales of the functioning of the government

National social policies encompass different aspects of social welfare, such as housing, education and income redistribution. Their main goal is to increase the well-being of society. This can be done by providing public services to specific groups or by redirecting resources to groups in need (Midgley, 2009). National social policy involves a combination of enacting workers' rights, maintaining income security, and addressing deprivation (Daly, 2017). Social policy can also be understood as a tool to improve employment rates, working conditions, social protection, labour skills, and social inclusion (Wagner et al., 2006). The concept of social policy encompasses social security, as well as employment and labour-market regulation (De Grahl et al.,2013). Taken together, these definitions show that national social policies pertain to the improvement of the welfare of the individual citizen. The existence of redistributive, democratic and solidary wage-setting mechanisms, coupled with public investments in education and training, form part of European social models (Manners, 2006). Although the European Social Models have a lot of commonalities, some differences remain.[3]

[2] Directive 96/71/EC of the European Parliament and of the Council of 16 December 1996 concerning the posting of workers in the framework of the provision of services

[3] Those differences will be discussed in greater depth in chapter 4.

From a traditional public-finance view, one can differentiate between three branches of governmental activity: (macro-) economic stabilization, redistribution and resource allocation (Musgrave, 1959). Individual social and employment policies can belong to either of the three branches. Unemployment benefits for example can have a stabilizing effect in an economic downturn, helping bridge demand gaps. Other kinds of redistributive policies relate to resource allocation. In chapter 2, it was said in passing that governance operates on several levels. For each branch of governmental activity, there are different optimal levels of governance (Musgrave, 1959).

Macroeconomic stability can be sustained by government spending to re-establish demand after a macroeconomic shock. Beyond unemployment benefits, this spending can be financed by borrowing from the private market. If the country is composed of several regions, there is also the possibility of fiscal transfers, in which the prosperous regions are taxed to revitalize demand in less prosperous ones. The logic behind the centralization of the stabilization function is that the central government is better situated to discharge this function due to its higher revenue raising capacity. In addition, providing for stability may have spill-over effects to other regions, which a local government cannot constrain and might therefore under provide the insurance (Musgrave, 1959; Oates, 2004). Regarding the EU, Tabellini (2003) argues against allocating the fiscal stabilization function to the EU. In his view, the potential for bailout generates moral hazard. If national governments have the prospect of being bailed out in case of over-indebtedness, incentives for efficient spending and resource allocation are low. Therefore, the maintenance of fixed budget constraints is important.

Another function which is often assumed to fit the central level is income redistribution. The reason is that mobility of tax bases might reduce the ability of governments to redistribute incomes. (Oates, 2004, Tabellini, 2003). The mobility of capital and households constrains national (local) governments in their redistributive capacity. On the one hand, redistributive programs might attract low-income households and deter high-income households from migrating into a specific region. This in turn might lead to the under-provision of redistributive programs therefore, the centralization of redistribution appears to be more efficient. Redistribution can be welfare enhancing, especially in the face of relatively immobile labour and households.[4]

The third important activity of the government, differentiated by Musgrave (1959), is resource allocation, that is, the production of publicly provided goods and services. Such goods include large public infrastructure, public health care, education and defence, to name but a few. Analytically, the government, which designates 'a bundle of administrative, judicial, economic services and public policies'[5], can also be defined as a public good. Hence, from a broader perspective, one could attribute the government with is regulatory framework to this branch.

Latent in the foregoing review is the existence of concrete criteria that enable us to gauge the desirability of centralisation and decentralisation at the national and Union level. The crucial factors are efficiencies and preferences. Efficiency gains can be achieved by cost savings related to economies of scale or scope. Providing a public service or good to more individuals reduces the per capita fixed costs of the good, which in turn lowers its overall cost. Further efficiency gains can be achieved through the reduction (increase) of negative (positive) externalities. This relates for example to common labour standards and the race to the bottom introduced above. The different functions of the government can have different characteristics. The benefits from public policies can accrue to several citizens at the same time, so that the consumption of one citizen does not retract other citizens' consumption horizons. Hence, the consumption of these public goods can be

[4]However, a thorough discussion of this would go beyond the scope of this study.
[5]See Alesina et al. (1997), p. 1030.

		Excludability	
		High	Low
Consumption	Rival	Private Good	Common Pool Resources
	Non-rival	Club Good	Pure Public Good

Table 3.1: Characteristics of public policies and their classification.

more or less rival. At the same time, some public goods are excludable, while others are not. This relates to the extent to which the provision of public goods has external effects. Social investments, for example, improve the lot of their direct beneficiaries. In the standard theory, there are four types of goods: private goods, public goods, club goods, and common-pool resources. These goods differ in their degree of excludability, that is, the degree to which someone can be excluded from consuming them, as well as the degree of their rivalry in consumption.

As table 3.1 shows, the different types of goods are characterized by different degrees of excludability and rivalry in consumption. This might increase or decrease incentives for Member States to join common policies or to leave coalitions of countries who wish to provide the policy, that is, it may induce centripetal or centrifugal effects. Centripetal effects can be explained as: 'the smaller the core of co-operating member states necessary to give initially unwilling outsiders the incentives to join in, the stronger the centripetal effects of the respective policy.'[6] Everything else being equal, the more excludable the public good, the likelier the eventual participation of initially reluctant members.

If the public good is excludable, the possibility of free-riding is foreclosed. This provides incentives to join the union of countries which provide the. However, if countries cannot be excluded from the benefits of a policy, then they will free ride. For example, if a country implements strict rules to protect the environment, neighbouring countries get cleaner air at no cost. Rivalry in consumption is also important. However, it only

[6]See Koelliker (2001), p. 131.

has an impact if a good is excludable. For non-excludable goods, the benefits that accrue to insiders and outsiders are similar. However, rivalry (or complementarity) of consumption is relevant for excludable goods. If the benefits of participation decrease as more countries are added, outsiders' willingness to participate will be lower. If, however, there is complimentary in cosnumption, incentives to participate are heightened. For example, frameworks enabling national administrators to learn from each other are more beneficial if more countries participate because there are more systems to learn from. If administrations can be excluded, they have to become 'members of the club' to reap the benefits. Active participation and contribution by different countries grows likelier. Therefore, rival consumption of an excludable good results in centripetal effects.

The description of the incentives to join a union of countries to provide common public goods highlights the fundamental dilemma of public finance - pure public goods should be provided by a central authority, but the incentive for individual states to support such an authority are very small. In terms of Koelliker's theory, there are centrifugal forces at odds with common policy-making. This is a collective action problem - a situation in which it is rational for individual entities to oppose the socially optimal solution to a problem. Another collective action problem is related to labour and wage standards and the potential race to the bottom, which will be discussed below. The review above shows that different approaches to common policies are possible, depending on the characteristics of the respective policies. Those policies, which are characterized by a high degree of excludability and complementarity are more likely to attract Member States, which are not yet part of the provision of the policy. If Member States can be excluded from the benefits of a policy, then incentives to join the group of countries providing that policy are high. Therefore, policies characterized by such features lend oneself for a multi-speed approach. Thereby a core group of countries pursues common policy goals together, assuming other countries would follow.

These normative principles show when there should be common policies and when these are less meaningful. An additional factor hampering effective collaboration between Member States is the strategic behaviour of countries, exploiting the opportunities for free-riding discussed above.[7] An important reason for common policies is the realization of cost savings. If one single administration could provide the same service to several countries instead of having 27 national administrations, reproduce the same service economies of scope can be achieved. This, however, is only achievable if the different countries can agree on how this service should be designed and implemented. Therefore, beyond the normative principles just outlined, political interests play an important role. If those are aligned, then policies designed according to the principles outlined above will be beneficial and successful. To get an understanding of EU policies, the following section will review some of these effects.

3.3 European integration - employment and social policy

Chapter 2 has suggested that short-run redistribution between Member States helps stabilize the economy. In the long-run, economic activity can only be supported and increased by structural reforms. In both cases, the EU can support Member States. It already does that, to some extent, within the framework of its social and employment policies. The Juncker Commission, which took office in 2014, focused on strengthening social rights (De la Porte & Natali, 2018). With the introduction of the European Pillar of Social Rights, the Commission's social and employment goals became labour-market access, skills development and poverty reduction. The Pillar is 'a compass', guiding the social and employment policies of the EU to which Member States committed. The aims and principles enshrined in the Pillar can increase competitiveness (Deakin, 2017).

[7]This will also be discussed further in chapter 5.

In addition, the prominence of social dialogue in the policy agenda has grown.[8] It can have a positive impact on the productivity of workers and, depending on the structure of collective bargaining, it can increase wage flexibility. However, collective bargaining over working conditions and wages lays outside the purview of the EU social dialogue. Collective bargaining takes place at the national level and the autonomy of the social partners has been preserved. EU legal instruments that ensure that every EU citizen earns a certain income could furthermore interfere with national bargaining systems. Wages are decided at national level. Although an EU law related to wages might be justifiable by the presumption that such rules reduce the likelihood of a race to the bottom, differing preferences over how such an instrument should be designed reduce the likelihood of its implementation. What role should the EU play?

In 2000, the Lisbon Strategy was launched, with a focus on competitiveness and innovation within the EU. One of the main targets of the European Commission since the Lisbon Strategy has been sustainable economic growth in the EU and increased global competitiveness. At the time, it was thought that the Lisbon Strategy would transform the EU Member States' economies into the most competitive economies worldwide, a prospect which did not materialize. In 2010, the new ten-year growth strategy, Europe 2020, was introduced (Zeitlin & Vanhercke, 2014). The Europe 2020 strategy specifies goals and targets for different policy areas relating to economic, social and environmental issues. To further the goals of Europe 2020, several initiatives were launched. These included the Employment Package, which guides the employment objective of Europe 2020 and steers the use of the EU budget (ESF) as a tool to achieve these employment goals.

[8] See for example European Commission (2016): A new start for social dialogue. Luxembourg: Publications Office of the European Union, 2016.

The literature often highlights the limitations of EU policies. The specific programs for tackling unemployment, such as the Youth Guarantee, were criticized for their weak impact (De la Porte & Natali, 2018). The new programs did not make new funds available, but were financed by existing funds (Copeland & Daly (2018). Some of the employment policies respond to threats of social dumping and a race to the bottom. To a large extent, integration in these fields follows the logic touched upon in chapter 2. Generally, social policies at the EU level have similar goals to national ones, that is, increasing the well-being of citizens. However, the following review shows that EU policies are broader and there is no direct redistribution between individuals. Although Art. 154 TFEU stipulates that the EU shall support Member States to improve working conditions or social protections of workers. However, issues related to pay are explicitly excluded from this scope by Art. 154(5) TFEU. So, what role shall the EU play in guaranteeing a decent income and social standards?

3.4 Coordination of the EU social policy

The previous chapter concluded that long-run economic impasses call for structural changes. Those could be aimed at increasing flexibility in the labour market to adapt to changing economic realities. The EU could provide room for mutual learning. Existing coordination methods, such as the European Semester, can potentially be deployed to advance this agenda (Deakin, 2017). Deakin (2017) suggests that existing coordination mechanisms within the EU could be used to develop common collective-bargaining standards. Such standards could increase the flexibility of Member States' labour markets. Since the early 2000's, many social and labour policies were coordinated within the framework of the Open Method of Coordination. It was formally established by the Lisbon European Council in 2000, although its roots go back to the creation and implementation of the European Employment Strategy (EES). This strategy was developed in 1997 in order to create better and more numerous jobs within the EU.[9] In the late 1990's, many of the European Member States shared problems like high unemployment, unreformed social security systems and low workforce participation. At that time, the European level was perceived as a potential source of solutions. However, the competence of the EU was relatively limited, so that the promoters of the Employment Strategy had to fall back on soft law to coordinate their policies (Moscher et al., 2003). Nowadays, the EES constitutes part of the Europe 2020 strategy and feeds into the European Semester, which is described in more detail below. The EES foresees policy coordination between Member States through the circulation and dissemination of best practices and the publication of guidelines[10] and shared indicators, all to be used within the framework of the OMC. In this framework, Member States agree on goals, principles, and performance indicators. The central elements of the OMC are quantifiable objectives, which are executed on a decentralized level (Needergar, 2007). The OMC provides room for mutual learning through peer reviews and the exchange of examples of good practice. The OMC together with the respective committees founded in the framework of the EES, are now all embeded in the European Semester framework.

The Employment Committee (EMCO), composed of two representatives of each Member State and the representatives from the Commission, contributes to the evaluations and the setting of targets.[11] This Committee is responsible for reviewing and monitoring national social and employment policies and draws up guidelines and recommendations.[12] It is the OMC's exchange forum and it is also an advisory committee to the Council of the European Union[13] for employment and social affairs. It is responsible for the Em-

[9] See https://ec.europa.eu/social/main.jsp?catId=101&langId=en. (last accessed: 09.12.2018)
[10] These are the so-called employment guidelines.
[11] Moscher et al. (2003).
[12] The committee was established by the Council Decision of January 24, see https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32000D0098 (last accessed: 09.12.2018).
[13] More precisely to the Employment and Social Committee (EPSCO) of the Council.

ployment Guidelines[14], which have, since 2010, formed part of the guidelines to achieve the Europe 2020 targets. The employment guidelines specify social and labour-market priorities which should be tackled at the national level. It takes the form of a Council decision and thus binds Member States. However, the guidelines are formulated in a relatively vague manner, so as to secure the acceptance of all Member States.

The Social Protection Committee (SPC) also advises the Council. Within the framework of the OMC, the SPC is responsible for the exchange of information on practices and policies that concern social inclusion and social protection. The SPC is tasked with monitoring national social protection policies and the exchange of good practices between Member States. Additionally, it prepares reports and formulates opinions within its field of competence, at the request of the Commission, the Council or on its own initiative. It consists of national and Commission public officials and experts who interact to construct informal rules. There are, however, no formal means of enforcing these rules (Horvarth, 2008).

In the framework of the EES, Member States, together with other relevant stakeholders, such as social partners, agree on goals and strategies to be implemented. These are summarized in the so-called employment guidelines. With the introduction of the Europe 2020 strategies, the OMC was integrated into the European Semester (Bekker, 2015). The European Semester streamlines the policy coordination process in social and employment policies, along with other fields, such as education and fiscal oversight.

Within the EMCO, countries who received a CSR related to employment or social issue in the previous year are reviewed. Furthermore, this committee gathers national administrators and Commission officers to develop and discuss indicators and employ-

[14] See https://ec.europa.eu/social/main.jsp?catId=101&intPageId=3427 (last accessed: 09.12.2018)

ment strategies. Country representatives benefit from exchanges with administrators from other Member States. These insights, in turn, can find their way into national laws and regulations (Sabato, 2017). Although some national policy makers tend to deny the impact of the OMC, the literature finds that issues and phrases highlighted by the analysis of the OMC find their way into the national policy agendas. Weishaupt (2014a), for example, points out that the information made available by the OMC raised awareness about a rise in child poverty in Germany, which fed into the public discourse. Weishaupt concludes that the OMC can be effective, especially if national actors consider it valuable.

The literature also suggests that, since the introduction of the European Employment Strategy, national expenditure on Active Labour Market Policies as a share of all Labour Market Policies (ALMPS) has increased. Labour market policies encompass regulations, such as those determining working times for example, but also government interventions, which aim to help people to find work. These interventions encompass training schemes and subsidies giving unemployed people the opportunity to build up new skills, before taking up a new job. These interventions are called ALMPS. Van Vliet & Koster (2011) conclude that the introduction of the EES has contributed to a shift from passive to active labour market policies. Of course, there are factors which influence the number of interventions, such as the unemployment rate income levels and, perhaps more importantly, domestic politics (left- vs. right-wing government). But, taking a variety of these factors into account, Van Vliet and Koster still find that the EES exerts a serious influence on policy. It appears that the OMC, or more broadly speaking, the coordination within the framework of the EES, benefits participating countries.

The peer reviews within the framework provided by the EMCO pressure on national administrations and force them to reflect on 'uncomfortable' topics (Weishaupt, 2014a,b). Coordination further enhances the technological capacities of national administrations.

The development of common databases, such as the EU Statistics on Income and Living Conditions, stimulate policy learning (Zeitlin, 2009). This data allows for cross-country comparisons and the identification of 'natural' differences and hurdles to national labour policies. The language and the ideas of the OMC are often used by national policy makers (Weishaupt, 2014a), which shows that the ideas and proposals discussed within the OMC reach the national level. Greater participation would certainly enhance governance across the Union. It would yield a larger sample, that would enable more comparisons to be drawn and more experiences exchanged. In addition, it is easy to exclude countries from these benefits. Non-participants could pick up the discussions held within the EMCO, and access data from other countries for example. However, without participating in the respective Committees, Member States will neither benefit from exchanges nor shape indicators determined by the EMCO indicators groups. This means that the measurements might not be adaptable to the national specificities and that national administrators do not gain new experiences or knowledge from the exchanges. Countries outside this coordination process are not reviewed and do not benefit from recommendations of policies to improve the functioning of labour markets. In a stylized description, following the theory outlined in section 3.2, the coordination of employment and social policies allows to exclude countries from its benefits. Furthermore, the more countries are involved in the coordination process, the higher the benefits, as more national experiences can be compared. Therefore, the coordination processes resemble a club good - there is non-rivalry in the use of the policy outcome and it is easy to exclude others from its benefits.

The EES coordinates Member State action and provides a framework in which Member States can learn from each other. The successes of the European Semester, in which the EES is nowadays embedded, are not uncontroversial- its reformist potential is unknown. Efstathiou & Wolf (2018), for instance, find that the implementation of the CSRs made within the Semester process is weak. This section started with the proposal that such coordination mechanisms could be used in order to support reforms of wage setting mechanisms.

3.5 EU Employment and social regulation - countering the race to the bottom

The free movement of services allows foreign producers and companies to provide their services across borders. Due to disparities in working conditions and wages, companies from some countries can provide services at lower costs than host-state companies. This leads to conflicts between foreign companies and employees, trade unions and host-state governments.[15] The previous chapter covered the resultant regulatory competition in some depth. To recapitulate, the need to attract companies may cause Member States to reduce taxes and labour standards. Theory predicts that the process may be reiterated as a result of inter-state competition. Regulatory competition, when it proceeds thus, produces lower revenues for welfare states and, if taken to extremes, in its complete erosion. The Union's Member States are social market economies, characterized by social policies and more-or-less generous welfare systems. The size of the social welfare state is limited, as is the number of regulations related to employment standards. Therefore, there is a limited pool of standards and by underbidding each other, Member States deplete it. At the same time, without coordination, it is impossible for Member States to discourage other Member States from satisfying their needs from this pool. There is an obvious analogy with the textbook example of grassland belonging to a community of farmers. It is individually rational for each farmer to let his cattle grass on the land as much as possible. However, in the long run, this may lead to overuse. In the case

[15] See Wagener et al. (2006), p. 244.

of labour standards, overuse results from strategic underbidding, resulting, at least in a theoretical extreme scenario, in the abolition of labour rights. Hence, this is a case of non-excludability and rivalry in consumption, a common-pool resource problem.

The incentives to join a common policy are low. In chapter 2, the posted workers problems was described as an illustration of the race-to-the-bottom paradigm. The Posted Workers Directive[16] aims to provide a comprehensive solution. The Posted Workers Directive applies when a worker, employed by an employer established in an EU Member State (the home state) under a contract regulated by the law of that state, is seconded for temporary work to another Member State (the host state).[17] The Directive requires that the host state apply to that employment relationship certain basic standards of its own labour law, although such standards have not been agreed between the home-state employer and the employee. These standards are applied even if the home state would not apply them to the relationship between employee and home-state employer. The protected standards include working hours, holidays, minimum pay, health and safety, protective rules for pregnant workers and the equal treatment of the sexes. If the home country is an exporter of labour and the terms and conditions of employment required by law or established by practice in the host country are stricter than those of the home country, trade host-country governments should welcome the Posted Workers Directive (Davis, 1997). Competitive advantages due to differences in labour standards are reduced or eliminated.

The Posted Workers Directives includes elements such as minimum pay and prescribes minimum rates of pay in the host state. However, different Member States regulate pay differently. In countries such as Austria, Belgium, France and the Nordic countries[18],

[16]Directive 96/71/EC
[17]See Davis (1997) for more detailed explanations.
[18]See European Parliament (2016), table 3.

minimum rates of pay are regulated by collective agreements. In other countries, such as Bulgaria, Hungary or Poland, or Germany for example, the minimum rate of pay is set by statute. The original Posted Workers Directive stipulated that the minimum rates of pay as defined by national rules of the host state should be guaranteed.[19] The European Commission (2016b) highlights that in those countries where there is no generally applicable collective agreement, Member States are free to apply collective-bargaining agreements by way of analogy. In Sweden and Denmark, for example, the Directive may have been ineffective at times. In the absence of statutory minimum wages, minimum rates of pay are determined by collective agreements, which leave ample room for company-specific agreements that play an important role in domestic economies. However, few collective agreements have been concluded with cross-border companies. This can result in situations where different rules apply to national (local) workers and posted workers, with the corresponding wage differentials. This winds up conferring a competitive advantage on posting companies, who can offer the services at a lower price level.

In 2016, the European Commission proposed amending the Posted Workers Directive.[20] The purpose of the amendment is to increase certainty and avoid social dumping. The new provisions cover bonuses, allowances, as well as wage increases tied to length of service. The Directive enhances 'the equal pay for equal work principle', according to which the same work executed in the same place should be remunerated at a similar rate. The revised Directive was welcomed by the EU's trade unions,[21] despite some criticism that it does solve all related issues.[22]

[19] Directive 96/71/EC

[20] Amendment to Directive 96/71/EC Directive by (EU) 2018/957 of the European Parliament and of the Council of 28 June 2018.

[21] https://www.etuc.org/en/pressrelease/equal-pay-sight-posted-workers (last accessed: 11.08.2018)

[22] https://bruegel.org/2017/10/revision-of-the-posted-workers-directive-misses-the-point/. See also https://bruegel.org/2016/03/social-dumping-and-posted-workers-a-new-clash-within-the-eu/ (last accessed: 11.08.2018)

The problem of posted workers is related to a potential race to the bottom, due to the nature of employment standards, which - as mentioned - can be considered a common pool resource. According to Koelliker (2001), policies relating to common pool resources are unlikely to be integrated. If integration among a subset of Member States was possible, those outside this group would still be better off avoiding the common policy. Non-participation would actually facilitate competition over income and labour standards - low- income countries can simply undercut the higher standard set by other countries. In 2018, the proposal of the European Commission was adopted. Many Eastern European countries accepted the new Directive in the Council.[23] Thus, the legislative outcome deviated sharply from theoretical predictions. One hypothesis put forward in this study is that mainstream theory overlooks the behavioural aspects of decision-making. European Member States can be characterized as social market economies which share features like solidarity and basic social standards. These points of commonality could have impacted the willingness of countries to form a common policy on posted workers. Social Identity Theory provides relates such norms to (economic) behaviour through specific mechanisms. The theoretical discussion will make clear whether policies aiming at eliminating a race to the bottom can be implemented in a differentiated way, where some core states adopt the policy immediately and others decide whether to follow them later.

[23] The voting outcomes for the amendments of the Posted Workers Directive can be found here: https://www.consilium.europa.eu/en/general-secretariat/corporate-policies/transparency/open-data/voting-results/?meeting=3625. (last accessed: 18.09.2019)

3.6 European cohesion expenditure - solidarity versus effectiveness?

The more developed a region, the more it benefits from EU integration. The previous chapter explained the reasoning behind this argument. It also showed that the EU Cohesion Policy was established, among others, to alleviate the potentially negative effects of integration. Cohesion is commonly understood 'as the degree to which disparities in social and economic welfare between different regions or groups with in the European Union are politically and socially tolerable'.[24] The main objectives of the Cohesion Policy are to improve economic, social and territorial cohesion or, in other words, to stimulate growth, to reduce poverty and to upgrade regional infrastructure. The Cohesion Policy primarily aims to reduce income disparities, especially after the accession of the Eastern European Member States, as the disparities would otherwise endanger the Union's internal cohesion (Molle, 2011). To achieve these goals, the EU has specific funds to provide financial means to disadvantaged regions, the so-called European Structural and Investment (ESI) Funds. Those funds are used to further the overall growth strategy (Molle, 2011). The Cohesion Policy is an investment instrument which should aid the attainment of long-term goals, such as Europe 2020 (Begg, 2017). The analysis of Cohesion Policy may also help to understand the logic of common investments and what leads Member States to them.

The ESI funds do not redistribute financial means between individuals, but between regions. This redistribution has an obvious advantage, in that the peripheries can catch up with the stronger economic agglomerations. This could increase demand for products from the more productive regions, and thus increase overall prosperity. Providing a

[24]See Molle (2011), p. 3989f.

common Cohesion Policy at the level of the European Union has the additional advantage that administrative costs, linked to the provision of training or infrastructure, can be reduced due to economies of scale (Molle, 2011). In general, the funds can increase the welfare of the low-income regions, which in turn increases productivity in these areas. This can enhance overall demand and in turn add to the welfare in the core regions. The funds are invested into infrastructure projects, that is, into the improvement of transport, communication and education. Therefore, these policies should improve the supply of factors of production and with it competitiveness and comparative production advantages.[25] The Cohesion Policy is supply- side oriented (Hix, 2005). It supports investments in productive infrastructure, among others. The ESF is dedicated to investments relating to job creation, vocational training and education, and social inclusion.

The empirical evidence on the effectiveness of the funds is inconclusive. The ESF was found to have positive impact of regional Spanish labour markets and increase the effectiveness of active labour market policies in reducing unemployment (Gonzalvez Alegre et al., 2013). Generally, the funds were found to have a stronger impact in economically more developed regions and this can be related to a higher absorption capacity of these regions (Cappelen, 2003). The absorption capacity of a country in the framework of EU funds is the ability of national and regional administrations to spend the allocated funds in line with the plans agreed with the Commission and within the agreed timeframe. It depends on several factors, such as the ability to co-finance projects, i.e. the financial absorption capacity, and the administrative capacity, i.e. the ability to plan and mange programs which are co-financed by the respective funds (Kersan-Skabic et al.,2017). Overall, the empirical evidence on the effectiveness of the funds is inconclusive. This is due to different factors, such as complex local environments and different spillover effect

[25]See Hix (2005), p. 293

of local policies and diverse national and regional policy interventions beyond cohesion policy. A lack of appropriate data adds to these complications (Darvas et al. 2019). The ESI funds could support the stabilization of regional economies in case of asymmetric shocks, by providing the means necessary for expansionary policies. However, they are not designed as insurance, but as permanent funds. This allows governments to provide stable policies over time.[26] Before discussing the effectiveness of the funds, the following section will explain their functioning.

3.6.1 The functioning of the funds

The Cohesion Policy funds are formed from the European Structural and Investment (ESI) Funds.[27] Apart from the Cohesion Funds, which are composed of the European Rural Development Fund (ERDF), the European Social Fund (ESF) and the Cohesion Fund, the ESI funds comprise the European Agricultural Fund for Rural Development (EAFRD) and the European Maritime and Fisheries Fund. The latter form part of the Common Agricultural Policy and the Common Fisheries and Integrated Maritime policy. The most relevant funds for the Cohesion Policy are the EAFRD, the Cohesion Fund and the ESF. The ESF holds funds earmarked for job creation, vocational training and education, and social inclusion. The EU budget for employment and social issues is small when compared to national welfare budgets. The commitments for the ERDF and the ESF make for about 0.25% of combined Member State GDPs,[28] whereas overall welfare spending across the EU makes up about 18.8% of national GDPs.[29]

All of the funds are governed by the Common Provisions Regulations (CPR)[30], which

[26] Ecorys (2008), p.91.
[27] See European Commission (2015)
[28] Based on the calculation by Darvas et al. (2019), of the commitment appropriation for the MFF 2017-2020.
[29] Source: Eurostat - Eurostat (gov10aexp), government expenditure on social protection, year 2017.
[30] Regulation (EU) No 1303/2013. The analysis of the Cohesion Policy discusses the frameworks of

coordinates the use of the funds. The CPR specifies the allocation method of the Cohesion Budget per country.[31] At the beginning of each multi-annual financial policy cycle, the overall budget is proposed for the seven-year cycle. Thereafter, resources are allocated to individual funds. In the second step, resources from within the funds are allocated to individual Member States. This is based on gross domestic income and population size.[32] In addition to the CPR, each fund is regulated by a fund-specific regulation, specifying, among others, the fund's objectives and functioning. The ESF funds are structured around the shared management principle. The Member States are responsible for the management of the programs into which the funds are invested, and for the establishment of management and control systems. The Commission supervises the implementation and the management of expenditure and control systems. To ensure that the funds are invested into the priorities of the EU, the European Commission and the Member States conclude partnership agreements at the beginning of each multi-annual cycle. These describe the investment priorities of the Member States and their connection with the goals of the European Union. These goals are broken down into specific operational programs, where more specific targets - as well as measurements - are specified.

The role of the European Commission is to ensure that the partnership agreement is in line with the long-term goals. The operational programs can be considered as investment plans, specifying the volume of funds to be allocated to thematic goals. National authorities are then appointed to manage the respective programs. Potential beneficiaries apply for project funding to the authority managing the relevant program. In this way, Member States are driven to invest into region-specific needs while still respecting

the 2014-2020 Multi-Annual Financial Framework.

[31] See Annex VII of the Regulation (EU) No 1303/2013

[32] See https://www.eca.europa.eu/lists/ecadocuments/rcr_cohesion/rcr_cohesion_en.pdf (last accessed: 23.11.2018)

the central aims and goals of the EU. The structural funds projects are co-financed by the EC and the national authorities. The respective levels of fund contribution (co-financing) depend on the wealth of the regions and vary between 50% and 85%. The funds which are allocated to a region need to be spent within the agreed time-frame (Bachtler & Ferry (2013). The literature points to a problem related to spending: not all the national administrations have the capacity to manage and spend the funds efficiently.

The European Structural Funds encompass several funds, each with a different focus. The effectiveness of the funds is not clear-cut. The ESF fund for example was found to have had a positive impact on regional Spanish labour markets and to have increased the effectiveness of active labour market policies in reducing unemployment (Gonzalvez Alegre et al., 2013). Although the literature on the impact of the cohesion funds is inconclusive (Darvas et al. 2019), there appears to be a consensus in the literature on the importance of the institutional and administrative capacities of national administrations.

Less developed areas are less receptive to the funds, due to a lack of competence in the receiving environments (Cappelen et al., 2003). In addition, the recipient regions also need to have the necessary absorption capacity, given the requirement to spend the funds in predetermined timespan. In the framework of the EU funds, absorption capacity can be described as the capability of Member States to spend efficiently the financial resources allocated from structural funds (Cace, et al., 2009). The absorption capacity of regions and countries depends on several factors. Apart from the administrative capacity, which is the ability to plan and manage co-financed programs, absorption capacity also depends on the capital endowment of the regions in which the fund should be invested, that is, its human and social capital, as well as existing infrastructure (Kersan-Skabic et al.,2017). In order to manage large-scale projects, the respective local authorities or organization has to have the right capacities in order to be able to spend the funds allocated to the project, which often is not possible. Common reasons are a weak legal framework for financial management or public procurement procedures (European Parliament, 2013). The management framework of the ESF is complex. Therefore, administrative capacity is important.

3.6.2 Redistribution and the institutional framework

The aim of cohesion policy is to lower income disparities in order to foster cohesion between the Member States. However, poorer regions appear to have difficulties in obtaining and managing the funds. Under the proposed framework for the MFF 2021 to 2027, the overall volume of the cohesion funds will be reduced and the poorer regions are expected to lose more than richer ones.[33] The cohesion policy could support the macroeconoic stability of the Member States. However, due to a relatively low endowment of the funds, the potential effects on stability are expected to be rather small (Monti et al., 2017; Katterl A. & Koehler-Toeglhofer, 2018; Ecorys, 2008). In addition, the management of the funds is complex and has been criticized to discourage efficient allocation to places where these are needed the most. Two possibilities emerge from this discussion. One is to increase the budget for the funds. The other is to change administrative requirements.

Administrative capacity is one of the most clear-cut explanations of some national administrations' failure to apply for funds. Thus, the regulations of the funds make it more difficult for recipients to apply for and manage projects. Simplifying the framework could alleviate this burden and potentially increase the likelihood of funds reaching

[33]http://www.euvisions.eu/eu-cohesion-policy-2021-2027-mff-winners-losers-europe-peripheries/ (last accessed: 21.09.2019) At the time of writing, the framework has been proposed by the Commission and is under negotiation between the Member States.

the 'right' recipients. However, the framework is necessary to avoid moral hazard and misuse of funds. It ensures that the funds are allocated to the policy for which they were intended and not to other areas. This contributes to the discipline of national government spending and ensures hard budget constraints, a necessity for effective centralization of policies and the functioning of the internal market. Accordingly, the surveillance of the funds is important. Given the way the cohesion funds are managed, they could be considered a private good (Koelliker, 2001). The funds can only be accessed by beneficiaries who fulfil predetermined criteria. Once the funds are allocated, they can only be "consumed" by the beneficiary. Hence, there is rivalry in consumption and excludability. Simplifying the framework could result in less excludability. More regions (or geographical areas) might be reached, but it would be more difficult to observe whether funds are deployed for their intended purposes. Eventually, reducing standards could turn the funds into a common-pool resource, whose ultimate dissipation would grow likelier. Therefore, changing regulations is unlikely to be acceptable for the Member States.

The stabilization mechanisms depicted in the previous chapter, such as a European unemployment benefit scheme, can benefit EU citizens in ways similar to the Cohesion Policy. An unemployment benefit scheme would transfer funds either between countries or between citizens of countries. If citizens need to decide about a common unemployment scheme behind a veil of ignorance, acceptance would imply a strong bond of solidarity. Thus, despite its potential benefits, the creation of that scheme is unlikely without solidarity. The ESI funds are underpinned by strict regulation, with the amount allocated to each region negotiated in advanced. The overall budget, compared to national budgets, is small, which is also criticised by stakeholders such as ETUC. The low endowment, together with the strict monitoring requirements, explain widespread scepticism towards the funds. As in the case of a common insurance benefit scheme, increasing the effectiveness of the funds necessitates solidarity between the citizens of different Member States.

When comparing the funds to other financial instruments at the EU level, such as unemployment insurance, it is important to consider policy changes. If a fund is used as a means to insure individuals against the risks of becoming unemployed and any individual in a given group has access to these funds, then these might become a common pool resource, with well-known problems of overuse. In that case, a well-defined framework regulating access to the source is vital.

3.7 Conclusion

Some observers find that there is an increasing political awareness of the need for a Social Union (Vandenbroucke, 2017a). The European Pillar of Social Rights is 'proof' of the willingness to deepen Europe's social dimensions, although it has been criticized for being ill-equipped to secure its goals (Deakin, 2017). The review in this chapter distinguished between three types of EU policies or strategies. Firstly, the Open Method of Coordination is the process of national labour and social-policy coordination which is nowadays managed within the framework of the European Semester. The OMC serves as a tool to improve national social and employment policies and to align them with the functioning of the internal market. Secondly, social investments and redistribution are operationalised in the framework of the European Cohesion Policy. Thirdly, the Union passes legislation related to employment and social affairs, which contributes to the creation of a level playing field in the EU market. The Posted Workers Directive is a prominent example. From an economic perspective, such legislation can reduce the risk of a race to the bottom in labour standards.

The comparison of the policies to the theoretical economic framework has shown that coordination methods are attractive - in theoretical terms, they have centripetal effects. In practice, their effectiveness is contested, but there is some evidence showing that coordination has its merits, although its effects are not easily quantifiable. Although no laws emanate from the framework, policy coordination has the potential to support the Member States in undertaking structural. The section on the Cohesion Funds has shown that they could have a stabilizing effect and bolster national competitiveness. However, the fund regulations, as well as their low endowment, mean that the possibility of a substantial impact for macroeconomic stabilization is remote. To establish sufficient funds which could be redistributed between states, solidarity is needed between the individuals among whom redistribution takes place. So far, economic theory has failed to analyse the mechanisms for achieving solidarity, instead treating it as being exogenous to economic models. The models and theory presented so far, based on the assumption of rational actors, could not explain the developments related to the Posted Workers Directive.[34] The respective discussion has shown that Member States sometimes reach agreements that violate rationality constraints for at least some Member States, who have surrendered their competitive advantages without any immediately discernible recompense.

Chapters 5 and 6 will provide more detailed explanations of the psychological processes and mechanisms which underlie the formation of solidarity and identification. The analysis has not only shown that solidarity between citizens is needed for successful redistribution. The distribution (allocation) of the funds requires rules and a framework to monitor the use of the funds. However, if that framework is too strict, then the funds may not be allocated effectively. The framework regulating the funds regulates access.

[34] Amendment to Directive 96/71/EC Directive by (EU) 2018/957 of the European Parliament and of the Council of 28 June 2018.

However, in case the funds fulfil an insurance function, access to capital needs to be regulated differently. Such funds need to be open to the members of the insurance club. Therefore, such schemes resemble a common pool resource, rather than private good. Chapter 5 will show that this differentiation is particularly relevant for the mode of integration.

Chapter 4

The diversity and commonalities of social and economic models

4.1 How to define a rational EU voter?

The EU is faced with structural problems which are partly caused by the integration of markets. It can solve these issues. The previous chapters discussed the kinds of problems that exist in the EU and the attempts that have been made to tackle them. One of the main issues with defining common policies concerns preferences. Since Tiebout (1956), the assumption in economic models of centralization is that people living within a region (or country) share similar preferences over public policies. These determine whether a region (or country) will accept a certain policy or structural reform proposal. Preference over policies are determined through socialization (Alesina & Giuliano, 2015) and they are shaped by the socio-economic situation, which prompts the need for certain policies.

This chapter will provide an overview of economic and welfare institutions, as well as national structural issues. Broad groups of Member States emerge from the analyses of economic structure, institutional set-up and labour-market organisation. This picture provides some insights into the preferences that a rational and well-informed citizen would hold over public policies.

4.2 An overview over national social economic models

The European Social Model has different meanings to different institutions and actors. The term European Social Model can refer to initiatives which are delivered at the EU or the national level. In a broader sense, the term might refer to the welfare state, to education, healthcare and social security, and others (Barnard, 2014). The different national social models are characterized by common values: democracy and individual rights; free collective bargaining; market economy; social welfare; equality and solidarity (Barnard & Deakin, 2012). The 'threefold commitment'[1] to expansive benefits, coordinated wage bargaining and relative income equality constitutes, in technical parlance, the European Social Model. This is partly distinct from EU social policy, which complements common market policies.

Esping-Anderson was the first to develop a typology of welfare-state regimes. Following in his footsteps, Sapir (2006) suggest the following differentiation of welfare states in Europe:[2]

i The Nordic countries, such as Denmark, Finland, Sweden and the Netherlands. These countries are characterized by the highest levels of social protection expen-

[1] See Mosher & Trubek, 2003, p. 64.

[2] This chapter is based on a research project executed in collaboration with Joerg Peschner, Senior Economist at the DG Employment, Social Affairs and Inclusion of the European Commission. See Rieff & Peschner (2020).

diture and universal welfare provision, together with extensive fiscal intervention in labour markets. Labour protection is rather weak in these countries, but unemployment benefits are generous.

ii The Anglo-Saxon countries, the UK and Ireland. These countries distinguish themselves from others by a system of social assistance of last resort, with cash transfers primarily oriented towards people of working age. The activation of benefit measures can also be based on regular employment. In addition, there are relatively weak labour unions, wide wage dispersion and a high incidence of low paid employment. Employment protection legislation is weaker than in other countries, but unemployment insurance is comparable to Nordic countries.

iii The continental countries: Austria, Germany, France, Belgium and Luxembourg, also framed as Christian Democratic regimes (Aspalter, 2009). These countries rely extensively on insurance-based, non-employment benefits and old-age pensions. They are characterized by strong labour unions. Unemployment benefits are rather generous, with stricter employment protection legislation as compared with the Nordic countries.

iv The Mediterranean countries: Spain, Greece, Italy and Portugal. They concentrate social spending on age-related expenditure. These systems draw on employment protection and early retirement provision to exempt segments of the working-age population from labou- market participation. This model is characterized by strong employment protection and low coverage of unemployment benefits.

Central and Easter European countries have not been analyzed by Esping-Andersen. However, Aspalter et al. (2009) identify Poland, Czech Republic, Hungary and Slovenia as having some neo-liberal tendencies, such as health care which is partly provided by the private market. However, they conclude that these countries, since their return to capitalism, have become Christian Democratic welfare regimes.

The European social models are characterized by democratic participation, redistribution and collective bargaining. Industrial relations are widely acknowledged to influence the structure of the welfare state. Accordingly, strong unions and collective bargaining allow for egalitarian welfare states - strong labour unions and strong collective bargaining equalize primary income distribution (Schroeder, 2013). Labour unions represent and defend the needs of workers. Thus, unions take over crucial roles in the governance of the welfare system and use their position to advocate workers' interests.[3] The role of social partners in the economies is described by the Varieties of Capitalism (VoC) literature, which describes how (labour) market institutions explain market outcomes in different types of 'capitalist' economies.

The VoC literature distinguishes Coordinated Market Economies (CME), Mixed Market Economies (MME) and Liberal Market Economies (LME).[4] As compared to the Varieties of Capitalism literature, Esping-Anderson differentiates countries such as Sweden, Finland and Denmark from the group of Coordinated Market Economies, dubbing the former social democratic regimes. Other countries from the CME and MME are regrouped under one regime, namely the Conservative Welfare regimes (or what Aspalter et al. call the Christian Democratic regime).

Industries in CMEs tend to rely on highly skilled[5] workers. They tend to be specialized, and therefore need very specific skills. Welfare states are typically strong,

[3]The participation of social partners in governance and legislation varies across EU Member States, from consultative roles to direct involvement in the governance of social security systems, as is the case in Austria. See European Commission (2016 b,c)

[4]Hall & Soskice (2001). The conceptualization might differ across specific analyses, that is, some authors do not use the MMEs, but rather differentiate specificities within the group of CMEs. Iversen et al. (2016) for example distinguish Northern from Southern European economies

[5]We use the terms 'skills' and 'qualifications' as synonyms unless otherwise specified.

supporting training and incentivising the acquisition of these skills (Soskice, 2007). Specialization reduces the number of employment fields, so that a welfare state with high unemployment benefits can compensate the workers in case of job loss. Therefore, higher unemployment benefits incentivize the workers to acquire specific skills, as it guarantees income even upon the materialisation of risks as technological change or economic downturn. Employment and wage protection were found to be strong in CMEs. Stronger protection strengthens workers' bargaining position relative to that of employers (Soskice, 2007). Rather than bargaining with workers, firms are inclined to organize themselves and do the wage bargaining at the industry level, where they deal with industry-wide trade unions, with both partners being able to respond flexibly to the industry-specific market context. Wage bargaining in Germany, for example, mainly happens at the industry level, with minimum wages set by the government. Likewise, workers' training in CMEs tends to be supported by industry-wide employer associations and trade unions[6] while governments limit themselves to the coordination and maintenance of training programmes. A higher degree of job protection may increase job quality, but it may also hinder the diffusion of new technologies from firm to firm, as workers stay longer with a firm even if conditions are suboptimal (Soskice et al, 2001).

In MMEs, labour unions are more fragmented and employers' associations are less developed than in CMEs. Correspondingly, firms' associations and trade unions are less able to engage in wage bargaining, employment protection or workplace regulations than in CMEs (Hassel, 2014). The state plays a more active role in providing those public goods. According to Molina and Rhodes (2007), compared with CMEs, MMEs show lower levels of social protection, yet stronger employment protection. In addition, the level of investment in specific skills tends to be lower in MMEs than in CMEs. Lower skills tend to dampen investment in new technologies that would increase competitiveness. Molina

[6]Soskice et al. (2001). This is the case in Germany, for example

and Rhodes argue that overall product market regulation is stricter in MMEs, which lowers competitive pressure as market entry becomes more difficult. Firms in MMEs 'compete mainly over the price'[7] rather than through innovation stimulated by better skills. In contrast to the position in CMEs, state intervention tends to come in the form of bailouts for actors in economic distress, but it does not provide means or incentives to maintain (or restore) competitiveness. As Hassel (2014) points out, in these economies, firms are protected by the government from foreign acquisition and the role of the state as a lender of last resort is rather strong.

Liberal Market Economies (LME) can be found in the Anglo-Saxon and in Eastern European countries. Trade unions tend to be less powerful than in CMEs, as are employers' associations. Firms are thus unilaterally governed by managers. Under these circumstances, economy-wide wage coordination is more difficult to achieve. Instead, both firms and workers tend to rely on the market to resolve coordination problems such as the setting of wages or negotiations over working conditions (Soskice et al., 2001). Wages are determined by the supply of and demand for skills. In order to remain competitive, companies offer in-house training to complement the broader and more general education provided by educational institutions. Due to less stringent employment protections, labour markets are more fluid than in CMEs. This, according to Soskice et al. (2001), facilitates the transfer of technological progress across firms and workers as 'the movement of scientists and engineers from one company to another' becomes easier.[8]

The welfare state and the systems of production are complementary, given that labour unions and employer organizations can have strong ties with bodies governing the welfare state and that employers base their strategies on existing welfare structures (Wood,

[7]See Molina & Rhodes (2007), p. 226.
[8]See Soskice et al. (2001), p. 31.

2001a; Schroeder, 2013). Welfare states increase incentives to acquire specific skills. Specific skills increase the competitive advantage of companies, which in turn increases incentives for employers to support a stronger welfare state. Considering the welfare state typologies, Social Democratic and Conservative welfare regimes support industry- or firm-specific skills, which are a crucial factor for Coordinated Market Economies (Schroeder, 2013). Welfare systems in LMEs do not encourage the acquisition of specific skills, given the focus of welfare systems on maintaining basic rather than equitable income levels. Similarly, in the Mediterranean countries, the acquisition of industry-specific skills is low. Overall, in LMEs, labour is valued at its market price, whereas in CMEs and MMEs, the welfare state increases the price of labour because they finance welfare provision through payroll taxes. This, in turn, makes low-wage labour unattractive in these economies, as compared to the LMEs.

Taken together, the production systems are complementary to their respective welfare systems. The discussion shows that the taxonomies of welfare state regimes overlap with the clusters of capitalist welfare states, according to the varieties-of-capitalism literature. The following discussion will follow the VoC literature to describe the industrial relations systems in question. From the review above, it becomes clear that establishing a single uniform EU wide social policy is difficult, if not impossible.

4.3 The dimensions of national economies

National welfare state and industrial relations institutions reflect differences in labour market and economic outcomes. High social standards and cooperative social dialogue promote training and thereby valuable skills. This increases overall productivity. So much becomes apparent from the comparison of national institutions, and country clusters, with labour market and economic performance.

In Rieff & Peschner (2020), a Principal Component Analysis, comparing welfare systems, education and collective bargaining systems, as well as their labour and product market outcomes, confirmed the existence of the clusters identified by the VoC literature. That analysis included further factors, which show that social institutions promote productivity. In a Principal Component Analysis, a broad set of variables that describe labour market and social conditions in EU countries is narrowed down to a few dimensions. Based on correlations between sets of variables, groups of variables are 'filtered out' and separated from other variables on which there is no correlation. The dataset is thus reduced to a few uncorrelated factors which still explain a significant share of the original data's cross-country variability.

Starting from 70 variables describing skills, education, unemployment, wage growth and labour costs[9], Rieff & Peschner (2020) narrow the analysis to just three dimensions, given that these 70 variables are correlated with each other. More than half of the cross-country differences in the original 70 variables can be explained by three main dimensions, which can be seen as the principal components of labour markets and social policy in Europe – EU countries are clustered around them. Rieff & Peschner find that the resulting country-clusters match the ones identified by the Variety of Capitalism literature developed by Hall and Soskice (2001) and other authors.

A first factor shows that social institutions promote wages and productivity. Countries that score high on this dimension are characterized by high collective bargaining coverage[10] and high trade-union authority. In these countries, labour productivity is high, as is expenditure on social protection and labour market policies.

A second factor identified in this analysis shows that countries where students and

[9] For a complete list, see Annex of this chapter B.1.

[10] Which is the percentage of workers covered by a collective bargaining agreement.

the labour force have good skills, [11] as identified by PISA and PIAAC, show a higher degree of labour-market inclusivity, which is measured by low rates of individuals not in employment, education or training, low-educated persons and early school leavers.

A third factor identified within this analysis shows that matching problems correspond to low wage growth. Countries that score high on this factor combine low wage dynamics with high unemployment and significant (skills) matching problems in the labour market. Under such labour market conditions, workers are in a weaker bargaining position vis-a-vis firms. They therefore struggle to push for higher wages.

Table B.1 in appendix B shows the different variables and how they load on the different dimensions. The three factors just enumerated explain very different dimensions of labour-market functioning. The method of their extraction ensures that the correlation between the factors is minimized; the factors are in that sense 'orthogonal' (uncorrelated). The shaping-out of Factor 1 speaks of a positive link between high productivity (and high wage levels) and a certain 'conductive' institutional setup, that is, a setup that combines strong social dialogue with high social standards. Yet Factor 1 is uncorrelated with the other factors. Therefore, such 'conductive setup' will not in itself guarantee high and inclusive employment (Factor 2) or fast-growing wages (Factor 3). For these goals to be achieved, more conditions need to be fulfilled. Figures 4.1 and 4.2 show how 26 EU countries score on the three main dimensions.[12] North-western countries tend to combine institutions conductive to high productivity with a skill mix that promotes good labour market performance. Eastern Member States tend to perform well on matching & wage growth and (except Romania and Bulgaria) on the 'skills that promote inclusive labour markets' factor, but they also reveal clear problems with the

[11] Such as numerical, reading and problem-solving skills

[12] The figures are the outcome from the research in Rieff & Peschner (2020).

functioning of institutions. The next section will identify clusters of countries, sharing similarities considering the above dimensions.

4.4 The clusters of national welfare and capitalist systems

Using hierarchical clustering, Rieff & Peschner identify groups of countries based on their similarity, according to the three core labour market dimensions discussed above. Although the empirical analysis reviewed does not include variables that describe corporate governance or competition, the five-cluster solution matches the taxonomy of welfare states reviewed above well. North-western European countries of Cluster 1 regroup as VoC's Coordinated Market Economies[13]. They score high on the Institutions/Productivity factor. In these countries, trade unions tend to play a major role in wage bargaining, which tends to proceed in a coordinated way: workers and employers balance out their respective interests in a social dialogue at collective, mostly sectoral levels with minimum government interference. Centralised wage bargaining dominates. Investment in workers' training is necessary for forming specific skills, as industries tend to be innovative and competitive, yet highly specialized. Spending on both labour market policies and on social welfare tends to be significant. Indeed, the high score on the Skills/Inclusive Labour Market factor signals high engagement in life-long learning, the take-up of vocational training, and an array of different skill variables, including complex problem-solving skills and digital skills. Compared with the other clusters, high labour productivity allows for both higher wages and higher social standards. It also allows for stronger job protection, which is considered necessary by unions as job losses have severe consequences in an environment of high specialisation.

[13] Austria, Belgium, Denmark, Finland, France, Germany, Luxembourg, Netherlands.

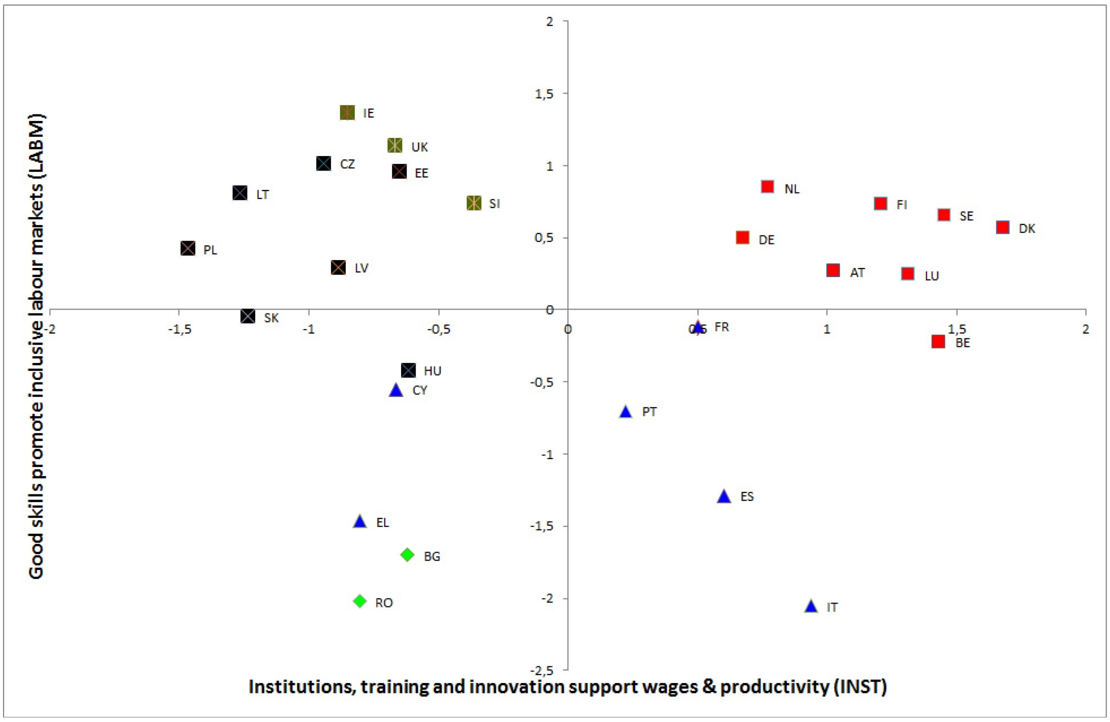

Figure 4.1: Main dimensions of labour market functioning and inclusiveness.
Note: Factor 'Institutions/Productivity' against Factor 'Skills/Inclusive Labour Market': Central and northern Europe tend to combine high social standards, good skills, high productivity growth.

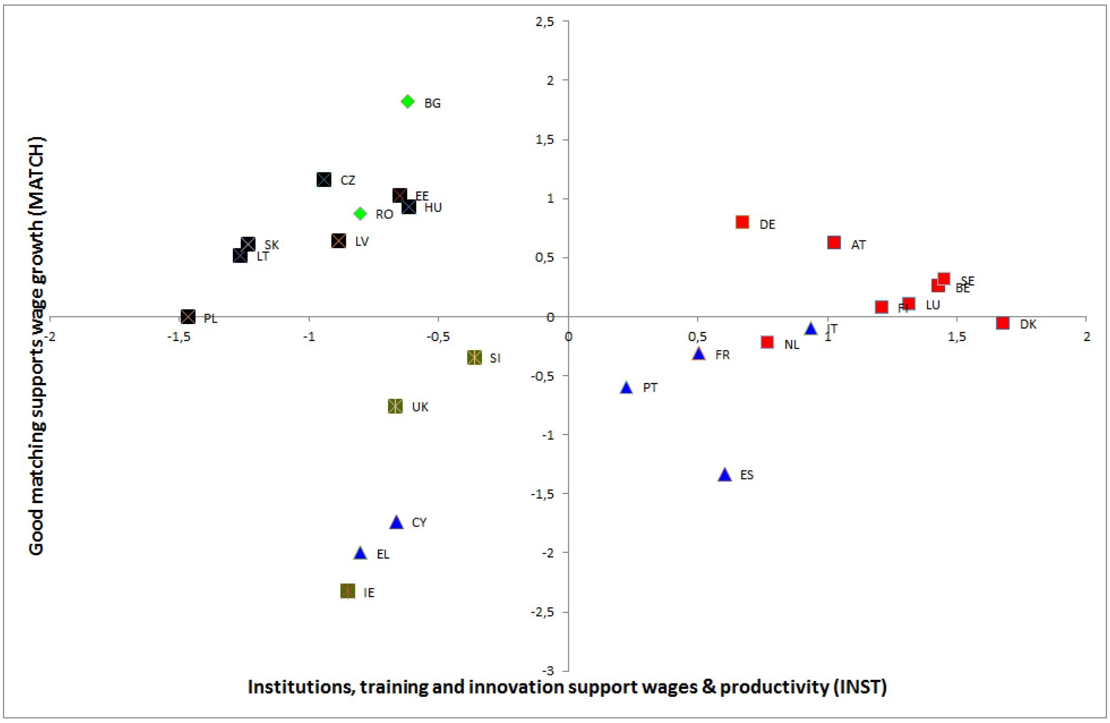

Figure 4.2: Main dimensions of labour market functioning and skills matching.
Note: Factor 'Institutions/Productivity' against Factor 'Matching/Wage Growth': matching problems and low wage dynamics in southern Europe and Ireland.

The Anglo-Saxon and Eastern European countries of Clusters 3 and 4 correspond to LMEs in the VoC literature[14]. They tend to score high on Skills/Inclusive Labour Market as they show stable labour markets (low unemployment). A low score on Institutions mainly reflects the way workers and firms define wages and working conditions: they are shaped by market forces rather than being coordinated by social partners. In the absence of coordinated social dialogue, firms tend to negotiate with workers at the individual level, with productivity performance rather than social considerations being the main criterion. Social protection expenditure is low, and the role of the welfare state tends to be limited to the setting of minimum standards. The low score in Matching/Wage Growth in the Anglo-Saxon Cluster 4 reveals that there is little scope for strong wage increases due to, among others, the workers' limited bargaining power the economy's strong exposure to global competition in small, open countries such as Ireland or Slovenia. By contrast, the Eastern European countries of Cluster 3 tend to see higher wage growth as they are less open and/or are still in the process of catching up after their accession to the EU.

The Southern Economies of Cluster 2 show a very diverse pattern in terms of Institutions, and therefore correspond to the Mixed Economies section in VoC literature.[15] They have in common low scores on both the Skills/Inclusive Labour Market and the Matching/Wage Growth dimension and are therefore regrouped to one cluster. These economies tend to suffer from labour-market dualities, as flexibility in the labour market has mainly been achieved through non-standard, especially temporary contracts, while high unemployment persists. Workers' skills tend not to match firms' needs. Spain, Cyprus and Greece are severely affected by matching problems that make it difficult for people outside the labour market to find a job and force many workers to take up jobs

[14] Czech Republic, Estland, Hungary, Ireland, Latvia, Lithuania, Poland, Slovenia, Slovakia, United Kingdom.

[15] These are: Cyprus, Greece, Italy, Portugal, Spain.

at skill levels way below their qualifications.

Romania and Bulgaria have not been assigned to any of the three types of capitalism by VoC analysis. After accession to the EU in 2007, these countries are still in the process of economic and labour-market transition. Though still far from EU standards, wages are climbing at the fastest rate in the EU which explains the above-average score in the Matching/Wage Growth dimension. Yet wage levels in both countries are at less than half of the EU average. Workers' bargaining power is limited by the setup of institutions: both workers' coverage by collective bargaining agreements and trade union density are amongst the lowest in the EU. Agreements on wages and working conditions are usually achieved at the level of the company, rather than collectively at the sectoral level.

The factor explaining most of the original variables' cross-country differences is the Institutions factor that relates high social standards to coordinated, collective wage bargaining and high productivity. The shaping-out of the Institutions factor from the core indicators is evidence that these institutional variables are complementary. In other words, high social standards and a cooperative social dialogue, both promoting training, can pave the way to higher productivity. At the same time, the existence of the 'Coordinated Market Economies' cluster is evidence that a country can combine high productivity performance with good labour market outcomes, that is, a high score on Skills/Inclusive Labour Market. This is so because the availability of skills through training improves individuals' labour-market performance and increases the probability of finding a match on the labour market (as CMSs also score high on Matching/Wage Growth). Turning the argument around, if one of these 'ingredients' is missing, this may not lead to the desired effect which would then have to come from other forces. Suppose that a country's welfare spending is ungenerous. This tends to be the case in Liberal Market Economies, where spending on labour market policies is rather low and negotiations on wages and working conditions tends to be decentralized. Rather than social dialogue, wages would be shaped by market forces that would ensure that skills generate a wage premium that would broaden the wage spread between skilled and unskilled labour. Workers would then be motivated to invest in skills, as noted in section 2.2 above. A high level of skills would then push labour-market performance. Indeed, like Coordinated Market Economies, Liberal Market Economies tend to score above the average on the Skills/Inclusive Labour Market factor.

4.5 Discussion and conclusion

A taxonomy of different capitalisms can be distinguished. Within the EU, different capitalist regimes exist, and the clusters of countries sharing similar (labour) market institutions also share similar social welfare institutions. The analysis above has filtered out a dimension related to institutions. The first and the second cluster of countries, namely the liberal market economies and the coordinated market economies, strongly differ along the institutions dimension. However, no strong difference can be discerned in dimension-related structural issues, such as labour-market inclusivity and skills. Unemployment remains high, especially in the Southern economies, where low productivity remains an issue. In some Member States, a lack of skills retards the adoption of new technologies in the production process. Furthermore, low skills are a hindrance to productivity and employability. These issues are especially strong in the Southern economies, as well as in Romania and Bulgaria. Labour market and social policies need to adapt to these differing realities. The analysis further shows that labour market institutions explain the differences in labour market performance, productivity and competitiveness.

The economics literature posits that preferences are acquired through socialization and learning, a process which is also impacted by existing institutions. The studies reviewed by Alesina & Giuliano (2015) show that previous experiences with institutions form individuals' preferences. Economic institutions, for example, may affect the formation of preferences through different channels: the evolution of norms or learning (Bowles, 1995). The creation of new institutions in turn depends on these norms, and the resultant preferences. At the same time, values may impact preferences, too. The economics literature often defines culture as preferences and beliefs or values.[16] Alesina & Giuliano (2015) relate labour market policies to family values and explain that labour market regulation is especially high in those countries where family ties are strong. Laissez-faire policies necessitate higher labour mobility, as dismissal becomes more likely. This, however, is not necessarily compatible with strong family ties, so stricter labour market regulation is preferred. These examples show that then values and existing institutions impact and form preferences over policies and new institutions.

The analysis confirmed the hypotheses of the existing literature and showed that labour market institutions can indeed support productivity and thereby economic growth. Labour market institutions contribute to the matching of workers with a specific skillset to jobs requiring these skills - institutions aid skills-matching.[17] Institutions often complement each other. For example, the acquisition of highly specialized skills has been found to be bolstered by unemployment benefits. The analysis has shown that clusters of countries with similar institutions are likely to confront similar structural issues. The coordinated countries score high on the institutions/productivity dimension. At the same time, workers in these economies are equipped with good skills and labour markets are inclusive. In addition, the liberal market economies score on average equally well on labour market inclusiveness.

[16]See Alesina & Giuliano (2015) for an extensive review of culture and institutions, explaining various definitions of culture

[17]See analysis in Rieff and Peschner (2020).

Structural issues, as well as existing institutions, determine the need for reforms and new policies. Hence, the preferences of citizens over the policies discussed in the previous chapters are determined by the dimensions discussed here, which relate to labour market inclusiveness, productivity and skills. The findings presented above suggest that coordinated market economies and liberal market economies can produce equally good labour market outcomes, despite strong differences in institutional set-ups. The is no one size that fits all labour market institutions. Existing institutions change the need for and requirements from new institutions. Therefore, institutional set-up, as well as structural problems, determine preferences over new policies. This chapter showed the way in which these institutions are shaped and gave some worked examples of their determination.

Chapter 5

The economics of regional integration

5.1 The rational choice approach to EU integration

The EU is composed of diverse economic systems whose integration has caused frictions. Common policies can have benefits for every country involved, but they can also carry considerable costs. Nevertheless, common policies could remedy the frictions within the EU. The review of the existing common policies, as well as national welfare and capitalist systems, has shown two things. Firstly, the policies are not always sufficient to address the issues at hand. Secondly, Member States are heterogeneous with regard to their existing welfare, state and labour-market regulations. The national economies and the welfare states together with national laws and labour market institutions result in different preferences over policies. A single policy can have higher net benefits (or costs) for some Member States than for others. The discussion of the Posted Workers Directive and regulating the race to the botton in chapter 3 has shown that its application can bypass the strategies to compete of some Member States.[1] Companies in low income-countries have a comparative advantage in providing services in the internal market, hence the introduction of regulations abolishing this comparative advantage. Such costs are generally referred to as heterogeneity costs in the literature.

Informed utility maximizing citizens would only agree with the centralization of policies if it results in a net benefit. In economic models of policy decision making, that is, public choice, these cost-benefit considerations are central to the voting behaviour of citizens. This is the focus of second-generation fiscal federalism theories - the analysis of the voting behaviour of citizens and the incentives to politicians to act in the best interests of the citizenry. The following chapter will review the mechanisms of centralization and discuss basic requirements for stable centralization. These will then be compared to the policies reviewed in chapter 3. The chapter will draw on the public choice literature on the size of nations (Bolton et al., 1996; Alesina & Spolaore, 2005c; Spolaore, 2006). This literature examines the stability of nations and its prerequisites. Following this literature, the model presented below depicts the centralization of a single policy as the creation of a union between countries. The aim is to identify the prerequisites for the emergence and stabilisation of a common policy. In other words, what makes a common policy acceptable to the Member States and what leads to its transposition at the national level? What conclusions can be drawn about the policies described in chapter 3 and about the future policies in the EU? The analysis in section 5.3 will show what the prerequisites for the stability of institutions - or common policies - are.

[1] Amendment to Directive 96/71/EC Directive by (EU) 2018/957 of the European Parliament and of the Council of 28 June 2018. See section 3.5.

5.2 The size and stability of jurisdictions

The previous chapter discussed common policies. Member States determine their content together. Enabling a common policy causes an extension of the jurisdiction of the EU onto new fields. Therefore, generating common policies means extending the policy prerogatives of the EU. In the literature about the size and stability of nations[2], the size of nations, or the geographical expansion of jurisdictions, is depicted as a trade-off between economic efficiency, for instance the use of economies of scale, and the heterogeneity of preferences. This literature[3] is based on the premise that the central role of the government is to provide public goods. The populaces of countries or regions are depicted as associations of individuals with similar tastes and preferences for goods (Tiebout, 1956; Buchanan, 1965). In Tiebout's theory for example, different bundles of public goods are offered in different locations and individuals sort themselves into the geographical areas. As in club good theory (Buchanan, 1965), the optimal size of the jurisdiction (club) is reached when the marginal cost of an additional member (due to crowding) equals the cost savings from spreading fixed costs over larger numbers of individuals. The cost savings stem from efficiency gains, like economies of scale in the provision of the public good or the internalization of externalities. For instance, it was shown in chapter 3 how a state may impose an externality on another state by lowering its labour standards or labour costs[4], which may, in theory, divert economic activity from other states, lowering their welfare. A central government can solve this impasse, by adopting and enforcing rules to regulate this issue.

In models of the size of nations, preference heterogeneity is assumed to increase with

[2]Bolton et al. (1996); Alesina & Spolaore (2005c).

[3]See Spolaore (2006) for an overview over the literature on the size of nations.

[4]For example by reducing minimum wages.

the geographical distance between constituencies within a state.[5] In the face of uniform provision under centralization, heterogeneous preferences might lead to costs in terms of reduced social welfare - the public policy benefits some more than others. If differences in preferences increase with geographical distance between constituents, geographical expansion is limited by these differences. Assuming that decision-making is democratic and the costs of integration increase with increasing distance from the country capital, where the public good is produced, Alesina & Spolaore (2005c) find that the regions close to the border have a stronger incentive to secede and thereby produce public goods that are better aligned with their own preferences.

Other sources of costs and political conflict are regional income differences (Bolton et al., 1996; 1997). The decision of regions or countries to integrate (or separate) is influenced by efficiency losses from separation. In the event of separation, the poorer region would incur a loss due to foregone transfers from the richer region. The richer region, on the other hand, would benefit from separation, for the same reason. Bolton & Roland (1997) find that if median incomes differ, separation can occur due to tax revenue differentials. Therefore, tax transfers are an important reason for separation. It is important to note that less redistributive policies reduce separatist tendencies in the richer region[6]. However, lower redistribution might fuel separatist tensions in the poorer region[7]. Therefore, income redistribution is likely to have a centrifugal effect by adding to the costs of (political) heterogeneity. Conversely, if there is high interregional income inequality, redistribution can help keep the poorer regions inside the country (federation). Income differences are mentioned here for completeness, but an in-depth analysis would go beyond the scope of this study.

[5] See for example Alesina & Spolaore (2005c).

[6] Bolton & Roland (1997) mention right-wing Flanders.

[7] Bolton & Roland (1997) mention left-wing Wallonia. They do not explicitly income with regard to the regions, but refer to the political dimension

The heterogeneity of preferences can be due to ethnic, cultural and linguistic diversity, which have been shown to influence policy outcomes and the provision of public goods (Spolaore, 2013). There are different concepts to measure and define heterogeneity within a country or region. Some measures used in the literature relate to ethnolinguistic fractionalization. Other measures relate to religious, linguistic or, more broadly, cultural distance (Spolaore, 2013). Cultural diversity can be measured using survey evidence on the perception of life, family, religion and morals, which can be found in the World Value Survey. Linguistic diversity was found to have a negative effect on redistribution, that is, in areas or regions where linguistic diversity is high, overall redistribution is low (Desmet et al., 2009). Alesina & Ferrara (2005d) argue that ethnically diverse groups are often associated with diverse preferences over public goods, which can lower the individual utility gained from the consumption of public goods provided within a diverse society.

Empirical evidence reviewed by Alesina & Ferrara (2005d) and Spolaore (2013) suggests that ethnic diversity decreases public goods provisions. If individuals with diverse preferences have to share uniform policies, then increasing heterogeneity decreases average utility from public policies. Desmet et al. (2009) find that cultural heterogeneity reduces the utility from consumption of the public good. Therefore, the preferred tax rate to finance the public good decreases as cultural heterogeneity increases. From this, it can be concluded that the unification of countries is influenced by the costs of cultural heterogeneity and that economic differences provide incentives to secede. Spolaore (2013) concludes that ethnic and linguistic diversity have significant effects on redistributive policies, as well as the provision of public goods and that the EU can be considered quite heterogeneous on most indices. Chapter 4 concluded that differences in the preferences of national citizens over labour-market policies are determined by existing institutions and the performance of the labour markets and economies of Member States. Institutions complement each other, so the creation of new institutions might be limited by previous institutions. A rational citizen, taking these issues into account, should favour policies which improve their lot. This is the premise on which the analysis that follows is built.

5.3 A model of centralization

The following section will provide a brief model to show the determinants of the geographical span of institutions, as well as their stability. The discussion is held at a relatively high level of abstraction. It essentially summarizes results from the literature and provides a baseline model to be extended with insights from psychology in the next chapter.

On the following pages, a model of centralization of public goods within a union of heterogeneous populations (countries) is developed. It depicts a situation where a group of countries vote over a proposal to centralize a public good, which includes two possible options. Those countries in favour of the majority's preferred proposal enter the union and the good is provided to its members uniformly. Following the discussion above, it is assumed that there is no heterogeneity within countries, but different countries differ in their citizens' preferences over the public good. Chapter 4 highlighted that the preferences of rational voters derive from the structural needs of the economy, as well as its existing institutions. Both differ from country to country. Comparable needs call for comparable policies to address them. Hence, needs impact the preference over policies. Beyond needs there is a cultural component impacting preferences, that is traditions for example. Chapter 4 concluded that there were at least three or to four groups of countries, such as the CMEs or the MMEs, where institutions are comparable. These groups of countries are characterized by comparable welfare states and collective bargaining systems, suggesting that citizens have similar preferences at least over welfare state and labour market institutions. Therefore, rational, self-interested citizens from the same country group should have similar preferences over new, European labour market and social policies. Formally, the model consist of a voting game, in which the strategies of country representative consist of voting for a given proposal, in order to maximize their utility π_i, given the utilities of the other players π_{-i}.

For simplicity, the model assumes that incomes, y_i, are the same for all citizens in each country. Following the intuition of the citizen candidate models (Osbourne and Slivinski, 1996), countries are represented by a representative citizen within a central committee which decides on common policies and which votes over the centralization under a one-country-one-vote rule. In this way, a rigid union is represented in which policies are uniformly provided across countries. This representation of the world allows the model to focus on the basic conditions for the stability of a union of countries, that is, the optimal size of the jurisdiction of the union.

Countries can be ordered according to their preferences over the public good, i.e. $\alpha_1 \leq \alpha_2 \leq, ..., \leq \alpha_N$, where N is the number of countries and $\bar{\alpha}$ is the highest possible preference. $\alpha_i > 0$ describes how much the citizens of each country value the public good. This is depicted in figure 5.1: For example, in countries where labour market inclusivity is low, there should be a strong interest in active labour-market policies, in other words a high value for α. Following the literature, this parameter is referred to as the preferences parameter of country i. This parameter can also be interpreted as a measure of the size of the material benefit from the public good or as a measure of individual taste. It simply describes how much different citizens like a certain policy.

It is assumed that citizens in each jurisdiction spend their entire income on the consumption of the private good x and on the public good g respectively. The public good

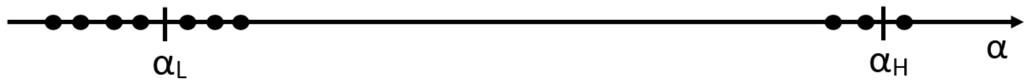

Figure 5.1: Distribution of countries according to their preferences over the public good

is financed by a lump-sum tax and it is assumed that the government runs a balanced budget, such that $g_i = t \in [0, y_i]$. Each citizen would have to pay a fixed amount t, which can at most be as high as the citizen's income. Therefore, in the cases of centralization and decentralization, each country pays 'its share of the good consumed'. Furthermore, the size of the countries is assumed to be the same, as are individual incomes within each jurisdiction. By using a lump-sum tax scheme for the financing of public goods, the following analysis can abstract form strategic consideration. Thus, each citizen pays what (s)he consumes and can therefore not defer the costs onto other citizens. As Besley & Coate (2003) have shown, cooperation in the form of cost-sharing may result in strategic interaction and free-riding. For this reason, the formulation above maintains the model's focus on outcomes under the assumption of sincere voting. In addition, by assuming that each individual citizen pays for consumption, the principle of fiscal equivalence (Olson, 1969) is maintained. According to that principle, the funders and beneficiaries of a public service should coincide in order to achieve the efficient provision of public services, in line with the preferences of local citizens. This argument presupposes that the boundaries of jurisdictions can be adjusted according to the provision of public goods. Put differently, for given jurisdictional boundaries, the principle of fiscal equivalence suggests that public goods which induce spill-overs should be centralized. The following analysis aims to discuss under which circumstances this is feasible.

Following the literature, the utility of a citizen depends on the consumption of the private and the public good, and is described by: $\pi_i(x_i, g_i) = x_i + 2\alpha_i\sqrt{(g_i)}$. This functional form assumes that utility is linearly increasing in the consumption of the private good, while utility is marginally decreasing in the public good. For private good, the assumption follows the standard assumption in economics - more is better, hence the more income an individual uses to consume, the better (s)he feels. For public goods on the other hand, it holds that beyond a certain quantity, there is no more utility to be gained from consuming even more. For example, once public infrastructure is in place and provided in sufficient quantity, there is not much more to be gained by increasing its size. Assuming that prices for the public and the private goods are both equal to 1, the budget constraint for each citizen is given by: $x_i = y_i - g_i$. Rearranging the budget constraint and plugging it into the utility function, the latter can be redefined by[8]:

$$\pi_i(x_i, g_i) = y_i - g_i + 2\alpha_i\sqrt{(g_i)} \tag{5.1}$$

As discussed above, the public policies under scrutiny result in the internalization of externalities, transaction-cost savings or economies of scale, that is, the benefits from centralization. In what follows, these effects are simply called spill-overs, which is captured by the parameter $\beta \in [0, 1]$. It is assumed that a Member State benefits from the spill-overs of all the other states of the union. This is represented by multiplying the spill-over parameter with the sum of the provisions in the other countries. Given symmetry of countries, an individual country receives a gross benefit of $g_j(1+\beta)(n-1)$. For every unit of expenditure in one country, the other country obtains one unit of the good and the remaining countries receive β units of the public good, due to the positive spill-over which was explained above. So, if the social costs of $1 + \beta(n - 1)$ units is

[8]For a brief discussion of the form, see Appendix A.1.

1, then the social costs of 1 unit of the public good is $\frac{1}{1+\beta(n-1)}$. n is the number of countries in the union.[9] Taken together, the utility from the policy to a representative citizen can be rewritten as:

$$\pi_i(x_i, g_i) = y_i - g_i + 2\alpha_i\sqrt{(g_i(1+\beta(n-1)))} \tag{5.2}$$

Here, this specification will be used to analyse the formation of a union of countries which decide to coordinate the production of public goods, generating international spill-overs (Alesina et al., 2005b). Following Alesina et al. (2005b), a country can only benefit from centralization if it is a member of the union. In other words, the public policy is assumed to be excludable. In addition, given the assumption about the spill-over increasing with the number of countries, the consumption of this policy is also non-rival. Hence, the good represented by the model is a club good. Under centralization, the central government determines the level of public expenditure, whereas under the decentralization, the level of expenditure is set by the local government.

Countries can vote over two options, which means that g^c can be either large, α_h, or small $\alpha_l \leq \alpha_h$. Furthermore, the majority's preferred option will be provided. The voting procedure can be represented as a non-cooperative game: the countries can communicate, but they cannot make binding agreements (Bernheim et al., 1987). A strategy of a country consists of a vote for α_h or α_l, respectively, which maximizes p_i given the the votes of the other countries. After communication, when each country has signaled its preferences, voting takes place. In this setting, it is assumed that countries have no incentives to misrepresent their preferences. This stands to reason, as countries

[9] As pointed out by Alesina et al. (2001b). The social costs include the private (individual costs) of the public good and any external costs to society, which are not directly borne by the individual consuming the good.

can observe the needs of another country and are able to assess the overall economic and cultural situation of the other countries. By voting, the countries express their willingness to join the union which provides the public good according to the majority's preferred proposal.

As shown in the appendix A, the utility function as defined by 5.2 represents single-peaked preferences, which means that there is one single utility-maximizing size of the public good. It follows that the final provision of the public good depends on the distribution of countries. Given single-peaked preferences, the median voter theorem can be applied, which is why the provision which will receive the majority of votes is the one which comes closest to the provision preferred by the median country. Therefore, the selected proposal coincides with α_m. Countries observe the distribution of all the other countries, as shown in figure 5.1, from which they can infer, which countries will be in favour of one of each of the proposals.

Countries vote, and the centralized public good will be provided according to the majority preferred quantity, to all those who voted in favour. Hence, those countries which will be better off by consuming the centralized public good will join the union. In order to solve this strategic form game, with a fixed number of n countries, whose actions can be to vote for α_h or α_l and with payoffs given by π_i, the concept applied to find the equilibrium union is coalition-proofness. In theory, a stable (equilibrium) union must be coalition-proof (Bernheim et al., 1987):[10]

Definition 1. *A union of countries is said to be stable, if there is no country inside the union which would be better off outside the union, and if there is no country outside the union, which could make union members and itself better off by joining the union, given the preferences of all countries.*

[10]Appendix A.1 provides a more thorough explanation of the equilibrium concept used.

According to Bernheim et al. (1987), a coalition-proof Nash equilibrium is self-enforcing because the utility of a representative cannot be improved by either joining or leaving the union, taking the other country representative's preferences and possible coalitions as a given.[11] In terms of the model, whether a country is better or worse off inside or outside the union can be measured by the surplus from accession.

In order to have an incentive to join the union, the surplus from centralization must be positive for each country i. The utility of a country outside the union is denoted by $\pi_i(g^d)$, where g^d denotes the decentralized provision of the public good. The utility from the centralized provision of the good, g^c, is given by $\pi_i(g^c)$. The respective sizes are defined in appendix A.1. In order for a union to be coalition-proof, it must hold for any country i within the union that $\pi_i(g^c) > \pi_i(g^d)$, or in other words, the surplus from centralization Δ_i must be positive.[12]

A strategy profile for a country is then given by a vote, taking the preferences of the other countries as given. Formally, the n-player voting game is given by a set of strategies for each player i, defining a vote for a proposal α, given the utility functions π_i and π_{-i}. A vote is then a best response to the votes of the other countries, if it maximizes the surplus from centralization for that country, given the majority preferred proposal of the other countries. If the surplus is negative, then the best response is to vote against the majority preferred public good and not to join the union. The centralization surplus is given by:

$$\Delta_i = \pi_i(g^c) - \pi_i(g^d) \tag{5.3}$$

[11]See Appendix A.3.
[12]See appendix A.1

As discussed in appendix A.1, it follows from the concept of coalition proofness that an equilibrium union is stable if the surplus from centralization is positive for any member of the union. The surplus Δ_i entails a trade-off between heterogeneity of preferences (tastes) on the one hand, and the benefits due to the internalization of spill-overs on the other:

$$\Delta_i = 2\alpha_i\alpha_m(1 + \beta(n-1)) - \alpha_i^2 - \alpha_m^2(1 + \beta(n-1)) \tag{5.4}$$

Centralization results in spill-overs, which can be due to the internalization of externalities or cost savings, as noted earlier. The heterogeneity of preferences is represented by the differences between the first and the last term of the equation. This reflects the critical insight from normative theories of federalism, namely that the benefits of centralization come at the cost of public-policy uniformity.

Proposition 1. *A stable (rigid) union of countries has to be composed of members for which the benefits from membership are similar. In other words, the union of countries must be composed of countries with contiguous preferences.*

If the public good is provided according to the majority's preferred provision, any country joining the union must have preferences close to those of the median country. Otherwise, the costs of centralization would outweigh its benefits for that country and a country would not play its best response. This has implications for the enlargement of existing unions. A new country will only apply to join the union and be permitted to do so, if the change of the median after its entry to union is small enough.[13] If the median change is too large, the change in the public-good output might render benefits to

[13]See Alesina et al. (2005b), proposition 2.

existing members non-positive. Accordingly, in a stable union, the citizens of countries have similar preferences over the good.

According to the definition of the surplus in appendix A, the benefits from centralization increase in the spill-over β. In addition, they are larger if the preferences of the representative i are close to the majority's preferences. From this, the following prediction - which is in line with Alesina et al. (2001b, 2005) and Ahrens et al. (2004) - may be derived:

Proposition 2. *The size of the union is a trade-off between heterogeneity of preferences and economic efficiency. The size of the union is increasing in the size of the spill-over.*

This has several implications. First of all, the higher the efficiency gains from centralization, the greater the maximum heterogeneity of the total population of the Union. If, however, the gains from centralization are low, then the population within the union has to be more homogeneous in its preferences over the public good. According to Ahrens et al. (2004), this means that the EU should leave policy areas where heterogeneity costs are high to the national level. More generally, for some countries, agreeing to policies different from their preferred ones would entail higher costs, due to the loss of independent policy making (Alesina et al., 2005b). However, these costs may be offset by increased efficiency, which might allow the countries in question to provide a larger quantity of the public good at lower costs. On the other hand, there are political impediments: the larger the union, the more diverse the populace's preferences. Alesina et al. (2001, 2005) analyse a situation where there are no predetermined proposals and the size of the union, as well as the public goods, are endogenously determined. They argue that in such cases, the accession of an additional country changes the median towards the new entrant. This means that potential policy outcomes will change accordingly. In other words, for existing members of the union, the outcomes might change under majority voting and a larger number of members increases the difficulty of finding common agreements, yielding deadlock (Schimmelfennig et al., 2016).

The preceding arguments run on the assumption that the options to be voted on are given. Those joining the union would not change the outcome. From the definition of the surplus in equation 5.4, it can be inferred that for a given spill-over, the surplus of the members of the union increases with the number of members, due to an increase of the size of the spillover. This can be due to the exploitation of increasing economies of scale. The incentives for a country are attenuated by an increase in the benefits of accession. Considering the definition of the surplus Δ_i, then holding all other things equal, this means that the incentives to join the union increase with the size of the spill-over β. Above, a club good was modelled, which means that countries can be excluded from the benefits of the good. Furthermore, the benefits only accrue if there is centralization. From this, the following proposition emerges:

Proposition 3. *If spill-overs from centralization are high and only accrue to union members, centrifugal forces, i.e. incentives to leave the union, are low.*

This follows the logic discussed by Koelliker (2001) - the benefits from the public policy accrue only to those inside the union, whereas non-membership has smaller benefits. This shows that excludability is a crucial factor - without it, the incentives to form coalitions are diluted.

The model above took a static approach to centralization. However, it is more realistic to analyse several periods in order to make inferences about stability. De Figueiredo & Weingast (2005) provide a dynamic analysis of federal institutions and find a number of conditions for their stability and self-enforceability. First, the expected fines from shirking must exceed the cost of contributing, so that states have an incentive to contribute. Secondly, the centre must be given a strong enough incentive to detect shirkers.

Additionally, the authors find that the allocation of authority to a central government should occur in areas where monitoring is relatively easy and cheap. Furthermore, there must be sufficient gains from exchange within the federation. Not only would this keep individual states from shirking, but it would also cause the centre to refrain from one-off appropriations. Decentralized states may face a coordination problem: if the transgression by the centre is not easy to detect and prove then the states may fail to coordinate on an appropriate punishment. Considering centrifugal tendencies, some additional assumptions needs to be fulfilled in order for the agreement to be stable. Most conditions pointed out by De Figueiredo & Weingast (2005) are fulfilled within the model. The gains from centralization are given by the positive spill-over. Shirking and not being part of the federation would come at a higher cost than the cost of the centralized provision of the respective public good (agreement). Seeing as the recalcitrant country could not benefit from the respective spill-over anymore, individual provision would come at a higher cost.[14] One condition, which also needs to be fulfilled for such agreements to be self-enforcing is that centralized policies must be easy to monitor for a central agency. If this is the case, then:

Proposition 4. *Institutions which can easily be monitored and which are designed so that the surplus defined by equation 5.4 is maximized, are self-enforcing.*

The equilibrium concept used to define the union, namely as a coalition-proof union of countries, already entails self-enforceability. In many respects, the model applies to the results by De Figueiredo & Weingast (2005), without focussing on the exact institutional design. In order to draw conclusions on the stability of geographically expansive centralization, it is useful to apply the condition on costless monitoring here. Earlier, the good was financed by a simple lump-sum tax, and the individual income

[14] Developing regulations is first of all linked to certain research costs which are lower per country in case one central agency takes of it for several countries, as if every country would do it on its own.

of the citizens across jurisdiction was assumed to be the same for any jurisdiction. In practice, the costs of centralized public policies are likely to differ between jurisdictions. States have heterogeneous cost functions, so the respective fines need to differ by state (De Figueiredo & Weingast, 2005). This can be achieved by an appropriate choice of institutions, such as a constitution which prescribes the appropriate punishment for transgressing states and the centre and the appropriate allocation of cooperation surpluses between states and the centre.

5.4 Discussion and implications of the model

According to the economics of federalism, the organization of a system of multi-level governance contributes to the correction of market failures. Policy responsibilities can be provided in a decentralized way, in which local governments decide individually on the provision of public goods and services. The policies could also be provided by a central government to all regional governments. The centralization decision hinges on three choices. Firstly, how are citizens divided into different localities? Secondly, how are those localities represented? Thirdly, what responsibilities are assigned to which level of government (Inman, 2017)? The above analysis was concerned with the third question, that is, the allocation of policy prerogatives to the optimal level of governance. It was assumed that the first and second decisions were already taken. This depends partly on normative criteria, which suggest that a central government should be responsible for policies resulting in efficiency gains. The analysis discussed some features of an appropriate institutional design leading to stable centralization. Most importantly, it revealed that in a system of multi-level governance, there need to be sufficient gains from cooperation to ensure that the institutions will become self-enforcing.

Scrutinizing the assumptions

The model depicted centralization as a rigid union, that is, a union in which policies are uniformly provided for all the Member States (Alesina et al., 2005a,b,c). However, one could also think of a union where responsibilities are shared between the member countries and the central government. In such a case, countries first choose their own public good spending. Thereafter, the union of countries chooses how much to allocate to centralised spending. This permits for the differentiated allocation of public goods. Given the higher degree of flexibility, overall spending by the union of countries would be lower relative to that of a rigid union. Those countries with a preference for less spending than the median country would not support individual spending. This is the result of the formalization of the subsidiarity principle by Alesina et al. (2005b). They argue that the Member States of the EU assume primary policy responsibility, with EU interventions secondary.[15]

One of the major reasons for failures to centralise is the heterogeneity of preferences. The foregoing concerned unidimensional policies. However, the analysis changes when transposed to policy bundles, owing to economies of scope. Carbonara et al. (2012) adopt a similar framework to the one developed above, to discuss the subsidiarity principle within the EU. Generally, one speaks of economies of scope if the production of several public goods reduces the unit costs, relative to the costs of producing a single public good. That is the case if production requires resources which could also be employed for the production of other public goods at no additional costs (Carbonara et al., 2009). Using the above logic as a basis for the centralization decision with a step-wise centralization of only some functions, economies of scope might lead to, what Carbonara et al. call lock-in effects at the central or the local level. In case some func-

[15] For an overview over the literature, see Carbonara et al. (2012).

tions are centralized and others are not, centralization might become more attractive if similar resources can be employed to the production of a newly centralized good than for the production of good centralized at an earlier stage. Furthermore, the earlier centralization of certain functions of the government might make further centralization of other functions more attractive. Therefore, the timing of the centralization of different policies may be a determinant of the efficiency of centralization. Chapter 2 highlighted that market integration, together with the introduction of free movement of services and workers, has led to the necessity of a common framework. Market integration has caused a lock-in effect, strengthening the case for centralization beyond economic issues.

The analysis and the discussed propositions relate to a public policy which could be characterized as a club good, which allows for the exclusion of countries and its citizens from the benefits of the policy. Excludability ensures that only members of the union benefit from the public policy. If excludability is not assured, then there is a free-rider problem. Without having to bear the costs, outsiders can benefit from the agreement. When taking public-good investment decisions in a decentralized setting, outsiders take into consideration the positive spillover from the investments of the insiders. Hence, for outsiders, own investments are a decreasing function of the investments of the union. Therefore, the incentives to join the union are small. Given that spillovers decrease with the number of member countries, the spillovers get smaller with a lower number of participants. In this way, the overall benefits from the union decrease. Eventually, the benefits from membership become too small, which decreases the stability of the union. Thus, under a pure public good, proposition 2 and 3 will not hold. This means that from a rational actor's point of view, the centralization of policies is unlikely.

Rivalry of consumption reduces the benefits from a resource to others. If the resource permits the exclusion of potential consumers, then the use of the resource can easily be regulated. However, if exclusion is not possible, the use of the resource cannot be monitored. Therefore, a common policy to protect a resource cannot be self-enforcing. In the previous chapter, an example was given in relation to labour standards and labour. By aiming to attract foreign investors, countries might lower employment standards. As a reaction to this, other countries might follow. A race to the bottom in employment standards could be the result, potentially leading to a deterioration of working conditions. A common policy to prevent this could be decided, in line with the model prediction above. However, such a policy cannot be self-enforcing. The next section will discuss the implications of the model in relation to this policy in more detail.

5.5 The implication for EU policies

The model and accompanying review summarized insights which are essential to any discussion of EU policies. The model simplified the decision-making process. The Commission proposes new legislation, which has to be adopted by the Member States, represented by the Council of the European Union and the EU Parliament. This structure featured in the model in the form of the assumption that the countries vote over predefined proposals. Within both institutions, there are committees responsible for specific legislative fields. In the Parliament, there is the Committee on Employment and Social Affairs (EMPL Committee) and in the Council, there is the Employment, Social Policy, Health and Consumer Affairs Council configuration (EPSCO), which hosts the national ministers responsible for these topics. Both groups decide on employment and social affairs, after the respective legislative files have been scrutinized by working groups. The Commission, the Parliament and the Council can also legislate within the framework of inter-institutional negotiations[16], the so-called trilogue negotiations. The goal of these procedures is to reconcile the positions of the different actors in order to

[16]This has been laid down by the 'Joint Declaration on Practical Arrangements of the Codecision Procedure'.

reach an agreement at an early stage of the legislative procedures, so that Parliament and the Council can adopt a decision more quickly.

The Council and the Parliament both comprise citizen representatives. Although the Council represents governments, the Ministers taking final decisions on legislative files are elected and should represent their citizens. Similarly, the Parliament, being elected directly, should also represent the best interest of their citizens. When applying the results from the model to the EU's decision-making process, one can assume that the decision makers in both institutions represent the national citizen. Aiming to get re-elected, these decision-makers should follow the behaviour depicted in the model.[17]

5.5.1 Policy coordination and the role of social policy

In chapter 2, it was argued that social dialogue and collective bargaining can improve the competitiveness of national economies and increase resilience against asymmetric shocks. Existing coordination methods such as the European Semester could be used to improve the functioning of social dialogue and collective bargaining across Member States (Deakin, 2017). Coordination through the OMC and the European Semester do not produce legally binding rules. In terms of the theory above, the recommendations provided by these processes need to be self-enforcing in order to be successful. Is that the case?

In chapter 3, the processes of policy coordination, that is, the European Semester and the EES, were depicted as club goods. Countries can be excluded from the review process and the discussions within the EMCO fora. At the same time, the exchange of best practices and the formulation of recommendations can benefit the reviewed coun-

[17] This abstracts from other issues, such as pressure from interest groups.

tries. The more countries that participate, the higher the volume of exchange. Can these processes yield wage coordination at the national level? Within the framework of the European Semester, the country reports and the country specific recommendations review national collective bargaining and social dialogue. The Commission sees social dialogue as an important instrument to support labour markets. The European Semester and the EES might be used to steer national collective bargaining systems.

In order to be successful, the outcomes, that is, the recommendations and guidelines of the coordination process, need to be self-enforcing. In other words, there need to be benefits from coordination. For example, suppose, that the Semester process identify some best practices of collective bargaining at the national level, such as coordination. Collective bargaining can take place at different levels - at the company level, at the sectoral level (industry-wide agreements) and at the national level. Coordination denotes a process in which smaller bodies follow or apply what larger bodies decide. In other words, coordination refers to the degree to which company-level bargaining applies to sector-level decisions. Coordination has been linked to good employment outcomes (OECD, 2018). But in order to have such beneficial effect, certain conditions need to be fulfilled.

In Germany, collective bargaining takes place mainly at the industry level, but, at the same time, the system allows for collective bargaining at the company level.[18] This allows for more flexible adaptations in times of economic downturns - instead of dismissals, wages or working times can be reduced. Accommodations can be achieved through the use of opening clauses in industry-level agreements. These clauses allow company-level workers' representations to negotiate different arrangements in areas specified in the

[18] https://www.worker-participation.eu/National-Industrial-Relations/Countries/Germany/Collective-Bargaining. (last accessed: 05.08.2019)

industry agreement, while following the industry level agreement.[19] After the great recession, different Member States made reforms in order to align their wage bargaining system with the German model (OECD, 2017). The OECD (2018) points out that the lack of strong local workers representation in Southern countries limited the scope for reform. This shows that there are complementarities between different institutions, which limit the potential success of reforms. To achieve the desired effect, the bargaining entities at different levels need to complement each other. To this end the necessary exchange needs to take place. In some Member States, there is this tradition, whereas in other this tradition does not exist.

At the national level, different collective bargaining institutions exist and these are complementary with other national institutions, as discussed in the previous chapter. In the terms of the model, the preferences of the national constituency over reforms to increase coordination or to transplant a foreign bargaining system are very likely to differ.

Preferences are also likely to differ across the group of countries identified in the previous chapter: LMEs, CMEs and MMEs. From figure 5.2 with the coordination and centralization values, it can be inferred that LMEs have the lowest degree of coordination among EU Member States. For these countries, increasing coordination would not necessarily result in better employment outcomes, as the national systems need to be set up effectively as in the case of Germany, described above. Given the differences in preferences, a common strategy to coordinate collective-bargaining systems would be unlikely to be accepted by all Member States. In light of its probable failure, the spillovers from that strategy would be low. In technical terms, the assumptions and

[19] https://www.eurofound.europa.eu/observatories/emcc/erm/support-instrument/opening-clauses. (last accessed: 05.08.2019)

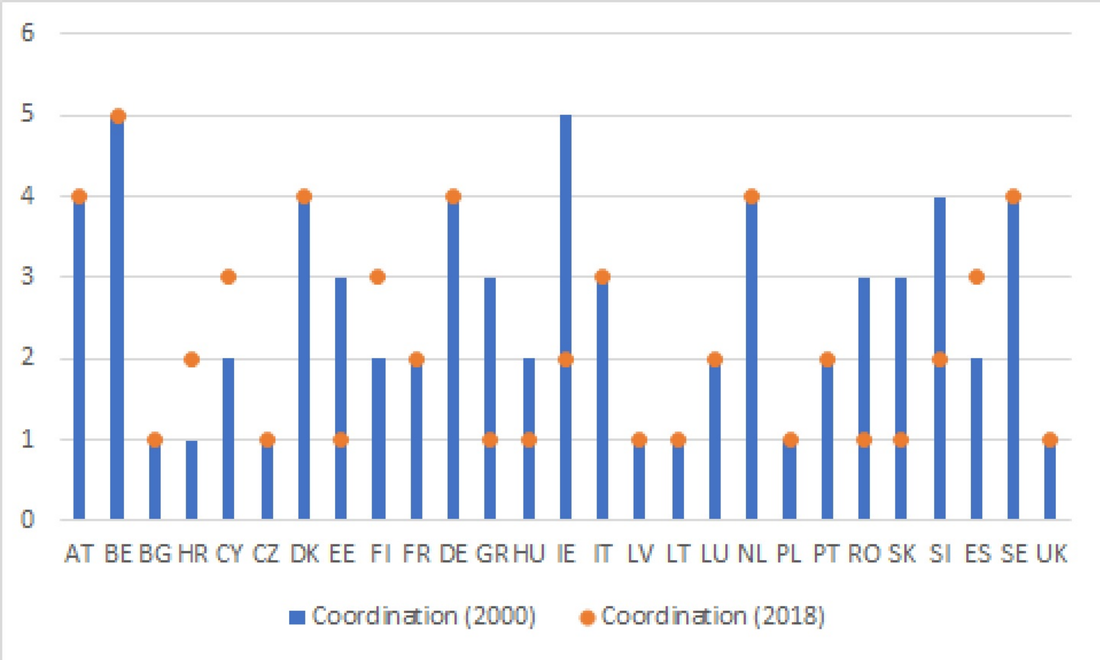

Figure 5.2: Coordination of collective bargaining in EU Member States
Source: Visser (2019). Values from 1 to 5. Higher values indicate higher degrees of coordination between different levels of bargaining entities. Coordination takes place for example through norms or guidelines set by higher level bargaining entities, for examples at the industry level.

prerequisites leading to proposition 2 and 3 are violated. Therefore, no single from the EES and the Semester process can succeed.

Conversely, when the strategies and recommendations are differentiated, acceptance grows likelier. Considering the discussion in chapter 2, differentiated recommendations could increase stability at the national level, say through increases in flexibility, which would result in positive spillovers. More countries could be attracted to the process, leading to the stable implementation of these recommendations. Therefore, the case for differentiated policies is strong. Chapter 2 introduced several differentiated policies and showed that differentiation can be related to the time at which different Member States join the policy and to its subject matter. In theory, the process could also easily accommodate a multi-speed approach. If a new specific area is considered for coordination within the EES, the analysis holds that countries initially willing to participate in the process can form a core group. Given the centripetal forces described in chapter

3, other countries are likely to join the policy. Therefore, such policies offer themselves for a multi-speed approach, which can and should be offered a la carte.

In general, social policy appears to have gained in importance at the EU level, especially since the Juncker Commission, but it remains subordinate to economic policies. The launch of the OMC[20] could have led to the development of a common European social model (Vandenbroucke, 2017a). However, there is still no consensus on what the European social model should contain. Financial and economic emergencies have revealed the need for a clearer consensus on the role of the EU in the field of social policy. From their analysis of the Semester process and the respective CSRs, Zeitlin and Vanhercke (2018) conclude that the Semester process has tended to become increasingly social. Copeland et al. (2018) conclude the Europe 2020 strategy led to substantial changes to EU governance, as well as the Union's social policy. They find that the social policy of the EU aimed at stronger monitoring of the economic and financial situation of the Member States, with the goal of achieving balanced national budgets. Accordingly, purely market-correcting mechanisms appear to be rather scarce, in comparison to market-making policies. Overall, social actors were able to strengthen market-correcting CSRs. However, the degree of 'socialization' of the semester process has been said to lack continuity and to be contingent on economic policies Whether or not a more social trajectory will be adopted remains unclear and Copeland & Daly (2018) argue that the signals are rather mixed. The analysis provides potential explanations. Differences in preferences make the political acceptance and implementation of common strategies difficult. In terms of the theory above, the benefits of uniform and one-sided strategies for labour market coordination are too low for some countries. This leads to resistance to the recommendations. The analysis highlights the importance of differentiation: without differentiation, CSRs are unlikely to be implemented.

[20]Open Method of Coordination.

5.5.2 Social investments of the European Union

Social protection expenditure, which includes investments into skills and training, can increase labour productivity and thereby competitiveness. Autor & Dorn (2013) point out that these investments become increasingly important, especially in times of automation and digitalization. Maintaining and increasing productivity in all the regions is important to the EU. Not only is there a potential danger from an increased periphery-core divide, but there is also a need to increase the competitiveness of Member States. A common policy for investments into skills can also have a stabilizing effect in economic downturns - common funds, such as the ESF, can complement national investments into skills or into active labour market policies, and thus enhance the Union's capacity for economic adaptation Common social spending on skills can also reduce welfare disparities.

The cohesion funds underlie the shared management principle. This gives autonomy to the Member States in allocating funds to specific purposes, while permitting the Commission to monitor their use. The management of the funds at the national level is intended to capture regional and national preferences for investments. This is in line with the economic theory of federalism, which argues that policies should be allocated to the lowest possible level of governance. On the other hand, the shared management of the funds allows the European Commission to ensure that the funds allocated to the different regions are used for the intended purposes. This adds to hard budget constraints for Member States, that is, the funds cannot be allocated for expenditures other than their intended use. Bachtler & Ferry (2015) analyse several different rules regulating the ESI Funds and find that those related to earmarking are adhered to by the Member States, to a large extent. Their analysis relates to the earmarking of funds for the Lisbon Strategy goals - innovation and job creation. Despite the pre-specified goals, Bachtler & Ferry (2015) find that Member States still negotiate different allocations. They conclude that earmarking is partially effective. Accordingly, the design of the funds appears to be in line with proposition 1 and 4 - the funds accommodate divergent preferences and are self-enforcing.

To the extent that one focuses only on the direct benefits that accrue to recipient Member States, the ESI Funds can be described as a private good: the financial means can only benefit the recipient and funds provided to one Member State cannot be shifted to another. At the same time, a centralized administration responsible for spending would reduce administrative costs, owing to economies of scope and scale. Since the management of these funds is shared, this argument holds only partly. National authorities still play an important role in fund administration, but the determination of objective and supervision are entrusted to the Commission. Therefore, there are certain efficiency gains from these common funds, which are captured by the spillover parameter β above. They could be described as a private good with spillover effects. Although the effectiveness of the funds is controversial, they might have some stabilizing function. Considering the different shares of co-financing, which depend on regional GDP sizes, they can also be considered redistributive. Net benefits differ from one country to another, at least in theory, which could result in a violation of proposition 1. This proposition holds that a union of countries providing a public policy is formed by countries with contiguous preferences. Having similar preferences in the model means having a similar net benefit from a policy in practice. This is not always so. The regulations of the funds leave the Member States some room for manoeuvre in investment choices. Therefore, the heterogeneity of preferences should not play a role for the ESI funds. In addition, the funds can have some positive spillovers, which can even make investors better off. Therefore, given the positive spillovers, the funds should constitute a stable policy, as suggested by proposition 1.

The discussion in chapter 3 revealed that the monitoring framework causes poorer regions to miss out on funding. There, the state's administrative capacity is insufficient to meet the Union's requirements. There are thus large transaction costs that hinder the efficiency of the funds. Moreover, the costs in question are likely to differ between countries, which leads to differentials in net benefits. These are not accounted for by the model. Darvas et al. 2019 call for a simplification of the compliance mechanisms, arguing that a results-oriented allocation is not always effective. This appears to be related to methodological issues, namely the definition and measurement of results. Simplifying the compliance mechanism would reduce transaction costs. However, monitoring is important for the stability of policies, as discussed under proposition 4. The main lessons to be drawn are that the funds allow to take regional preferences into account and that their institutional design underpins hard budget constraints. However, it has to be remembered that the enforcement of hard budget constraints can also limit the efficient allocation of funds. Strong monitoring requirements can reduce the potential of the funds to improve the competitiveness of the regions. For the funds to assume a stabilization function, more solidarity between the Member States is needed. In 2019, observers of the MFF negotiations for the budget 2021 to 2027 do not foresee any increases in the budget for the Cohesion Policy within that MFF framework. The negotiations determine the Cohesion Budget allocations for each Member State. Member States of the Eastern European periphery are likely to receive less than they did in the previous budget framework.[21] This shows a low acceptance of redistribution between Member States.[22]

[21] See http://www.euvisions.eu/eu-cohesion-policy-2021-2027-mff-winners-losers-europe-peripheries/. (last accessed: 05.08.2019)

[22] The epilogue at the end of the present study provides a discussion of the later developments of the budgetary negotiations and shows how these changed in the face of the COVID-19 crisis.

In relation to certain insurance functions, such as a common unemployment benefits scheme, the ESI Funds differ in the allocation of payments. Within the ESI Funds, the allocation is negotiated up front during the negotiation of the MFF. However, a true insurance scheme would pay out if and when shocks arise, say after a drop in GDP accompanied by an increase in unemployment. This unpredictability of benefit payments makes the assessment of benefits less obvious. Restoring macroeconomic stability across the EU has a positive impact on every Member State, even if funds were allocated to only a few. It would lead to a stabilization of demand, as much of the demand for national products and services comes from within the internal market.[23] Similarly to the description of the ESI funds, the benefits from the unemployment insurance can only accrue to one individual or, depending on the design, to one region - once consumed they cannot accrue to someone else. Individuals (or regions) can be excluded from the benefits of unemployment insurance, depending on its design and intended effects. Therefore, one may describe it as a private good, which is attractive to Member States. Considering that insurance will stabilize the internal market and demand from other Member States, there are also spillovers. The insurance scheme generates direct monetary benefits for countries in distress. By supporting them, it contributes to political stability and the stability of demand in the internal market. Behind the veil of ignorance, the expected net benefits from a common insurance would be positive for all. Accordingly, the Member States should be likely to accept such a scheme, if it is ensured that funds are allocated to ensure macroeconomic stability. The funds need to be clearly ear marked and monitored, in order to maintain hard budget constraints. In this way moral hazard can be eliminated and it is ensured that the funds are put to proper use.

[23] See section 2.3.

In practice, in some countries, the negative effects of external shocks are likely to be harder than in others. High unemployment and low labour market inclusivity make economies much less resilient against shocks. There, dependency on an EU unemployment scheme is more probable. Accordingly, some Member States are more likely to receive funds and others are more likely to give them. This results in a discrepancy between the net benefits of the funds and reduce the likelihood of political acceptance. Then, acceptance depends on the size of the spillover, that is, the degree to which such a scheme could support to re-establish demand in the common market. The ESI Funds showed that a clearly defined investment framework and monitoring are important. In order to ensure that the spillover from such a policy is sufficiently high, hard budget constraints are even more important, especially when it is clear that direct benefits are distributed unevenly.

In terms of differentiated integration, the analysis suggests two conclusions. Due to the regulation of the funds, the immediate benefits[24] can only accrue to those countries which are covered by the scheme. The resulting centripetal effects favour differentiation, under which a core of countries could lead and others could follow. However, for the structural funds, this would not necessarily work, since the goal of the Cohesion Policy to compensate those which were made worse off by market integration. As for an unemployment mechanism to ensure against shocks, differentiation also needs to be limited to the extent that insurance function is given, that is, the size of the contribution of the countries is sufficiently similar for sustainable contributions and payoffs. In addition, the goals of the respective funds need to be precise and there must be a framework to monitor the use of the funds. In light of the foregoing, the differentiation of those policies in time and in content matter appears to be prohibitively difficult.

[24]Which are benefits other than indirect benefits stemming from spillovers.

5.5.3 Regulating the race to the bottom

An important issue in the internal market is the creation and maintenance of a level playing field. The previous sections have shown that there is a potential for a race to the bottom in labour standards and that regulation is advisable. Competing over foreign direct investment, governments may reduce labour standards in order to increase the attractiveness of their jurisdiction as a production location. This competition could, at least theoretically, reduce labour standards and the welfare of the workforce. In chapter 3, it was argued that labour standards can be seen as a common-pool resource. The previous subsection already introduced several regulatory theories on non-excludable and rival goods. In the case of the race to the bottom in employment standards, the non-excludability relates to the issue that no country can be hindered from decreasing employment standards. The race to the bottom logic suggests that this reduces standards om other countries. The consumption of labour standards is rival: countries can only reduce labour standards until the 'pool of labour standards is empty'.

In the model, an assumption was made to the effect that outsiders can be excluded from benefits and that the addition of more countries would not reduce benefits for insiders. In the case of regulating the race to the bottom, these assumptions are violated. Therefore, a stable policy is unlikely. Suppose that a group of countries form a union to introduce a minimum threshold for labour standards. Let us assume that the coalition agrees on some minimum standards. A country leaving the union and reducing labour standards by a little below the agreed standard could 'under-cut' all the other countries at once. Theoretically, it could thus attract economic activity from all other countries. Accordingly, in terms of the model above, the surplus from joining the union is low because the costs of adapting labour standards are too high or because the spillover effect from the policy is low. In addition, preferences over labour standards are likely to differ across states. Conversely, leaving the union becomes attractive. In other words, a policy to protect social and employment standards cannot be self-enforcing. Contrary to this prediction, a consensus about labour standards was reached within the EU, as shown by the Posted Workers Directive.[25]

The original Posted Workers Directive stipulated that the minimum rates of pay in host states should be guaranteed to foreign workers. The European Commission (2016b) highlights that in those countries where there is no generally applicable collective agreement, Member States may decide to base the transposition of the Directive on agreements which are applicable to similar undertakings in each country's geographical area. In Sweden and Denmark, for example, the Directive might not always have been effective. In the absence of statutory minimum wages, minimum rates of pay are determined by collective agreements. Those agreements leave ample room for company-specific agreements, which appear to play an important role with local companies. However, there is only a low number of collective agreements with cross-border companies. This can result in situations where different rules are applied to national (local) workers and to posted workers, with wage differentials the obvious result. This confers competitive advantages to the posting companies, who can offer the services at a lower cost. In order to avoid such cases and to increase the certainty of the application of the Directive, and to prevent social dumping, the European Commission made a proposal to amend the Posted Workers Directive. The main elements which change concern rates of pay.[26]

The Posted Workers Directive includes elements such as minimum pay (remuneration).[27] So far, the Directive has only prescribed that the worker is subject to the minimum rates of pay in the host state. However, the amended rule stipulates that workers are subject

[25] Amendment to Directive 96/71/EC Directive by (EU) 2018/957 of the European Parliament and of the Council of 28 June 2018.

[26] https://ec.europa.eu/social/main.jsp?catId=471. (last accessed: 12.08.2018)

[27] Directive 96/71/EC

to the same rules as workers employed by companies resident in the host country. The difference between the old and the new provision is that the new one extends to bonuses and allowances, as well as to pay increases related to seniority. In addition, collective agreements will become applicable in all sectors, which broadens the current framework under which collective agreements only extend to workers of the construction sector. The Directive enhances the equal pay for equal work principle, according to which the same work executed in the same place should be remunerated at a similar rate. However, in different Member States, minimum rates of pay are regulated differently. In countries such as Austria, Belgium, France, and in Nordic countries such as Denmark and Sweden[28], minimum rates of pay are regulated by collective agreements. In other countries, such as Bulgaria, Hungary and Poland, the minimum rate of pay is set by statute. The amendment proposal induced strong opposition by some Member States, on the grounds that it infringes on national sovereignty in wage-setting.[29] The European Trade Union Confederation (ETUC) supported the EC, which rejected the appeals of the Member States.[30] The arguments of the Member States show that wage regulation is not only about workers' welfare, but also about national sovereignty and collective identity.

The approach put forward in this chapter suggests that finding a political agreement on common employment standards and on a principle relating to equal pay for equal work among EU Member States is difficult. However, the Member States agreed to the amendment of the Posted Workers Directive.[31][32] Potential explanations include log-rolling, that is, the acceptance of some legislation by one Member States in exchange

[28]See European Parliament (2016), table 3.

[29]https://www.eurofound.europa.eu/fr/publications/article/2016/eu-level-posted-workers-proposal-gets-yellow-card-from-MemberStates. (last accessed: 05.08.2019)

[30]See https://www.etuc.org/en/pressrelease/commission-must//-now-press-ahead-urgent-revision-posting-workers-directive (last accessed: 05.08.2019)

[31]Directive (EU) 2018/957 of the European Parliament and of the Council of 28 June 2018

[32]See also section 7.4.3 for more details about the voting outcomes in the European Council

for acceptance of another preferred piece of legislation by other Member States. The discussion has highlighted the importance of national sovereignty and national identity. Social standards are part of the 'European Social Model', which is shared by the Member States. This could have affected centralization trajectories. However, the theoretical methods put forward in this chapter do not easily allow to explain how values affect decisions. These methods would have predicted that due to strategic room for manoeuvre for individual countries, leading to the common pool resource problem, allows in theory, to free ride on other states. Therefore, any form of differentiated integration, would undermine the potential for successful integration.

5.6 Territorial attachments and national identities

In at least two of three cases studied above, the conclusions highlighted that national identity and solidarity between Member States are important factors in achieving many policy goals. One of those goals was related to redistribution and another to common standards and institutions, which were supposed to be adapted. In the negotiations over the amendment of the Posted Workers Directive, some identitarian issues arose.[33] The economics of federalism and the model discussed in this chapter did not take national identities and values into account. However, some fields of economics are alive to the problems of identity.

In relation to income redistribution, standard economic models on voting over redistribution assume that voting decisions depend only on individual income and income distribution (Melzer et al., 1981). If the majority of voters are poor, redistributive policies grow in popularity. However, Shayo (2009) shows that preferences over redistri-

[33]Directive (EU) 2018/957 of the European Parliament and of the Council of 28 June 2018

bution within a nation also depend on membership in - and identification with - a social group. Based on models of social preferences (Akerlof & Kranton, 2000), Shayo (2009) argues that preferences over redistribution are influenced by the voter's identification with his or her social (income) class and nation. If identification with the nation is high, a low earner would prefer less redistribution than if he or she identifies with his social class. From this perspective, 'identifying with different groups means to have different preference over outcomes'.[34] Therefore, identification with one's home country might affect attitudes to centralization.

In chapter 4, it was said that existing institutions impact the costs and acceptance of new institutions. Solidarity, being one institutional value, may impact policies as well. Alesina et al. (2015) provide an extensive literature review on culture, values and economic outcomes: studies of second-generation show that cultural values are persistent and change only gradually over at least two generations. Licht et al. (2005) for example, find that national laws on shareholder and creditor rights reflect culture-specific considerations. Accordingly, institutions impact not only costs, but also individuals' preferences. Putnam (1993) argued that ancient institutions may have led to the development of current social capital, which in turn influenced the success of modern democratic institutions. Accordingly, popular acceptance and the success of institutions may be a function of a population's previous experiences with similar institutions.

Guiso et al. (2009) find that cultural relationships affect the level of bilateral trust between citizens of different countries. In their research, trust is defined as generalized trust, measured by the survey question '[...] please tell me whether you have a lot of trust, some trust, not very much trust, or no trust at all'. Trust in one's compatriots appears to be stronger than trust in outsiders. Guiso et al. (2009) explain the variability

[34] See Shayo (2009), p. 147.

in trust level by variations in information about the counterparties and by cultural commonalities. Therefore, shared legal origins and geographical proximity were found to increase trust in other nationalities. In addition, trust correlated positively with trade between the respective nations. Common cultural traits reduce uncertainty about other groups, thereby increasing trust. This suggests that cooperation is stronger between individuals who are geographically, culturally or ideologically close to one another. Tabellini (2008) analyses the influence of norms of good behaviour, like cooperation norms. In that model, the norms are transmitted from parents to children and formal institutions that enforce these norms are chosen by majority voting. Incentives to cooperate increase, as does the number of cooperators. Similarly, 'bad' formal institutions may cause breakdowns in cooperation. Furthermore, Tabellini (2008) shows that cooperation is higher if individuals have close social ties. Norms of good conduct apply with greater force if individuals are close to one another. A sense of social proximity appears to influence the application of norms of good conduct. From the foregoing, it can be concluded that social and cultural proximity have an impact on cooperative behaviour. However, different insights from the literature are not easily integrated in the model presented earlier. Identity economics, which integrates a similar reasoning into models of economic decision making, provides a methodological framework that facilitates the introduction of behavioural elements into the formal model proposed here.

Identity economics, developed by George Akerlof and Rachel Kranton, builds on the assumption that individuals gain utility from membership in a group. By following group norms, individuals gain utility. These refinements were introduced into a model of redistribution within a heterogeneous federation, showing that identification influences support for regional income redistribution (Holm, 2016). This is further theoretical evidence for the claim that inefficient centralization within the EU is not necessarily attributable to cultural differences, but to territorial attachments, such as nationalism

(Alesina et al., 2017). As a result, the EU is not an optimal political area (Alesina et al., 2017). This does not refute the results and the analysis from this chapter. It merely reflects the need to refine the findings and to extend the theories by a behavioural component. The next chapter will review theories from different fields and define, and describe, nationalism using insights from psychology. This definition will be picked up in chapter 7, which extends the model above and refines its results.

5.7 Conclusion

This chapter introduced the public choice literature explaining how to deal with aggregate preference of voter of different regions, the literature on the size of nations and the literature on the economics of federalism. Broad principles were presented and linked to specific EU policies. A central principle for the stability of common policies is that they make all involved parties better off. This chapter highlighted the importance of the institutional design for the successful implementation of common policies. It described a trade-off between efficiency and heterogeneity costs, which is decisive for the implementation of common policies and the number of countries willing to agree to them. Theoretically, the trade-off determines the political acceptance of common policies and whether they will be implemented nationally. The framework governing the policies is crucial to incentivise efficient spending, that is, stable budgetary constraints. The comparison of the theoretical benchmarks against contemporary EU policies revealed that current frameworks might fail, if not properly designed. The comparison also highlighted the importance of solidarity between the citizens of different countries among which common policies are implemented. This aspect is further developed in the chapters that follow.

The chapter discussed three EU policies, each of which is characterized differently by the public choice literature. Policy coordination in the framework of the Open Method of Coordination and the European Semester have been compared to a club good, redistribution and social investments in the framework of the ESM has been depicted as a private good, and rules to counter the race to the bottom as the regelation of a common pool resource. Each exhibits different degrees of excludability and by rivalry in consumption. A rational actor model would suggest that utility maximizing politicians do not have any incentives to agree to the centralization of public policies characterized by non-excludability. This feature of the problem reduces the likelihood for differentiated integration. The chapter furthermore discussed policies, which resemble regulating a common pool resource.

Investments by neighbouring states benefit citizens who do not bear their costs. Agreeing to restrict access to a common pool resource would also be irrational, since it would limit potential individual benefits. Therefore, theoretically, political acceptance for the central regulation of a common pool resource would not be forthcoming. However, the analysis above has shown that practice proves otherwise. In general, this chapter concludes that there is no case for the differentiated regulation of common pool resources.

In case some citizens can easily be excluded from the benefits of a policy, there is no room for strategic manoeuvre by national politicians and the incentives to agree to a common policy are high. This means that at least two conditions need to be fulfilled for redistributive policies to be implemented. There needs to be a framework to monitor the allocation and use of funds and fixed budget constraints must be guaranteed. Monitoring enforces budget constraints. However, the resulting transaction costs need to be limited. Secondly, the destined use of the funds needs to be beneficial for the respective Member State. Given appropriate design and positive spillovers, there should be political acceptance. However, there is no strong case for a differentiated approach to macroeconomic stabilization, as this would compound financing difficulties.

Another category of public policies which this chapter considered were club goods, as illustrated by the Open Method of Coordination and the European Semester. Such policies allow for exclusion and there is little room for strategic behaviour on the part of politicians. Accordingly, these policies can be designed and implemented so that they are self-enforcing. The analysis showed that the benefits from a policy are decisive for its implementation. The national context in which the policy is to be applied is important and the policy itself must accommodate it. Coordination thus allows for a differentiated approach. Differentiated integration could even increase the prospects of success.

Chapter 6

Identity economics and political integration

In chapter 5, the centralization of policies was conceptualised as the creation of a union of countries. This allowed the creation of common policies to be related to the literature of the size of nations, which is based on the economics of federalism. According to that literature, the boundaries of a jurisdiction are determined by a trade-off between economic efficiency and the heterogeneity of preferences. Chapter 2 pointed out that more centralization is needed to accommodate different national economic and social systems within a single market and a single currency. Although economic theory would suggest that the centralization of more policies would not be efficient as a stand-alone policy, path- dependency of centralization makes common policies necessary. For this reason, increasing flexibility in European labour markets and supporting Member States' structural policies can benefit all Member States. The previous chapter showed that the arguments for and against centralization become subtler if and when preferences over policies differ across constituencies. In short, preference heterogeneity is an important determinant of centralization.

Preferences are determined by existing instituitions, economic needs and culture. Therefore, greater cultural or linguistic differences result in more heterogeneous preferences. Alesina et al. (2017) are of the view that the EU is not an optimal political union and that this impedes decision making. They suggest that in the EU, impediments to centralization are caused by nationalism.

6.1 Nationalism and the need to enhance models of centralization

Nationalism has been defined in many different ways, as either a political and social movement or as a consciousness of belonging to a group.[1] Smith (1991) defines nationalism as 'an ideological movement for attaining and maintaining autonomy, unity and identity on behalf of a population deemed by some of its members to constitute an actual or potential 'nation'.[2] Accordingly, the world is divided into nations, that is, a populations that share a common historical territories and cultures.

The consciousness of belonging to a nation and the resulting efforts to maintain and promote the interests of that group against others pose limits to economic efficiency. Nationalism is a common cultural narrative (Fligstein, 2008). This narrative unites a group of people and sequesters them from others. Shared communication through media and other cultural instruments, as well as increased social interaction within institutions, are some of the mechanisms by which these narratives are constructed and developed (Fligstein, 2008, Deutsch, 1966). The narratives in their turn lead to the

[1] See discussion by Smith (1991).
[2] See Smith (1991), p. 73.

formation of a common collective identity (Fligstein, 2008). Small differences between individuals become amplified by national identity and language (Alesina et al., 2017). This amplification can be linked to a cognitive process of interpersonal comparison. In different social environments, individuals identify themselves with others based on the degree of perceived similarity. This produces a biased view about outsiders and insiders with whom individuals identify. That bias skews decision making.

Akerlof & Kranton (2000) were the first to introduce identity into a model of economic behaviour. They argue that, as far as decision making is concerned, individuals' decisional calculus is affected not only by the material preferences of agents, but also by the social context in which those decisions are made. Thus, if the borders of national states are an outcome of the interaction of economic agents, then they must be influenced by social context. However, the theories presented in the previous chapter do not make this distinction. Alesina et al. (2005c), for example, explicitly state that they use state and nation as interchangeable concepts that both designate a group of individuals who share a given set of public goods and policies. Identity economics has developed an approach that permits the integration of nationalist behavioural patterns into models of centralization. Including identity in these models can boost their verisimilitude. The next sections will review the main elements of identity economics and some of the insights from the literature. Nationalism will be conceptualized as a collective identity. The next section will discuss how such collective identities affect individual behaviour.

6.2 Identity and economic behaviour

In standard economic models, the utility of an individual depends only on pecuniary payoffs. However, identity may give rise to alternative motives and incentives for economic agents. Including identity into a function of utility should result in an 'enhanced utility function.'[3] In this context, utility is maximized by balancing the new trade-offs. Akerlof & Kranton start with a standard utility over a specific good. Then, the identity components are specified. That latter part includes norms of behaviour. Accordingly, decision making implies that a new balance must be struck between standard utility and identity utility. As Akerlof & Kranton point out, social norms change over time. This is comparable to technology, which evolves over time in production models. Hence, it is important to consider not only the social situation in which decisions take place, but also their timeframe.

From the viewpoint of identity economics, individuals are supposed to behave differently in different social interactions. People belong to different social categories, that is, groups of people. Different behavioural norms are attached to different social groups. Groups can relate to a profession, a family or an income class. A person can belong to several categories at the same time. The norms according to which a person acts depend on social context and category identification. Social categories tell people which norms apply in what situation, how they should behave in specific situations and how to treat people from different social categories (Akerlof & Kranton, 2010). An individual's identity defines who that individual is through his or her social category. Correspondingly, identity defines the self in relation to others.

6.2.1 Psychological determinants and impacts of identity

According to social identity theories, individuals are first linked to social categories in which social norms prevail. Given a certain identity and its norms, it can be posited that people make decisions by weighing gains against losses. Individuals hold several identities at the same time. One can be a worker at a company and at the same time act

[3] See Akerlof & Kranton (2010), p. 18.

as a supervisor. If the worker identifies more strongly with his colleagues, he will report misconduct less often. Whether the worker executes the supervisory tasks properly thus depends partly on his or her identity (Wichardt, 2008). The process of identification involves several steps. First, individuals categorize themselves into groups. Secondly, for identification to occur, the individual must evaluate some groups more positively than others. From a social psychology perspective, the essential condition for a group to become defined is that individuals should see themselves as members and that outsiders will recognise that allegiance. Accordingly, Tajfel and Turner (1986) conceptualize a group as a collection of individuals who perceive themselves as members of the same social category, being emotionally involved in that group and having some consensus about its purpose.

The process of self-categorization involves the representation of groups as prototypes (Hogg & Reid, 2006). In this process, individuals are depersonalized by perceiving the self and others in terms of specific attributes. A collection of attributes, which can include attitudes, behaviours, or physical attributes, comes to define a group and distinguish it for others. In other words, that set of attributes constitutes a group prototype. Group prototypes specify how people should think and behave and how they should perceive the outside world. This process of categorization generates stereotypical expectations about the behaviour of others. It induces thoughts, behaviour and feelings that enable the individual to adapt to the group prototype. Group prototypes describe 'individual cognitive representations of group norms'.[4] People mostly draw on readily accessible categories, that is, the ones which are easy to recall and the ones which are salient in many situations. Individuals also go through several categories before locating one that fits both group and situation. The categories could be linked to political orientations, religions or professions. Individuals categorize themselves and

[4] See Hogg & Reid (2006), p. 11.

thus derive a sense of self. Through this process, perceived similarities and differences are emphasized, a process which happens on dimensions which the 'categorizer beliefs to be correlated with the categorization'.[5] Apart from cognitive self-categorization, identification with a group relies on the positive evaluation of that group.

Groups are evaluated not only according to criteria of similarity, but also in terms of group value. Individuals aim to maintain or increase their self-esteem. Given that membership in a group becomes part of one's definition of oneself, the positive evaluation of the group on valued dimensions contributes to a positive self-image. According to Tajfel and Turner (1986), there is no absolute value according to which groups are evaluated. Instead, groups are compared to each other along valued dimensions. Hence, the higher the relative status of a group in comparison to other groups, the higher the self-esteem resulting from membership in that group. In the context of redistribution among different social classes, Shayo (2009) points out that material affluence is one such valued dimension. Individuals strive to belong to groups with a high social status. Membership in a social category is linked to beliefs and behaviours which are prescribed by the prototype of the respective category (Hogg et al., 1995). In a particular (social) context, a specific social identity becomes salient, which leads to stereotypical self-perception and behaviour. The likelihood that one will follow the norms of the group is increased. Furthermore, identification leads to the anticipation that other group members will follow the group norms as well. That is why cooperative behaviour is more pronounced within a group than between groups (Terry & Hogg, 1996, Everett et al., 2015). Through the process of identification, the perception of out-groups too becomes stereotypical. This increases the likelihood of discrimination against non-group members (Huddy, 2003). The process of identification can reduce the greed motive in social dilemmas by changing motives from self-interest to group-interest, which is often

[5] see Hogg et al. (1995), p. 260.

described as a change in preferences (Everett et al., 2015). Furthermore, in-group favouritism establishes beliefs about reciprocity and reputation. Using insights like the ones just described identity economics extends refines models of individual decision making.

6.2.2 The impact of identity on individual behaviour

Akerlof & Kranton (2000) developed the canonical economic model of identity. In their conceptualisation, social categories are based on attributes such as gender or income. Those categories are related to specific (physical) attributes and prescribed behaviours. Identity-related behaviour is the result of identity-based payoffs. In this model, the utility of an individual depends on the individual's own actions, the actions of others and the prescribed social category. The social categories have different social statuses and the higher the status of the group, the greater the self-esteem that individuals derive from belonging to it. Individuals maximize their utility for a given social category, its prescribed behaviour and the actions of others. Identities may be chosen freely or imposed. Due to identity effects, a new type of externality may arise because the actions of others alter individual identity utilities. The actions of others may threaten one's own identity, which results in a lower identity payoff. Akerlof (2007) formulates a principal-agent framework to describe the behaviour of employees in organizations. He shows that, by identifying with their organization, employees tend to behave more in line with the goals of the organization. Hence, identity can be a supplement to monetary compensation to incentivize employees. In Akerlof's analysis, the term 'identity' is used to describe a person's social category and their self-image. Conforming or departing from the group norm yields utility or disutility. As Akerlof (2007) points out, models of identity differ from standard economic models where preferences are fixed, because identity models make preferences depend on social context. In an interaction between a worker and a firm, Akerlof argues that if a worker sees himself as an insider, he or she has stronger incentives to act in line with the profit-maximizing behaviour of the firm and thus choose a higher effort. This, in turn, has implications for the wage-differentials needed to overcome the disutility from work activity and to incentivize a higher level of effort. Less variation in compensation is needed to incentivize insiders relative to outsiders. In this way, identification with the firm leads to cost savings.

Based on the model in Akerlof & Kranton (2000), Shayo (2009) endogenizes identity formation. In his model, individuals may either identify with their social class or their nation. According to social psychology, individuals tend to identify with groups which have a higher social status. In addition, according to self-categorization theory, individuals categorize themselves into groups which they perceive as being similar to themselves. Therefore, identification has a cognitive and an affective component. Shayo (2009) defines a Social Identity Equilibrium in which an individual's behaviour is consistent with his social identity, identities are consistent with the social environment and where the social environment is induced by individual behaviour. Shayo (2009) shows that electoral preferences over tax rates change depending on whether individuals identify with their social class or with their nation. Identification in this model is dependent on the cognitive evaluation of similarity and the status of the respective groups.[6] Accordingly, identifying with the lower (income) class appears to increase support for redistribution, whereas identifying with the nation has the opposite effect. This analysis shows that the levels of income inequality within a population may not be determinative of demand for redistribution.

The first study which relates identity to federalism economics is Holm (2016). It develops a theoretical model on the effects of regional identity on redistributive preferences within

[6] Class and nation are represented in terms of prototype, as discussed above.

heterogeneous federations. Holm (2016) shows that individuals from poorer regions exhibit lower support for income distribution if they identify broadly with the federation. Holm argues that individuals from poor regions would vote against their economic self-interest, given that federal identification entails the inclusion of individuals with differing incomes from their own. In other words, the in-group shifts towards another income class. The rate at which individuals from poorer regions are willing to sacrifice their own well-being for others increases. In addition, identification with the federation becomes less likely as the heterogeneity of the regional population increases. This highlights the relevance of identity for redistribution between regions and therefore certainly has an impact on redistribution between countries.

Beyond these theoretical studies, there is also experimental evidence on the effects of social identity on economic behaviour. Chen & Li (2009) follow the minimal group paradigm, an approach used in psychological experiments to study social identities. Subjects are assigned to groups using criteria which are as random as possible, such as a meaningless task completion or the choice of a favourite picture from a selection of images.[7] Chen & Li (2009) assembled groups on the basis of aesthetic preference and let subjects interact in a number of experiments. They found that players exhibited charitable concerns when the player they interacted with received a lower payoff than themselves and envy when the other player received a higher payoff. The charity concern was significantly higher when players were matched with another player from their own group than when they were matched with an outgroup player. The envy concern was significantly lower for ingroup matches as compared to outgroup matches. Furthermore, participants were more forgiving and more likely to choose social-welfare-maximizing actions when interacting with a group member. Identification with one's group motivates individuals to achieve and preserve positive collective self-esteem (Everett et al.,2015).

[7] See Chen & Li (2009) for a brief review of the methodology.

Similarly, to test whether group membership have an impact on individuals' willingness to cooperate, Goette et al. (2006) used random assignment to real social groups, such as officers in their military training. In simultaneous prisoner's dilemma games, with and without punishment, they found that cooperation with fellow platoon members was higher as compared to interactions with soldiers from another platoon. This finding supports the idea of in-group favouritism. Overall, there was no indication that individuals punish members from other platoons more often than members of one's own platoon. The authors concluded that there was no evidence that group membership increases hostility against outsiders. These academic contributions constitute an increasing body of evidence for the relevance of social identity to economic decision making.[8] However, in the analysis of centralization, social identity has not been applied very often.

In the context of EU integration, direct taxes are a recurrent theme. However, in the presence of sophisticated loopholes, the success of implementing a new tax depends on national taxpayers' willingness to pay it (Hartner et al. 2010). National identity is one determinant of that willingness. Another is the perceived fairness of the tax system - the likelihood of paying taxes voluntarily increases with the perception of the tax system being fair (Andreoni et al., 2008). Using a hypothetical situation, Hartner et al. (2010) show that the perceived fairness of an EU tax system depends on identification with Member States and the EU. Individuals who believe that the EU has a positive impact on the national political and socio-economic situation of their country perceive the EU transfer system as being fairer. National identification may therefore have implications for tax compliance. Generalising, it may also be said that national and European identities impact the success and failure of European policies.

[8]For a more extensive review, see Costa-Font & Cowell (2015b).

The following section defines national and European identities from a social psychology angle. This framework allows the paper to relate the insights from psychology studies to nationalism and facilitates a discussion of its impact on behaviour.

6.3 A conceptualization of European and national identities

The previous sections suggested that the social context in which decisions are made can have a strong impact on economic outcomes. Social identity might influence individuals' willingness to accept redistribution to distinct groups and different tax regimes. It was pointed out earlier that social identities are based on commonly held group meanings, that is, on shared representations of the group and on relational comparisons to other groups. These patterns are clearly reflected in the definition of nationalism. As pointed out above, nationalistic views hold that the world is divided into nations, which constitute populations that share common languages, common traditions and even common views and attitudes.[9] These characteristics are attributes on whose basis individuals can categorize themselves and others into distinct social categories.

6.3.1 Nationalism as collective identities

Psychological experiments based on the minimal group paradigm have shown that a small trigger is sufficient to generate in-group favouritism. Being marked as a citizen of a nation should have similar effects. However, relative to the experimental samples, nations are very large groups. Individuals can neither know all other citizens personally, nor can they make group comparisons easily. However, for nations there

[9] See Smith (1991).

is a similar logic to the minimal group paradigm to demarcate groups (Risse, 2015). Nations are 'an imagined political community - and imagined as both inherently limited and sovereign'.[10] It is imagined because, even in the smallest nation, no individual can know all of their compatriots (Anderson, 2006). Although borders are 'imagined', a nation will always be limited, and no nation will imagine itself as encompassing all mankind. Nations establish boundaries and limits by defining who is a citizen and who is an 'outgroup' (Fligstein et al, 2012). Thus, nationalism provides not only the 'story' to distinguish groups according to attributes and attitudes, but also the social norms that dictate the elevation of insiders over outsiders.

6.3.2 The delimitations and contents of national identities

Collective identities are strategies for groups to differentiate themselves from other groups. Therefore, national identity can be defined as a collective identity with a 'territorial reference'.[11] Fligstein (2008) points out that national identities have been conceived as collective identity claims that apply to people living in a particular territory. Collective identities entail shared representations of the group. Those representations are based on common experiences and interests. Beyond these commonalities, Brewer (2001) highlights that collective identities also entail shared representations, efforts and interests of the groups. Therefore, the concept of collective identity provides a link between theories of social identities and collective action in the political arena (Brewer, 2001). To be more precise, national identities are a form of a collective identity, which is a categorization of social identities (Kohli, 2000). Collective identities are not only related to a shared image of the group, but relates to an active process of shaping what the group stands for (Brewer, 2001).

[10] See Anderson (2006), p.6
[11] See Kohli (2000), p. 117.

National identities emerge intentionally or unintentionally from social interaction. They can therefore be seen as constructed (Fligstein, 2008). Nations are imagined communities and there are different ways to construct them. Smith (1991) differentiated between a civic and an ethnic conception of a nation. According to the Western civic model of nations, a nation needs a well-defined territorial space, which must be the population's historical homeland, linked to historic memories and associations. This link to historical development is often not made in economic theories, which tend to deem historical developments marginal. Secondly, according to the civic conception, there is the idea of a community of laws and institutions. Nations must have a measure of common culture and civic ideology, and a set of common understandings and ideas that bind the citizenry together. These beliefs are passed on to citizens through national education systems and mass media.

Smith (1991) summarizes the components of the Western model of a nation as: historic territory, legal-political community, legal-political equality of members and a common civic culture and community. He points out that there is another conception of the nation, which is based on ethnicity. The ethnic conception of the nation emphasizes the feature of a community of birth and common native culture. Accordingly, one remains a member of the community one was born into, irrespective of subsequent migration. According to this conception, a nation is a community of common descent. Taken together, Smith (1991) defines nations as 'a named human population sharing an historic territory, common myths and historical memories, a mass public culture, a common economy and common legal rights and duties for all members'.[12] Therefore, a nation is a cultural and political bond which unites a community, sharing a common culture and a homeland. In this manner, one can differentiate between different conceptualizations of national identities, such as between civic and ethnic cultural identities (Fligstein et

[12]See Smith (1991), p.14

al., 2012; Reeskens & Hooghe, 2010).

The ethnic conception of a national identity requires that individuals are born into a national culture in order to belong to it (Fligstein et al., 2012). From this point of view, ancestry determines allegiance (Reesekens et al., 2010). The focus of the ethnic conceptualization of nationality lies on a common religion, language, common traditions, and history and myths (Fligstein et al., 2012; Smith, 1992). Conversely, the civic conception relies on a conception of nationality which is based on legal status. This status can be acquired by anyone willing to accept a given political and legal order (Fligstein et al., 2012). A civic identity means identifying with a group of individuals who are governed by a similar set of institutions, rights and duties as oneself. Likewise, a European identity can be identified by reference to either civic or ethnic considerations. However, if one follows the ethnic conception of identity, then it would be difficult for European identity to develop, given the lack of a common shared language, or a culture which is shared among all the countries (Risse, 2015). Instead, one can define a European identity in terms of political identity, that is, a shared sense of belonging to a political community.

6.3.3 Nationalism and European identification

The European Union is a political project and therefore lacks 'cultural foci'.[13] Because of this, a European identity should be conceived as a political identity, which is taken to mean a 'sense of belonging to politically relevant human groups and political structures'.[14] In other words, collectives exist which share political cultures based on similar values, namely that of democracy or the rule of law. Political identity is a social and a

[13] See Thiel (2011), p. 47.
[14] See Bruter (2005), p. 1.

historical construct. It reflects the institutional nature of a political community. It is also linked to historical events and to narratives which shape individual self-conceptions (Castilogne, 2009). Bruter (2005) argues that the civic and ethnic (or cultural) components of political identity exist in parallel in the minds of citizens. In line with social identity theory, he argues that the different components may be more salient for different citizens, across different countries and across different time periods. Identities in real political communities are comprised of both components. It is safe to say that European and national identities are both political identities, but that for most members of the public, identification with the nation is much stronger than identification with the European Union.[15] Figure 6.1 shows the shares of EU citizens, who identify exclusively with their nation, with the EU, with their nation and secondarily with the EU, or with the EU firstly and with their nation secondarily.[16] From figure 6.1 it becomes visible that only a minor share of EU citizens identifies exclusively with the EU, Less than 2% in 2017 to be more precise. The share of those, who identify with their nation first and secondly with the EU has steadily increased, up to 54% in 2017. The secondly largest group is composed of those, who identify with their nation only, which were 35% of people in 2017.

Identification with the EU by the public officials of the European Commission is explained by prior experiences at the national level with institutions which are similar to those of the EU (Hooghe, 2005). The same study finds that officials from net beneficiary countries are more likely to describe themselves as European citizens. Identification with a supranational identity has been explained by domestic socialization, rather than socialization on the supranational level. In the terms of the self-categorization theory

[15] See also Fligstein et al. (2011) for a discussion, referring also to Eurobarometer up until 2011.

[16] The Eurobarometer is conducted yearly. In the survey round 2017, Eurobarometer 88.3, 33193 in the 28 Member States were interviewed. Figure 6.1 is based on the Eurobarometer question: 'In the near future, do you see yourself as' - with the possible answers as shown in the figure.

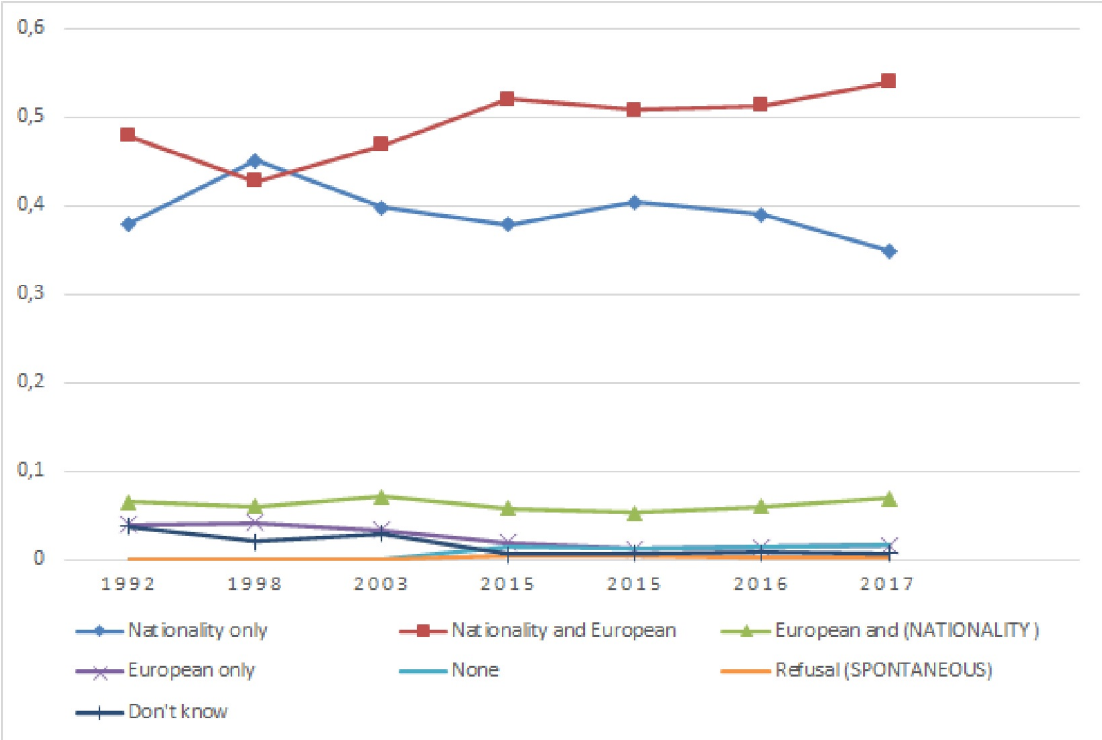

Figure 6.1: Identification with the EU or citizenship
Source: Eurobarometer Survey (European Commission, 2017c). Graph shows the percentage of EU citizens, living in the country of origin or abroad, identifying with their nationality or as European.

outlined above, individuals compare themselves to foreigners on the basis of national characteristics, views, and attitudes. This is further confirmed by the fact that political attitudes are formed in childhood. Common attitudes towards institutions as well as political systems are acquired over the process of socialization. Socialization broadly denotes 'the process of inducting individuals into the norms and rules of a given community'.[17] Socialization starts at very early ages, and proceeds in homes and schools, all of which are strictly national in Europe. According to Sears & Levy (2003), moral and political attitudes that are internalised during childhood are relatively persistent. Childhood attitudes manifest throughout an individual's lifespan, although adaptations may occur. Norms shared by a nation can include informal labour market institutions, such as informal norms of wage bargaining or norms of governance. In the context of

[17]See Hooghe (2005), p. 865, Checkel (2005) and Lewis (2005).

EU accession, Schimmelfennig (2016) finds that standards of good governance influence the decision to refuse or accept a candidacy. Countries with high standards of liberal democracy and market economy were found to be more likely to deny integration than states which perform worse along these dimensions.[18] The national institutional capacity of governance exhibits similar properties.

6.4 Conclusion

This chapter provided an overview of social identity theories and discussed the impact of social identities on individual behaviour. Based on this overview, the chapter identified the link between social identity and nationalism. The chapter argued that social identities in general, and nationalism in particular, may have an impact on economic decision making, voting behaviour, and the acceptance of EU laws and regulations. In theories of federalism, individuals follow the standard rational actor model - the state is seen as a public administration which is not differentiated from the nation. The review above provided concepts and methods allowing to introduce this differentiation into economic models. The literature on identity is rich and different scientific fields have covered the topic. The current study is interdisciplinary and has to limit itself to one conceptual approach. Following Akerlof & Kranton (2000), the present study will be based on the insights from psychology, which also have been discussed in the international relations literature. On that basis, the next chapter extends the model defined in Chapter 5 and analyzes its implications for supranational legislation and the stability of centralized policies.

[18] In other words access to the common market or being member of the economic union.

Chapter 7

A social identity analysis of centralization - a third generation theory?

7.1 A behavioural approach to the economics of federalism

Heine (2018) finds that the development of behavioural economic theory demands also for a behavioural approach to federalism economics. The previous chapters have shown that decisions are not always taken according to a rational actors approach and confirmed that such an approach indeed is necessary. For redistributive policies to materialize, solidarity is indispensable. The previous analysis showed that rational countries would not adopt some policies, such as the Posted Workers Directive.[1] Log-rolling and political pressure are potential reasons. The discussion of chapter 6 provided a basis

[1] Directive (EU) 2018/957 of the European Parliament and of the Council of 28 June 2018 amending Directive 96/71/EC

for the theoretical analysis of non-pecuniary gains. The economics of federalism follows a rational actors approach, where individuals are guided solely by material incentives. First-generation theories provide normative arguments for centralization, focusing on the benefits of centralization. Second-generation theories supply a positive analysis of centralization, showing why efficient centralization is often unachievable in practice. These theories abandon the assumption of a benevolent decision maker, acknowledging that politicians might not always act in the best interests of their constituency, instead using their position to benefit themselves personally. This chapter aims to build on those models through the addition of theoretical contributions from psychology.

Behavioural economics suggests that individual decisions are distorted by cognitive biases. As Benabou & Tirole (2016) point out, individuals hold beliefs to which they attach values. Often, those views are not responsive to contradicting evidence. Such beliefs can include self-perceptions, self-esteem, or beliefs about one's milieu. Such beliefs can be influenced by social or collective identity. As mentioned previously, identification with a group results in in-group favouritism. This, in turn, establishes beliefs about reciprocity and reputation within the group (Everett et al., 2015). Benabou & Tirole (2016) see identity as a set of beliefs about where belonging, say within a nation, or moral and religious values.

In order to answer the central research question of this study - what is the impact of nationalism on the creation and stability of common institutions - it is necessary to adopt a particular analytical stance. National identities, which are collective, carry with them a sense of belonging to a territorial group which shares common attitudes towards institutions. The possession of some set of attitudes defines a person and preordain their own identification with others. Identification with a group is a cognitive process in which similarity to others and the benefits from group membership are evaluated and assessed. This in turn causes the acceptance of certain policies to the exclusion of others. Evidently, it can lead to the rejection of otherwise efficient policies.

The analysis takes an interactionist approach. Its goal is to uncover what the impact of nationalism is on the negotiation of common policies. A broad definition of nationalism is latent: here, nationalism is a set of views about the cultural, geographical, and psychological attributes that distinguish one group from another. The analytical setup entails interactions between representative citizens from different countries, with groups forming in line with the mechanisms described in the preceding chapter.

7.2 A model of centralization with collective identities

The following section argues that the emergence and development of institutions depends on the identification of individual actors with a group, as well as the benefits of membership. It has been shown theoretically and empirically that this assertion holds for redistributive institutions (Shayo, 2009).[2] Based on the model introduced in chapter 5, it will be shown how identity may influence the centralization of public goods and policies among different countries. In this framework, national identity is understood as a nations awareness of themselves relating to each other as a community and perceiving themselves as being bound together by enduring characteristics. The latter has been found by Alesina et al. (2017) to inhibit the adoption of efficient policies in the EU. In an interactionist model, such as the one developed here, identity results from group processes, where acceptance or rejection of an institution is attributed to the fit between an individual and a group. Hence, norms and identities emerge from interactions and relations within the group. This is an accurate description of the model in Shayo (2009), where identification with a group depends on the status of the group and

[2]For an overview of this literature, see Costa-Font & Cowell (2015b).

the perceived difference between individuals and groups. Given the own social identity and the identity of the other individuals, identification with one group occurs and then determines behaviour. The model below will follow a similar approach.

7.2.1 Model setup

In chapter 5, common institutions were conceptualised as unions which would adopt one-dimensional policies. Representatives had identical utility functions, which differed solely in preferences over the public good, depicted by the parameter α_i.

The representatives had information about the preferences of the representatives of the other countries over the two alternative proposals. This allowed them to assess the voting behaviour of the other countries and in turn the potential surplus they would receive in case they formed a union with these countries, that is, from providing the public good in line with the majority's preferred proposal. The following section will extend this model by incorporating insights from in chapter 6. As in chapter 5, there is again a fixed number of countries N, voting over centralization within the union of countries. This is similar to the setup in chapter 5. Furthermore, a voting decision will be analysed which only involves two proposals for the provision of the public goods. One proposal involves relatively high spending, α_H and the other is relatively cheap, α_L. Centralization does not depend only on material benefits, but also on identity. In addition to the preferences of the other representatives, the country representatives are informed about the identities of the other representatives. They then vote over the provision of the public good, forming coalitions accordingly.

For identification to occur, prospective members must be capable of differentiating themselves from other groups. To illustrate the identification mechanism, initial groups (or categories) are defined among which negotiations take place. Representatives have information about each other's preferences and background. When exchanging information in the first stage of negotiations, they are likely to categorize their interlocutors. Preference for a certain proposal is seen as a marker, based on which representatives categorize themselves. Chapter 4 identified several groups of countries - the Coordinated Market Economies (CMEs), the Mixed Market Economies (MMEs) or the Liberal Market Economies (LMEs). It was said in chapter 5 that citizens from these countries are likely to have similar preferences over at least some institutions. Based on this intuition, it seems natural to assume that country representatives categorize themselves into different groups according to their material preference over the public good, which was previously described by the parameter α. It stands to reason that CME countries are likely to favour the same proposal. Given the similarities in their labour markets, they appear to prefer similar institutional configurations and to have similar perceptions about the costs of implementing specific policies. This shared interest may result in a collective identity, a social movement of the kind discussed by Brewer (2001). Therefore, the initial categories considered here are formed according to the distance between a representative's own preferences α_i, and α_H or α_L, in other words the closer α_i to either of the proposals, the stronger the preference for the corresponding proposal.

In section 5.2 the parameter α describes preferences over the public goods. In what follows, the utility describing preferences over outcomes also includes a behavioural component, that is, identity utility. The group forming around the proposal for the larger public good will be denoted by H, comprising representatives with stronger preferences, and the group with weaker preferences will be denoted by L. A representative in L will be denoted by l and a representative in H will be denoted by h. Given the spillover, which increases with the number of countries, the surplus from centralization to a union member also increases with the number of countries. Therefore, countries might have joined a union providing a public good α_H although their preferences were closer to α_L, if the number of countries is high enough. For this reason, the union of countries is likely to include representatives of both types h and l. This group is to be denoted by F.

In chapter 5, preferences over the public good were given by $\pi_i(x_i, g_i) = y_i - g_i + 2\alpha_i\sqrt{(g_i(1+\beta(N-1)))}$. Here, this is one component of the utility function. As discussed in chapter 5, a union is only stable if there is no country outside the union which would be better off inside and if there is no country inside the union which would be better off outside. Hence, the 'initial' groups, built around the two proposals α_H and α_L, cannot form stable groups. The benefits from the public good increase with the number of countries among which the public good is provided. If the preferences of other countries are known, the number of countries in favor of a proposal can be inferred, and with it the majority's preferred proposal. Therefore, if one focuses on the surplus from centralization, countries would always form a group of countries, depicted by F. These groups would include a majority of countries in favour of one specific proposal. This might, however, be different when identity utility is considered in the analysis. That concept will be defined in the next section.

7.2.2 Identity utility

In chapter 5, preferences over the public good were affected by the costs and benefits of new policies. The costs depend, among others, on existing institutions which can hamper the creation of new policies to varying extents. Existing institutions also include norms shaping behaviour. These norms depend on values as discussed in chapter 4. The benefits of new institutions and policies do not depend solely on the preferences (taste) over policies. There is also a material component, such as the direct benefits from improving market outcomes.

According to chapter 6, there is another way in which values or norms can impact preferences. In social interaction, individuals compare themselves to other individuals and to different groups. They thereby categorize themselves and others into different groups, based on the comparison of attributes. Such attributes can be physical, such as gender. They can also relate to values and beliefs. In the context of nationalism, the primary attributes are nationality and citizenship. The construction of a national identity can be based on a civic (political) or an ethnic conception. The ethnic conception is based on ancestry and relies on religion, language or common traditions. The civic conception on the other hand, is based on legal status, shared laws and institutions. It goes in hand with a political identity - a sense of belonging to a political group.

According to Turner et al. (1994), group saliency determines individual identification. Group saliency increases with the homogeneity of the group, that is, differences within a category are smaller than differences between categories. In order to measure the distance, one can use 'distance in conceptual space'.[3] Each individual can be characterized by a set of attributes $q_i = q_i^1, q_i^2, q_i^3, ..., q_i^V$. These attributes can represent attitudes and beliefs, among others. In the context depicted by the model, representatives from different countries negotiate and vote over a policy. National identification should play more than a minor role, as this attribute is different for all representatives. Differences related to ethnicity, such as languages or ancestry, should therefore be less salient or important in this context. However, the population of one country might value certain norms more than the populations of other countries.

Sears and Levy (2003) find that internalization of political attitudes takes place in early childhood. This is further confirmed by Hooghe (2005), who found that identification with the EU by an EU official is determined by prior socialization at the national level.

[3]See Shayo (2009) and Nosofsky (1986).

It thus stands to reason that citizens of the same country hold at least some values which are shared by their fellow citizens and that these values represent the relevant attributes. Chapter 4 demonstrated that different countries have different economic and welfare systems, which reflect different values and norms. For example, in CMEs, collective bargaining plays an important role. Its structure is different from that found in is LMEs. Therefore, such country-specific differences are more likely to be relevant when representatives negotiate related policies. Schimmelfennig (2016) shows that attitudes to the the rule of law or liberalism, are likely to impact acceptance of new EU Member States by existing members.

Identification starts with the process of group categorization, according to which individuals build group prototypes, that is, representations of a typical member of that group. Following Shayo (2009), the prototype of group can then be defined by J: $q_J = \frac{1}{|J|}\sum_{i \in J} q_i$, where $J = \{L, H, F\}$. The perceived distance of each country representative is then given by:

$$d_{iJ} = \sum_{v=1}^{V} w_v |q_i^v - q_J^v| \tag{7.1}$$

Under this definition, perceptions of distance are influenced by the individual attributes and by the attention weights, w_v ascribed to each attributed. These depend on the saliency of the respective identities. Different features of national identities may be salient in different situations[4]. This is captured by the factor w_v. Saliency of identity issues increases, if the differences between national identities are high, that is, saliency increases with increasing d_{iJ}. Taken together, the utility over outcomes does not depend

[4]This is similar to the observation made by Shayo (2009), who points out that perceived differences might be altered by changing the saliency of specific attributes.

on preferences alone, but on the 'choice' of identities as well. The latter depends on benefits of and the disutility from perceived differences. The utility over centralization of public goods is given by:

$$u_i(x_i, g_i) = \pi_i - \gamma d_{iJ} \tag{7.2}$$

In addition to the perceived distance to a group, individuals derive self-esteem from identifying with a group, which tends to increase with increasing group status. Thus, apart from the perceived distance, the status of each group influences individual identification decisions. As Shayo (2009) points out, social identity theory suggests that groups are compared along valued dimensions, given here material payoffs. Therefore, it is assumed that the higher the status of a group, the higher the surplus derived from centralization within that group. National identities re denoted by z_i. As mentioned above, the national identities are defined in terms of attributes, which reflect the content of identities. Above, the equilibrium union was defined by applying the definition of a coalition-proof equilibrium proposed by Bernheim et al. (1987). The definition given in chapter 5 is adapted as follows:[5]

Definition 2. *A union of countries is said to be stable if there is no country inside the union which would be better off outside the union and if there is no country outside the union which would be better off inside the union, given those countries' preferences and their identities.*

The decision of whether to vote for a certain provision depends on preferences and national identities. More ore precisely, voting decisions depend on whether an individual

[5] The formal definition given in appendix of chapter 5 is refined in appendix C.1 to include national identities

identifies with the respective union. For given national identities z_i and a given distribution of α_i, each country representative i inside the union is better off being a member of the union of countries. Furthermore, there is no coalition of countries outside the union, which would make all the union members better off if they join the union. In addition to the preferences over the public good, this also depends on whether a representative identifies with the other representatives. A country representative is said to identify with other representatives within a specific group if:

Definition 3. *Agent i is said to identify with group J if his utility over outcome decreases in d_{iJ} and increases with the status of the group.*[6]

7.2.3 Identities and public good provision

Unlike in the baseline model presented in chapter 5, representatives compare not only preferences but also identities prior to voting. As long as the benefits from joining F for a representative in H would be positive, there is an incentive to join, especially given that the benefits increases with increasing number of members. In this context, the status of the groups is considered the payoff due to 'membership' of one group , compared to the payoff gained through membership of another group.[7] The likelihood of identification with F increases if the surplus from membership in F is higher than the surplus from membership in H. For a representative from group H, this would hold if the benefits from centralization within F are larger than those from centralization within H.[8] In addition, the perceived distance between an individual h and other individuals in F, $d_{h,F}$ should be smaller than the distance between h and others in H, i.e. $d_{h,H}$. Taking the two conditions together, the likelihood of identification increases if it is true that:

[6] This definition follows Shayo (2009).
[7] Which is similar as in Shayo (2009).
[8] Assuming that both are larger than the benefits from local provision $\pi_h(g^d)$.

$$u_h(g_F^c) - u_h(g^d) > u_h(g_H^c) - u_h(g^d) > 0 \tag{7.3}$$

where $u_h(g^d) = \pi_h(g^d)$ is simply the material benefit - perceived difference to the own country is 0. In other words, the perceived distance to agents having the same national identity is zero. Therefore $u_h(g_F^c) - u_h(g^d)$ can be rewritten as $\pi_h(g_F^c) - \pi_h(g^d) - d_{hF}$.[9]

Following chapter 5, the term $\pi_h(g_F^c) - \pi_h(g^d)$ can be defined as surplus Δ from centralization within F. Taken together, equation 7.3 can be rewritten in terms of surpluses which are defined in Appendix C.1, similarly to chapter 5 above, i.e:

$$\begin{aligned} &\Delta_h^F - d_{hF} > \Delta_h^H - d_{hH} \\ &\Delta_h^F - \Delta_h^H > d_{hF} - d_{hH} \end{aligned} \tag{7.4}$$

According to 7.4, a representative makes two comparisons - (s)he assesses perceived similarities and the respective benefits of membership for each representative and for her- or himself. If the condition given by equation 7.3 holds, then a representative from a country H identifies with F. Equation 7.4 captures the evaluation of similarities to a group, as well as the process of self-enhancement, that is, that individuals strive to belong to higher-group status (Wichardt, 2008; Shayo, 2009). One can see that identification depends on the difference in perceived distances and on the size of the surpluses from centralization within groups. Identification with either group increases with the potential surplus from centralization. Given that the surplus increases with the number of countries which centralize, identification depends on relative group size.

[9] Similarly for the left-hand side, such that the terms $u_h(g^d)$ cancel each other out.

At the same time, perceived distance to each group matters. If the perceived distances are large, a representative of type h does not identify with other representatives who have similar material preferences, but rather with those from the other group. This can then result in inefficient centralization. For a given set of proposals, identities and preferences, the following proposition can be inferred:

Proposition 5. *In an identity equilibrium, centralization can be inefficient for a country.*

Representatives might vote for a proposal which results in a lower surplus as compared to a situation where identities play no role. Efficient centralization refers to the maximization of the surplus from common policies. Given that the formation of a union does not depend only on the preferences of representatives, but also on their identities, there are several possibilities for the formation of a union, as formally shown in appendix C.4. If the saliency of national identities is relatively low, identities play no role. Hence, attributes by which the national identities are defined are in accord with one another. For example, country representatives all invoke the importance of a social market economy or the rule of law. Identities playing no role can also mean that benefits from centralization are high. In this case, national identities play only a subordinate role, as the material payoff will compensate for potential losses in identity utility. If the benefits from centralization within either group are close to one another, then perceived similarities matter. The status of the group depends on the heterogeneity of attitudes in each country. If perceived similarities are low, the status of the group decreases. Given a lower surplus, joining this union of countries is less efficient. Considering the centralization condition given by equation 7.3, the utility from centralization has to be higher than the utility from decentralized provision of the good. This is the case if perceived differences are low or if the surplus from centralization in either group is high. The latter condition obtains if spill-overs are high or if material preferences are relatively similar. However, if some of these conditions are not fulfilled, no centralization will occur. This leads to the following proposition:

Proposition 6. *If the saliency of identities is high and if the material benefits from centralization are low, then no centralization will occur.*

From equation 7.4 it can be inferred that if identities are similar, then the standard results explained in chapter 5 hold. This can be due to a low saliency of national identities, say because they are not very different, or or due to little attention being paid to substantial differences.

Proposition 7. *If the saliency of identities is relatively modest, then the outcome will depend solely on material benefits.*

If the perceived differences to H as well as to F are low, only relative surpluses play an important role. These are dependent on the distribution of α_i . Those representatives whose preferences are closer to α_L than to α_H would vote for α_L . Hence F will again be composed of countries with contingent preferences and the public good will correspond to the majority's preference. According to equation C.11, proposition 6 also holds if spillovers are high. In that case, identity only plays a subordinate role. Representatives will vote for the proposal which maximizes benefits. Given that identity plays only a minor role, the union formation will follow the patterns highlighted in chapter 5 and the union will thus be stable.

Proposition 8. *If economic benefits from centralization are high, then differences in identity will not have any influence on centralization.*

The benefits in question depend on the spillover, that is efficiency gains, and on the number of countries within the union. For this reason, the number of countries within a group in favour of a certain policy will also influence identification.

The applied equilibrium concept should be considered as a refinement on previous centralization models. The concept also has implication for the self-enforceability of unions. If countries vote not only for their preferences, but also for their identities, then identities must overlap for unions to be stable. Alternatively, surpluses must be high in order to compensate for losses of identity utility. As proposition 8 suggests, identity plays no role if the spill-overs from centralization are large. Proposition 6 suggests if identities are not salient, then identity considerations also play no role. From this, the following proposition follows:

Proposition 9. *If the efficiency gains from centralization are high and (or) if saliency of identity is low, then unions will be self-enforcing.*

For stable centralization to occur, the potential benefits from centralization have to be high, as in the case where identity is assumed to play no role. Through interaction within the group, the representatives might face a reduction in (identity) utility, which is due to high perceived differences. It has been pointed out above that identification is context-dependent. This means that attention weights w are attached to the attributes on which perceived distances are assessed, which change depending on the context. In some cases, common feature of nationalities become salient, which leads to a decrease in $d_{i,J}$. The respective weights can also be influenced exogenously, for example by threats.

7.3 From one generation to the next - insights from the extended model

Similarly to chapter 5, the above section modelled the jurisdiction size of a supranational authority by analogy to the centralised provision of a public good. Insights from social identity theory were integrated into a model of centralization, which describes regional or political integration. According to the model presented in chapter 5, integration takes place within a group of countries that have similar preferences over the public good in question. Accordingly, a union of countries would be composed of countries with contingent preferences. Centralization is therefore efficient. Above, the saliency of identities was used to describe strong identities, modelled as the consequence of strongly differing attributes, that is, national norms or values. When aspects of identities differ strongly, identification with a group of countries becomes less likely and centralization may not be achieved. Identification with groups of countries depends on the specific policy being negotiated, payoffs as well as shared views and norms.

The behavioural assumption in the literature is that politicians are self-interested individuals, caring solely about material gains and reelection prospects. The model developed here extends normative centralization theories. However, the discussion throughout this study has shown that in the EU context, the explanatory power of these second generation theories is sometimes limited. Values shared by a nation, together with the goal to defend these and the interest of the national population - nationalism - are often accounted for poorly, and usually not at all. The review provided in chapter 6 found that an obvious way to remedy this deficiency in our theoretical understanding of the problem is to include nationalism in a model of centralization. Nationalism, accordingly, was modelled as a form of identity with territorial reference. This allowed to include the impact of traits specific to national culture. Given the analysis of previous chapters and the review of chapter 6, the model assumed that centralization does not depend solely on material preferences, but on values and norms shared within a country over which national identities are defined. Differences in identities influence economic outcomes, as they reduce the likelihood of identification with a group of countries and thereby the likelihood of cooperation. The model suggests that both preferences and identity need to match for a union to become stable. If identities do not fit, the resulting union of countries can be unstable, if the benefits from centralization are not high enough. Furthermore, as proposition 6 shows, the identities of individuals might prevent otherwise efficient centralization. Thus, identities may impose an additional cost, on decision-makers and voters, or more precisely a reduction of utility. In this manner, they may foreclose efficient centralization.

An interactionist approach was adopted to analyse the effects of identification on centralization. This permits comparisons with the existing models, which were reviewed in chapter 5. In those, a citizen candidate would select a policy together with representatives from other countries. Chapter 6 argued that national identity is stronger than supranational identity. Above, this entity was represented by groups among which centralization could potentially happen: H, L, and F. In chapter 5 it was pointed out that a stable union is composed of countries with similar preferences. The analysis of the previous section did not refute this finding. However, the interaction across and between different groups of countries might lead to a disutility due to a lack of perceived similarities. This lowers the potential to identify with the respective group and might increase the likelihood of breakdown or inefficient centralization, that is, agreements that do not maximize the benefits from centralization. According to proposition 9, the saliency of identity impacts the self-enforceability of institutions. The saliency of national identity depends on national attributes. A common threat may reduce perceived identities and thus increase the likelihood of common identification. Furthermore, as the surplus from a common policy increases, the saliency of national identities diminishes.

National identities are constructed along civic and ethnic dimensions. Some authors see national identities as being based on a legal and political community which shares a common civic culture and is based on a common (historic) territory (Smith, 1991). A national identity can be defined as a civic identity, the binding factor being the group norms that govern individuals. National identity can also be defined according to an ethnic conception, the main binding factor being common ancestry (Fligstein et al., 2012). When political decision makers negotiate supranational policies, attention w is likely to be drawn on attributes such as political and legal norms and frameworks. The previous chapters have focused on labour market reforms. As it was said in chapter 4, national labour markets differ from one another in the norms that govern markets. For example, different collective-bargaining norms prevail in different countries. This means that countries from the different groups identified in chapter 4, that is LMEs, MMEs or CMEs are more likely to identify with members of the same group than with members of other groups. Kaeding and Selck (2005), for example, find a North- South divide with regard to voting coalitions in the Council of Ministers. Kaeding and Selck argue that shared identities are at the root of agents' interests and are endogenous to the interaction within institutions. This supports the view that countries which adopt similar brands of capitalism are likely to identify with one another, given that this taxonomy also partly isolates North-South cultural patterns. Therefore, it is plausible to assume that in negotiations about wage-bargaining institutions, norms and institutions serve as grounds for inter-group comparisons. Based on these comparisons, representatives assess their material and identity utility from membership in different groups. This, in turn, determines voting behaviour. Right politicians presumably put more emphasis on the ethnic dimensions of identity. Assuming that citizens' preferences can be represented by the utility function given by equation 7.2, this will lead to an increase in perceived distances $d_{i,J}$ in the EU political arena. If these become too high, it might prohibit common policies as suggested by proposition 7.

The model shows that centralization could take place within different groups of countries and that some countries may be left outside. In the EU, if proposals are accepted by a majority, they are then applied to countries who voted against them. On the other hand, if proposals are accepted only by a sub-group of countries which does not constitute a majority, then the proposal will not be accepted. However, countries are likely to form coalitions. As in the baseline model in chapter 5, the model in this chapter was based on the citizen candidate approach. Accordingly, individual representatives compared groups and assessed centralization to make identification decisions. This, in turn entails, centralization between the group of countries among which identification takes place.

Research on European integration suggests that European integration is an elite-driven project (Risse, 2015). The expansion of EU governance has increased the saliency of identity (Fligstein et al., 2012). For some, this development might appear as a threat to national identity and sovereignty. However, European integration has increased interaction between people with different national backgrounds. Those involved more deeply in such interaction might perceive themselves as more European than others (Fligstein et al., 2012). The extent to which national identities are inclusive or exclusive is decisive (Hooghe & Marks, 2004). Paradoxically, national identity contributes to support for the EU and also acts to undermine it. One potential explanation is that public opinion is driven by national elites. The more negative the elite's attitude to integration, the stronger the effect of exclusive identities. Integration reversed the process of 'national boundary construction' and it appears that it ended an era of conflict within Europe.[10] The issues raised by negotiations between European elites have spilled over into the public sphere (Hooghe & Marks, 2009). Given that politicians participate in identity construction, the model would suggest that the citizen candidate takes his or her identification back to his or her country, thereby strengthening or weakening the identification of its citizens with other ountries.

Proposition 8 and 7 show that the saliency of identities can determine the success of a new policy. The higher the benefits from a common policy, the lower the saliency of identity and the more likely it becomes that efficient integration will be achieved. This

[10] Hooghe & Marks (2009), p.5.

is confirmed by the literature on EU integration, which shows that economic factors influence support for EU integration strongly (Hooghe & Marks, 2004). The countries that receive higher fiscal transfers tend to be more supportive of EU integration.[11] Additionally, Hooghe & Marks, 2004 find stronger support for EU integration in countries whose market institutions are less likely to be challenged by further integration. Taken together, this suggests that support for EU integration is guided by cost-benefit considerations on the one hand, and 'threat' to national identities on the other. Support appears more likely if the benefits from integration are relatively large and if the resultant upheaval is limited.

Proposition 9 further shows that identity impacts the enforcement of common policies. This is confirmed by Bayram (2017), who analyses whether politicians' identification with the EU strengthens their willingness to comply with EU law. Based on interview data with national German parliamentarians, she suggests that stronger identification with the EU is indicative of greater compliance with EU law. When EU law conflicts with German interests, those who identify with the EU strongly are more willing to support EU law than those who identify with the EU weakly, or not at all. Overall, compliance costs reduce support for compliance with EU law. It appears that compliance costs affect parliamentarians differently, depending on the degree of identification. Medium identifiers are more likely to maintain compliance if costs are low, but compliance decreases with increasing costs. If compliance costs are very high, medium identifiers reject compliance, similarly to low identifiers (Bayram, 2017). From this, Bayram concludes that cost sensitivity depends on individual politicians' degree of identification with the EU. This result is in line with the analysis presented here, which shows that the benefits from a policy may reduce identity frictions and that identity frictions may

[11] As Hooghe & Marks mention here, four countries, namely Spain, Greece, Portugal and Ireland, receive the bulk of EU cohesion funds, and the citizens of those countries seem to be generally in favour of EU integration.

reduce the importance of tangible benefits.

The political science literature confirms the findings of the extended model. The analysis in this chapter permits an extension of the discussion in chapter 5 to the interplay between nationalism, institutions, and institutional stability. The model and its conclusions rest on a number of assumptions. Citizens and their representatives acquire political values and institutions in early life, and this forms a part of their national identity. Accordingly, education can attenuate the inefficient effects of national identity in EU decision making. By teaching a more inclusive understanding of EU and national policies, future generations' national identities could become more compatible with one another. In addition, national interests play different roles in different political bodies. Accordingly, voting and coalition formation within the EP was found to be less dominated by national interests than by transnational party ideology (Hix & Noury, 2009; Kreppel & Tsebelis, 1999). This suggests that, in the EP, national identities play a subordinated role and are therefore less likely to lead to an inefficient outcome. Therefore, more political weight should be allocated to the EP, and less to the European Council.

7.4 The implications of identity for the EU policies

'We want our money back!'. This statement was used in the early 1980's by Margaret Thatcher during the negotiations over a rebate for UK contributions to the EU budget. More recently it was used by national ministers, such Xavier Bettel or Bruno Le Maire[12] in the framework of the Brexit negotiations. Back then, the 'we' in this statement comprised one single country. Lately, it has begun to stand for all the remaining EU countries. This exemplifies an important insight from social psychology, namely

[12] See Reuters (2017) or Cowburn (2017).

that groups always define themselves in relation to others. The stronger the difference between groups, the more pronounced the collective identity of one's own group. The analysis in this chapter revealed that identity impacts both the creation of new legislation and its implementation.[13]

The following sections discusses how the formal mechanisms described above may unfold in practice. The theoretical predictions indicate that cognitive aspects may distort the rational assessment of policies and lead to inefficient outcomes. Using the examples introduced in chapter 5, the following section discusses the potential impact of social psychology on common policy.

7.4.1 Policy coordination and the role of social policy

The model showed that there is a trade-off beyond efficiency and preference heterogeneity, or between centralization gains and the maintenance of national values. Differences in values may cause changes in popular perceptions of alternatives. Considering whether a representative citizen would accept common policies from centralization then depends not only on potential benefits, but also on whether views and values related to that specific policy are aligned among different countries.

Chapter 4 posited that labour market institutions differ across Member States. For example, in some Member States, such as Germany, social partners are frequently involved in policy making. In other countries, social partners play only a subordinate role.[14] The European Social Model is characterized, among others, by collective bar-

[13]Which seems further confirmed by empirical literature (Kaeding & Selck, 2005; Schimmelfennig, 2016).

[14]Romania, for example, received a country-specific recommendation to improve the functioning of social dialogue for several years in a row.

gaining. However, at the national level, collective bargaining takes several forms. The established collective bargaining systems are the result of historical developments and municipal preferences over institutions. As discussed in chapter 4, social dialogue and collective bargaining take different forms and have varying degrees of importance. Especially in the Nordic countries, many issues are 'regulated' through collective bargaining. Health and safety at work, working time, as well as wages are the focus of social partners. In the LME, collective bargaining is of less importance. Thus, social dialogue and collective bargaining have a different degree of importance and a different value in different countries. Social dialogue is a shared value among workers and employers and its nation-specific saliency might reflect domestic preferences over dispute resolution.

In the framework of policy coordination, chapter 5 argued that recommendations in the framework of European policy coordination exercises need to be self-enforcing. Since at least the new start of social dialogue, an initiative by the European Commission, the European Parliament and the Council of the European Union, the European Commission has aimed to grant a more prominent role to social dialogue and collective bargaining in the European Semester.[15] The recommendations that each Semester yields often relate to strengthening the role of social partners at the national level and to collective bargaining. Considering public choice theory, chapter 5 showed that such recommendations, in order to be successful, need to be self-enforcing. In other words, they need to have benefits to individual countries.

Within the EU, economic stability in some countries has positive spillovers in others. This is due to the economic interconnectedness which the internal market has created. One of the mechanisms to achieve stability could be coordinated collective bargaining.[16]

[15]https://ec.europa.eu/social/main.jsp?catId=88&langId=de&eventsId=1028 (last accessed: 05.12.2018).

[16]See discussion in section 5.5.1.

The literature suggests that the coordinated collective bargaining can improve labour market outcomes.

The discussion in chapter 5 highlighted that the recommendation and coordination efforts need to take the national context into account. Proposition 9 suggests that when national identity is more salient, the self-enforceability of recommendations is lower. Collective bargaining and social dialogue are a tradition in many Member States (Crouch, 1993). In some countries, the strong involvement of the social partners was born out of economic necessity. In Luxembourg for instance, social partners got involved in national tripartite committees during the steel crisis in the 1970s, which nearly had disastrous impacts on the national economy (Lorig & Hirsch, 2008). Considering these deep national traditions, shared values and views are likely to be salient. The analysis of the present chapter reveals a further argument for policy differentiation. Different social models are addressed when recommendations are made about collective bargaining.

A recommendation which is the same for all countries benefits some more than it benefits others. Taken together, proposition 6 is likely to apply in this case. The theory would predict that when single recommendations are issued, identification with the EU and its policies is unlikely. This would encourage calls to reject the recommendations, mirroring actual events within the Semester. For wage coordination at the national level to be affected, the specificities of national collective bargaining must be accounted within the process. This would increase the prospects of identification with the Union and its policy. In brief, differentiated recommendations which conform with national practices are more likely to be implemented. One could see differentiated integration as an *a la carte* approach, where Member States agree on an a discussion of wage setting mechanisms within the framework of the EES or the Semester process. Furthermore, the identity considerations analysed in this chapter suggest that a differentiation of the timing of Member States' participation would be desirable. Proposition 5 and 6, lower saliency of identities reduces the likelihood of agreement of common policies. Therefore, agreement is more likely if similar countries agree to coordinate. Considering the club good characteristics of such policies, the benefits for existing and newly participating countries could grow with every successive accession. Expansion is to be expected. In short, national identity considerations strengthen the case for a multi-speed approach to policy coordination.

7.4.2 Social investments of the European Union

Chapter 5 showed that structural investment funds, as well as an EU wide unemployment policy, can be characterized as a private good. The benefits can only accrue to one single individual and it is possible to exclude others from them. The ESI funds, as well as the common unemployment policy, would have the potential to smooth economic downturns or asymmetric shocks.[17] Therefore, such EU policies can be justified from a theoretical (normative) perspective. The discussion in the preceding chapter showed that the endowment of the ESF, for example, might be too low to have a smoothing effect, especially when compared to similar national expenditure. Due to their redistributive nature, both an increase of the endowment of the ESI funds and the creation of a European unemployment insurance with substantial endowment would have to be justified by a strong positive impact on economic stability. Furthermore, such funds would necessitate solidarity between the citizens of the different Member States. Solidarity is typically stronger among individuals who hold a common identity.

The model in this chapter has shown that solidarity is induced by identification with others. Identification, in turn, depends on the potential benefits of membership in the group, as well as identitarian commonalities. The analysis in this chapter ran on the

[17] If the ESI Funds were endowed with sufficient capital.

premise that the saliency of identity depends on the policies under negotiation. A representative citizen would compare him - or herself to the other groups involved in the negotiation. Chapter 4 highlighted that the EU comprises countries with diverse economic structures and welfare systems. The UK and Ireland have low unemployment benefits, relative to the Nordic countries, Germany or the Benelux states. With regard to labour market inclusiveness, education and skills, chapter 4 showed that different groups of countries cluster around various systems of skill transmission and labour market structure. These differences reflect varied redistributive preferences - the Nordic countries are in favour of strong social protection, whereas the Anglo-Saxon unemployment system provides last-resort assistance.

Chapter 5 raised the issue of hard budget constraints and the importance of monitoring to their enforcement. These plagued the negotiations over the MFF 2021-2027. During the negotiation of the new MFF, the Commission proposed to link payments from the EU budget to respect for the rule of law.[18] Chapter 3 showed that rent-seeking could be one possible explanation for those funds' relatively poor absorption. The German government proposed to establish a link between payments within the framework of Cohesion Policy and respect for the rule of law.[19] The Commissioner for Justice is in fact working on a proposal obliging Member States to pass checks of the independence of their judiciary before receiving cohesion funding.[20] Under the Finnish presidency in 2019, this proposal will still be negotiated.[21] Poland and Romania are against the proposals by Justice Commissioner, arguing the proposals go against solidarity, which

[18] See also the epilogue for later developments of this discussion?

[19] https://www.euractiv.com/section/central-europe/news/germany-to-propose-cutting-funds-to-eu-members-that-violate-rule-of-law/(last accessed: 29.09.2019.)

[20] https://www.euractiv.com/section/future-eu/news/eu-mulls-new-link-between-budget-and-rule-of-law/ (last accessed: 29.09.2019.)

[21] https://www.euractiv.com/section/justice-home-affairs/news/finnish-presidency-commits-to-linking-rule-of-law-with-eu-funding/ (last accessed: 29.09.2019.)

is the fundamental value of the EU. In addition, the violation of the Maastricht criteria regarding public debt are also often highlighted, together with a lack of trust in the credit worthiness of some Member States. This serves to underscore the proposition that negotiations over the Multi-annual Financial Framework are impacted not only by investment preferences, but also by values.[22]

There are several dimensions of potential similarity between Member States. There are values relating to redistribution and labour market institutions. There are also norms and values relating to institutional qualities of the kinds just described. Depending on the saliency of the respective dimensions, identification with different groups could be induced. According to propositions 5 and 7, centralization can be inefficient or fail completely if national identities are salient and the potential gains from centralization relatively low. In less stylized terms, differences in values and national institutions may impact individuals' sense of belonging. This sense may be determinative of their voting behaviour. Voting behaviour changes identification with the group and with the legislation, resulting in a lower degree of solidarity towards other Member States. An EU-wide unemployment insurance, being inherently redistributive, cannot succeed unless underpinned by solidarity. Less solidarity decreases the likelihood of substantial redistribution between states. Considering the differences in the national welfare systems discussed in chapter 4, identification may obstruct the realisation of a common unemployment insurance scheme or macroeconomic stabilization schemes more generally.

Different national welfare models reflect differences in preferences over redistribution, as well differing values relating to such policies. If these differences are pronounced, propositions 5 and 7 may again apply. Accordingly, the outcome of negotiation might be that no scheme is introduced at all, or that a scheme is passed but then undercapitalised.

[22] For a discussion of later development of the budget negotiations, see chapter 9.

Evidently, the latter possibility still leaves the policy's goal, market stabilisation, unrealised, although it would be beneficial to all Member States. But chapter 4 has shown that some common preference over such schemes exist. Identification depends on the traits and attributes which are salient in such negotiations and on the benefits and costs of membership in the scheme. The discussion about the MFF negotiations has shown which values can be salient during such negotiations. In the specific case of the MMF, the institutional design of the respective instruments should take the absence of certain values or institutional qualities into account.[23] Propositions 7 and 8 highlight that if identities are not salient, then the benefits from a common policies will decide whether it will be voted for. Hence, for efficient allocation to occur, it needs to be ensured that the expected benefits from the funds are sufficiently high. Therefore, the funds need to be ear-marked and their use supervised in order to eliminate moral hazard. Considering that values related to institutional quality are likely to be salient, identification between all Member States is unlikely. Accordingly, an agreement on macroeconomic stabilization mechanisms is more probable if the potential benefits from it are sufficiently high, just as suggested by proposition 8. An essential condition to achieve this is that a strong monitoring framework is maintained. If it is ensured ex-ante that the respective funds are allocated to the purpose of stabilization, the positive externalities from spending such funds can be expected to be sufficiently high, so that net payer Member States could agree on the respective proposal. In case of macroeconomic stabilization mechanism, moral hazard could be an issue. This could be ensured by making the triggers for the payments to national authorities contingent on automatic triggers. Such a trigger is for example an increase of short-term unemployment for a certain period of time. This could be combined with the condition of fulfilment of certain obligations, e.g. proven follow-up on country specific recommendation in the framework of the EU semester.

[23] Although this might reduce allocative efficiency, as highlighted in Chapter 3.

Generally, for public and private goods, national identities could support negotiations among countries, especially when allowing for differentiated integration. If schemes can be implemented among a sub-group of EU Member States, then the results above would suggest that the implementation of a common scheme becomes more feasible. However, as noted in section 5.5.2, redistributive schemes cannot be implemented without the participation of all (or at least most) Member States. Differentiation reduces the potential benefits from the scheme for the countries – the funds would be too low and likely not reach those countries in need of funding. If, in addition to this, attributes of the decision maker differ, then, condition 7.4 is violated. The benefits might be too low to compensate for differences in views and values. For these reasons, the inclusion of identity in a model of centralization does not change the conclusion from the rational actor model.

7.4.3 Regulating the race to the bottom

The amendment to the Posted Workers Directive aimed to implement the principle that there should be equal pay for equal work at the same place.[24] Although the original Directive covered remuneration, this did not extend to bonuses and other aspects of workplace compensation packages, such as wage increases related to seniority. Van Nuffel and Afanasjeva (2017) point out that the initial proposal by the European Commission aimed to oblige the host Member State to impose the entirety of its labour legislation on remuneration to non-host-state companies, as well as collective bargaining agreements. As pointed out in chapter 5, economic theory would generally suggest that finding a political agreement for the amendment or, indeed, the passage of the original Directive is difficult. Low-wage countries would lose one of their competitive

[24]Directive (EU) 2018/957 of the European Parliament and of the Council of 28 June 2018 amending

advantages. This argument was raised by the Visegrad states, who were convinced that the new rules would undermine competitiveness in the internal market.[25] Echoing that line of reasoning, chapter 5 concluded that, from a rational choice perspective, some Member States have no reason to agree to this new legislation.

Posted workers became salient in the public debate, especially in host states. Tolerance towards competition in labour standards and rights decreased in Germany and France (Roos, 2018). Poland and Hungary opposed the Directive and voted against it in the Council, whereas Romania and Czechia were in favour.[26] The costs and benefits for different countries differ, since some countries are poised to lose their competitive advantage in the internal market. Poland expected to incur huge losses in terms of employment, which explained their opposition towards the new regulation.[27] Spain and Slovenia post more workers than Hungry and, to a lesser extent, Czechia.[28] Nonetheless, after initial resistance, Spain accepted the amendments, whereas Hungary opposed it in the Council of the EU. Considering differences in (minimum) wages, the potential costs of the Directive to the different countries differ. This explains the variance in countries' willingness to accept them.

Within the Visegrad Group (Poland, Hungary, Czechia and Slovakia), there was also a divide in attitudes to the amendments. A few months before adoption of the amendments, the Slovakian Prime Minister stated that his policies were closer to the EU's core members. The core's evaluation of the rule of law in Poland and Hungary appears

[25]http://www.visegradgroup.eu/calendar/selected-events-in-2017-170203/joint-statement-of-the (last accessed: 29.09.2019).

[26]https://www.consilium.europa.eu/en/general-secretariat/corporate-policies/transparency/open-data/voting-results/?meeting=3625 (last accessed: 29.09.2019).

[27]https://www.euractiv.com/section/economy-jobs/news/macron-courts-eus-eastern-leaders-over-posted-workers-antagonises-poland/(last accessed: 29.09.2019).

[28]According to the number of portable documents issues in the reference year 2015. The document is a formal statement issued by the Member States, proving that the worker paid social security in a Member State (European Commission, 2016a).

to have also repulsed Romania and Bulgaria.[29] The European Trade Union Institute believes that the ultimate passage of the amendments can be attributed to a change in the preferences of European heads of state.[30] They argue that competition over labour costs entailed poor prospect of pay increases, especially for high-skilled workers. Low pay has therefore contributed to a brain drain, which has weakened the national labour forces and the domestic economy's ability to compete in high-added-value markets. Trade unions supported a process of convergence through increasing wages. This seems confirmed to some extent by the analysis of chapter 4. Hence, the increased significance of decent pay and protection contributed to the inclusion of pay into the Directive.

The values held dear by political actors can impact their decisions, beyond economic rationality. They can induce rapprochement between countries or groups of countries. In terms of the model above, these shared values may promote identification with specific groups, which can impact voting behaviour. Proposition 5 suggests that identitarian considerations could result in sub-optimal voting decisions. The anecdotal evidence suggests that values could have played a role for some of the decision makers involved in the Posted Workers Directive amendment process. In all the Member States, there is some form of social dialogue. The impact of social dialogue on policy varies between countries. Workers' rights are valued in all Member States, a fundamental component of the European Social Model, shared within the EU. This commonality, reflected in the trade-off depicted by equation 7.4, can detract from economic considerations, thus resulting in the adoption of otherwise undesired policies.

This serves to show that identity and its foundational values can solve collective action

[29] https://euobserver.com/political/139771 (last accessed: 29.09.2019).

[30] https://www.etui.org/Publications2/Policy-Briefs/European-Economic-Employment-and-Social-Policy/The-posting-of-workers-saga-a-potted-version-of-the-challenges-engulfing-social-Europe (last accessed: 29.09.2019).

problems. In chapter 3, the race to the bottom was described as a common pool resource problem. Although the benefits from a common policy might not be immediate or uniform in every country, common values can have a cohesive effect. Common values thus impact preferences and make voting behaviour conditional on social context. The analysis showed that common values can overcome collective action problems.

Even if the direct benefits from some policy are negligible or negative, gains in proximity to a specific group may justify acceptance of their costs. This could also explain the overprovision of social and employment policies, relative to the theoretical optima (Alesina et al., 2005a). With or without differentiated integration, a similar conclusion as in the previous section 7.4.2 applies. As discussed in chapter, if rules, which are in place to avoid a race to the botton, are not applied to all Member States in a similar vein, then there is potential for free-riding - the race to the bottom recurs. As a result, the benefits from participation decrease. Lower benefits may be exceeded by costs, so that 7.4 is no longer satisfied. Therefore, a differentiated approach to this policy should not be taken.

The Posted Workers Directive shows a deviation from the rational actor model. This section has shown that one explanation can be that common values gained importance within the EU and that it is indeed on its way to a Union of Values.

7.5 Conclusions

Existing economic theories do not account for the non-pecuniary motivations of populations and their representatives in the creation of common policies. This chapter sought to expand those models and to refine them. Economic theories on the centralization of policies oftentimes start from the premise that a decision-maker aims to be re-elected and therefore pursues policies which bring benefits for their electorate. Therefore, the main incentive for politicians in these models is to be re-elected by proposing and implementing policies which entail material benefits for their voters. This chapter has shown that this might only be part of the incentives for a politician. Values have been shown to impact decisions and therefore this chapter has developed a theoretical approach to include such values in a theory of centralization. In the framework of common policies, the analysis started from the premise that common beliefs about specific policies bound individuals together. In line with economic theory, the analysis was based on the premise that political attitudes are formed during early childhood and beliefs and views about institutions are formed early one's life. Such institutions and political attitudes are differing across countries and these differences are some aspects according to which individuals differ from one another. Differences, according to which individuals can categorize each other are at the heart of social psychology, which has been applied to EU integration in international relations theories. Categorization affects the perception of the surrounding groups and senses of belonging. This affects the willingness of politicians to agree on a common (EU) approach to policy making. In order to apply this approach to the economic theories related to EU integration, this study relied on identity economics.

Identity economics draws on social psychology and related theories. It provides a theoretical framework which can be used to explain how nationalism and national identity alter traditional theories of centralization. Voters and politicians identify with voters and politicians from other Member States based on group-specific traits and on the potential gains which could result from forming a common group. According to the literature on national identity and nationalism, there are two major dimensions along which national identities are defined: an ethnical and a civic dimension. The former is dependent on ancestry, highlighting features of nationality acquired through birth, whereas the former relates to the formal and informal norms that bind individuals within a national territory together. In the political context, or the political arena where new legislation and policies are discussed, it was assumed that the ethnic dimension of national identities are less salient, as these are different for all the politicians involved. These differ for all the policymakers from different national backgrounds. Rather, those dimensions which some policymakers have in common and differentiate them from others will be relevant here.

When taking these factors into account, the analysis describes centralization as the result of a process of identification in which preferences over material outcomes and identities need to match. The analysis shows that non-material benefits may constitute incentives to politicians to make certain decisions. Identification with a group, based on a belief in common principles and common values, often exerts a controlling influence. Common beliefs and values create a shared sense of identity and solidarity. Such sentiments make decision makers more likely to depart from their preferred policy and to adopt one which results in lower benefits. Therefore, identity can provide additional incentives to join common policies. The chapter discussed an important trade-off between the gains from centralization and differing national values. Its existence strengthens the case for more diversified policies and differentiated integration. Since an agreement on common policies is not only dependent on material benefits but also on identitarian values, common policies might encounter obstacles beyond the purely economic. Some legislation can only succeed if all Member States accept it, as is the case when there are free-rider problems.

This chapter further discussed the categories of policy introduced in chapter 3 - club goods, private goods and common pool resources. Excludability and rivalry are important aspects of centralisation, as they limit (or facilitate) strategic political behaviour. Club goods, illustrated by policy coordination, were shown to be less prone to strategic behaviour, due to excludability. However, whether or not a country is willing to join the club depends on the potential benefits from accession. National identity can create additional costs, and thus a need for even higher benefits. This was illustrated by the coordination labour market and social policies and the recommendations made in the framework of the European Semester. The recommendations need to benefit the respective Member States to be self-enforcing. They need to be even higher when national identities are accounted for, which is particularly salient in the context of labour and social policy.

Private goods also foreclose strategic behaviour by politicians. Chapter 5 showed that redistributive polices can be acceptable if effective monitoring is in place. This showed theoretically the importance of values too, at least in a supranational context. In the decision to allocate funds, solidarity is needed, which means that the countries involved need to identify with one another. Also, in this case, (national) identity can provide additional (dis-) incentives to agree to specific redistribution. Accordingly, basic common values can be decisive for the outcome of budgetary negotiations. Identity can also carry costs, especially when the benefits from the private good must compensate for loss of utility. Otherwise, identity can obstruct the passage of common policies.

Common shared values can facilitate the creation of common policies by reducing incentives for strategic behaviour. By identifying with other countries, politicians gain utility. Identification may induce agreement to a policy whose economic benefits for the country cannot be taken for granted. Some Member States agreed to amendments to the Posted Workers Directive that could not have benefited them.[31] The discussion attributed this phenomenon to the alignment of values between countries in the Union. Alignment induces identification, which yields higher identity utility and approval of the legislation. The example presented in section 7.4.3 showed that values are important to Member States.

National identities can impact all policies. Generally, the analysis would suggest that if outsiders can be excluded and the benefits from the policy do not depend on large-scale participation, then differentiated integration should be encouraged over identitarian concerns. Costs and benefits aside, political decisions can also be impacted by cognitive aspects. These include inter-group comparisons and the weighing similarities of between the different parties. Section 7.3 showed that the potential inefficiencies from identification can be reduced if saliency of identity is reduced. National political goals and views tend to be less salient in the EP than in the Council. A stronger mandate to the EP could eliminate inefficiencies. In the long run, teaching common understanding of political values and institutions could address political inefficiencies.

Inter-group comparisons impact common understandings. Such comparisons are more straightforward in smaller groups. Smaller groups thus reach consensus more quickly. In the light of national identity, differentiation would be desirable. The investigation of specific policies in section 7.4 confirmed the findings of chapter 5. The latter found no strong case for differentiated integration in cohesion policy and macroeconomic stabilization schemes. Differentiation could lead to complications in the financing of the schemes. This, in turn, would reduce the likelihood of identification between Member

[31] Directive (EU) 2018/957 of the European Parliament and of the Council of 28 June 2018 amending

States. In other words, lower benefits reduce the prospects of the respective scheme. Similar conclusions can be drawn about the race to the bottom. If some Member States adopt a Regulation or Directive to eliminate competition over labour standards, they could free ride on the other Member States. This would reduce the benefits of the legislation, eventually making it unfeasible. This analysis suggests that policies should be concluded uniformly across all the Member States. Policy coordination, conversely, can be implemented better if there is differentiation, in terms of both time and subject matter. Identity is an additional dimension of Member State compatibility. Consensus is easier within a core group of countries. After initial cooperation, the benefits become obvious and more states will wish to join the coordination exercise. This is all the more likely if the approach in question is flexible.

Chapter 8

Conclusion

8.1 Overview

This study overviewed EU social and employment policies within the macro-economic framework of the EU. These policies can support macroeconomic stability. EU structural policies can increase labour market flexibility. The study drew on the public choice literature and discussed the incentives of politicians and voters. EU policies are acceptable to the national electorates and their representatives if they make them better off. The costs and benefits of common policies differ across Member States, due to different economic structures and preferences. Additionally, national identities impact policy acceptance. Previous literature largely overlooked this motif. Here, national identities were defined in relation to nationalism, a narrative of commonalities between the citizens of a nation. These commonalities, which revolve around ancestry, citizenship, values and views on institutions, impact perceptions of different kinds of foreigners. In that way, they condition the coalitions that form behind specific policy proposals. The study argued that the successful passage of a policy depends not only on costs and benefits, but also on views and values. National identities impact coalitions, coalitions impact outcomes. Much of the study was taken up by the resultant need for an analytical framework that isolates the interface between identity and centralisation.

The EU is composed of diverse national economies with varied systems of industrial relations. Their co-existence under a single monetary regime has been problematic at times. The EU pursues economic goals, with internal market competition at the fore. While this study does not challenge the view competition can enhance social welfare, it showed that marketarian policies can disturb national social models. The integration of common social policies lags economic integration.

The 2008 recession highlighted the economic links between Member States. This was the subject matter of chapter 2. Economic competitiveness is distributed unevenly in the EU, which complicates the administration of the Union. It is meant to tackle common economic risks in the internal market, to provide macroeconomic stability, to increase competitiveness, and to create a level playing field between the Member States. The EU can also assume further macroeconomic responsibilities, say under EU-wide unemployment insurance. This could, in the short run, revive demand after an economic downturn. In the long run, structural reforms are necessary. Chapter 2 discussed ways to increase labour-market flexibility and competitiveness. Macroeconomics aside, the EU must also set minimum standards. Based on economic theory, the study has discussed what the role of the EU could be to achieve this. These policy goals, taken together, shaped the rest of the exposition.

The study is about identity. Anyone who studies Europe seriously soon discovers that very few EU citizens identify exclusively as Europeans. It is more common to identify with one's nationality first and with the EU second, if at all. Therefore, this study did not speak of an EU identity *per se*, but of identification with foreign citizens, that is, the citizens of other Member States. Identity is at its most salient when net benefits of common action are modest or when a policy excites serious normative or ideological controversy. National identities can have an adverse effect on integration. However, when the benefits from integration are high, identities are less likely to play a significant role. The analysis assumed that national identities are acquired early in life and that different policies touch on different aspects of identity. For there to be agreement on EU policies, national identities need to be mutually compatible. Common shared values and views enhance identification with other citizens and decision makers. Accordingly, citizens and their representatives are comparing not only benefits to cost, but also their understanding of the policy to the perspective of their peers. Coalition formation and voting behaviour can evidently be affected. Identification with other decision makers can eliminate strategic behaviour and help overcome collective action problems. Such problems stem from selfishness and maximizing own benefits. However, identity enhances solidarity. It can reduce greed motives.

Chapter 7 showed that identification can address the political aspects of the race to the bottom. Member States have come to advocate similar views and values, which they hold dearer than the short-term gains from exploiting strategic advantages. The analysis drew on policy coordination. To be acceptable, coordination has to be tailored to individual Member States. Identity also impacts other policy areas. For example, hard budget constraints must be built in the design of some policy tools. When the EU tries to achieve macroeconomic stability, some Member States receive benefits which are financed by others. This is rational: the transfers stabilize demand for the products and services that the net payers sell. Identity can impact this assessment, especially if funds are misapplied visibly. Fixed budget constraints ensure that funds received by states in distress are allocated according to their predetermined purpose. This reassures net payers and makes redistribution more acceptable.

The EU is based on different values and norms. The study focused on norms and views that relate to social and labour policy. Different social models exist in the EU. However, they have many essential features in common. These commonalities enhance coalition formation. That is why the EU involves itself in social and employment affairs more than what economists deem efficient. The internal market creates ever-stronger interdependencies. With more and deeper EU integration, policies to stabilize the economy and to establish a level playing field become more and more necessary.

8.2 Economics of federalism and identity

The law and economics analysis of EU policy draws on the economics of federalism. Throughout this study, the normative and positive principles of these theories were applied to EU policies. First-generation policies describe why EU policies can be better than national policies. A central or supranational government, such as the EU, is better placed to maintain macroeconomic stability because it can raise more revenue. At the same time, national governments need to have fixed budget constraints in order to ensure efficient spending. A central government is better placed to undertake redistributive policies. Different levels of governance may be used, depending on the type of the good. If the provision of a public good by one municipality benefits others, then strategic behaviour is to be expected. Because of this feature of the problem, the analysis of EU policies should cover strategy alongside efficiency.

Second-generation theories cover the strategic aspects of policy-making. If countries which do not pay can be excluded consumption of the public good is complementary, then the incentives to commit to a common policy are strong. As noted previously, there are many reasons to implement common policies. At the same time, divergent preferences can temper politicians' enthusiasm for integration. Preferences are acquired through socialization and experience of existing institutions. In this way, the viability of new policies depends on their compatibility with the old. This opens the possibility of strategic political behaviour, which can forestall efficient policy making. Strategic behaviour comes in many forms and it may have many causes. This study covered identity. Identity has not been very prominent in the literature, which is why this study proposed a third-generation theory.

National identity was defined as a territorial identity based on nationalism – a story based on ethnic and civic factors which bind people living in a territory together. Interaction with and socialisation within national institutions are at the root of national identity. Institutions are part of the civic construction of national identities; laws and policies are the basis for intergroup comparisons. Thus, institutions affect preferences through identity considerations which are distinct from the cost-benefit analysis that the mainstream literature covers.

Identity has important implications for economic theory. A union with common values can eliminate strategic considerations and the resulting collective action problems. Common values impact identification with foreigners. Identification can prompt wider acceptance of certain policies and thereby increase the benefits of common action. This highlights the importance of shared values for policy making. The economic analysis in this study corroborates this intuition. Using insights from identity economics, standard-form models were augmented with behavioural assumptions. Utility functions in centralization models are based exclusively on material costs and benefits. Here, the utility function also accounts for identity utility. Identification was modelled as having two determinants. First, individuals compare themselves to one another. They are more likely to identify with similar individuals. Secondly, the higher the status of a group, the more likely it becomes that an individual will identify with that group. In the political context, status depends on the potential benefits from membership to a group. The analysis in this study adopted an interactionist approach, whereby preferences and identities must match before integration will take place. Identity was shown to impact the formation of coalitions. For a given policy, countries, or more precisely, their representatives, assess potential coalitions through intergroup comparisons. In this comparison, different dimensions of national identity are assessed. Identity can compensate for lower benefits from a policy and therefore make centralization acceptable even if its alternatives are otherwise more beneficial.

In some cases, the analysis corroborated contemporary theories, as in the case of budget constraints. Moral hazard must be mitigated. Identity can create a cognitive cost in the process of a coalition formation - if different values are seen as important, solidarity is likely to be in short supply. Identity costs make hard budget constraints all the more necessary.

In chapter 7, the argument was made that identity can enhance centripetal effects. When states can be excluded from the benefits of a policy, a common understanding can impel Member States to form coalitions even when benefits are moderate. For some policies, benefits increase with the number of participating countries. Therefore, once some countries integrate, others are likely to follow in spite of their initial recalcitrance. Thus, attempts to organise the common provision of club goods can be aided by national identity. Similarly, in the management of common pool resources, national identity can eliminate incentives to strategic behaviour. The management of common pool resources is often blighted by collective action problems: the individually rational action is different from the social optimum. In races to the bottom, there is always an incentive to free ride on the goodwill of other Member States. However, free riding leads to losses, causing other Member States to retaliate. Eventually, regulation disintegrates. The analysis in chapter 7 suggests that gains in identity utility can compensate countries for short-term losses, and thus prompt decision makers to behave optimally. Of course, this requires a shared understanding of the importance of certain values. The analysis of the Posted Workers Directive in chapter 7 revealed a discrepancy between actual outcomes and the rational actor model. This provides some evidence for the existence of a value union beyond economic goals.

8.3 Identity and its implications for EU policy

The study reviewed some current EU policies and discussed how the EU could support Member States further. Chapter 2 demonstrated that EU policy coordination could support Member States in increasing flexibility within the labour markets. Member States have different labour markets and welfare-state regimes, which entail different structural issues. Despite differences, it is possible to discern groups of states with similar institutions. Coordinated economies like Austria, Germany and the Netherlands have mature labour market institutions, strong collective bargaining systems and relatively generous welfare states. Their economies are productive and competitive, owing to the availability of skilled labour. Mediterranean economies like Spain, Greece and Italy focus on age-related expenditure. Unemployment benefits are relatively modest and employment protection is strong. Wage bargaining coordination is limited. The analysis in chapter 4 showed that Mediterranean labour markets are less inclusive than in the coordinated economies. Unemployment tends to be high and the labour markets is often divided between workers with long-term employment contracts, good working conditions and high wages and workers on temporary contracts and low wages. The competitiveness of these economies tends to be low, with much labour unskilled. In liberal market economies, labour is valued at the market price and welfare systems are less generous, essentially offering last-resort assistance. Collective bargaining in these countries is rather weak. However, their labour market performance is comparable to that of the coordinated economies - employment rates and productivity are high, although wage growth is limited. Structural considerations of this kind impact national political agendas and the needs of citizens.

The study discussed the coordination of labour market and social policies. The Employment Strategy, in which employment and social policies are coordinated and which is integrated into the European Semester, provides room for mutual learning and the exchange of best practices. The Employment Strategy, and the related recommendations formulated within the European Semester, could contribute to better wage setting mechanisms, improved labour regulation and active labour policies. Coordination among administrators, the creation of a common review framework and the mutual review of policies benefit all participants.

This mode of coordination in the EU can be framed as a club good. Only active contributors can benefit. As chapter 3 showed, the more Member States participate in this exercise, the more beneficial this exercise. Recommendations need to be tailored to specific nations. National identity may hinder coordination, as shown in the part on wage setting. National collective bargaining systems, and more generally social dialogue systems, are values shared between Member States. However, as chapter 4 discussed, collective bargaining systems differ across Member States, as do perceptions on the proper function and organisation of social dialogue. Given these differences, national identities are likely to be salient when recommendations are issued. If national values are incompatible with the common approach, acceptance becomes unlikely. The likelihood that coordination will be beneficial diminishes altogether.

Provided a larger budget, the current Cohesion Policy can contribute to macroeconomic stability. A skilled labour force is an important component of competitiveness, especially in times of constant technological change. Therefore, investment into training and education, which presently fall in the purview of the European Social Fund, can support national economies. They may also become part of the solution to the core-periphery divide. Core countries or regions attract economic activity and skilled workers from the periphery. This decreases the economic capacity of the periphery. Structural investments are needed to keep these regions attractive for economic activity. Secondly, in regional economic downturns, investments may allow regional governments to correct the market by adopting active labour market policies. National governments may find it difficult to finance such policies during crises. Hence, the Cohesion Policy can supply a degree of economic stability. The discussion in chapter 6 suggested that identification is the basis of solidarity. Differences in views can hamper solidarity. For example, different interpretations of the rule of law principle hampered the MFF negotiations. However, funds like these can be important for economic and political stability. In this way, they benefit even the net payers. Agreement depends on the existence of a coalition with similar preferences and pay-offs. If there are no similarities in preferences, then benefits must be guaranteed. In the case of cohesion policy, some countries are net payers. They receive indirect benefits, like higher demands for their products and services, a better-educated labour force and greater political stability.

The prospect of attracting economic activity might induce Member States to reduce employment standards. Since others would follow, employment and social standard would decrease throughout the EU. The issues discussed throughout the study lie in the realm of social policies, like workers' rights, income security and combatting deprivation (Daly, 2017). For instance, the Posted Workers Directive could provide for a buffer against the race to the bottom. [1] Disparities in working conditions give companies from countries with lower standards the opportunity to post workers in other countries at a lower cost, compared to local companies. The Posted Workers Directive aims to maintain

[1]Directive 96/71/EC amended byDirective (EU) 2018/957 of the European Parliament and of the Council of 28 June 2018

high labour standards and a level playing field. Host states have to apply basic rules to the employment relationship between foreign companies and posted workers. Such rules safeguard the rights of workers and forestall strategic behaviour. The European Commission proposed amendments to the Posted Workers Directive aiming to ensure the equal work is paid equally. The analysis has shown that the acceptance of such rules was not rational for all countries, but many accepted them nonetheless. Chapter 7 highlighted that this counter-theoretical outcome can be ascribed to common shared values and a common understanding of the importance of basic standards.

The analysis of identity corroborated many theories in the economics of federalism. One of the original research questions was whether differentiated integration can work, especially in the light of national identities which can distort rational decision making. The identity analysis put forward in this study was applied to macroeconomic stabilization and social spending, to policy coordination and to the race to the bottom. Excludability and rivalry in consumption determine the feasibility and desirability of differentiated integration. The coordination of employment and social policies, for example, permits for the exclusion of non-participants but more participants can generate additional benefits. Therefore, a multi-speed approach is workable – reluctant countries can accede once the basic features are in place. In the framework of the European Employment Strategy, there are no strategic incentives. Identification can enhance coalition formation. As benefits increase, the policy becomes more attractive to non-participants. For these reasons, a multi-speed, a la carte approach can work.

However, if strategic behaviour is possible, differentiation grows less desirable. In the race to the bottom, those who remain outside of the policy enjoy a competitive advantage over participants. If some countries introduce common standards for pay, others could undercut them. Although identification may reduce incentives to act strategically, if some countries remain outside of the system, it will not have the desired effect.

Therefore differentiation cannot be recommended – identity does not change anything. Similarly, cohesion policy is supposed to reduce the core-periphery divide. Accordingly, all Member States should be part of the policy. Otherwise, the core countries cannot benefit from a better skilled labour force and higher demand from the periphery. Likewise, the periphery countries would have no chance to catch up. A similar argument applies to macroeconomic policy, which fulfils an insurance function for states. The diversity of national economies avoids the danger of all Member States having to rely on the insurance fund simultaneously as a result of an economic shock. The more countries participate in such a mechanism, the higher its capitalization, diversification and thus its effectiveness. Therefore, the differentiation of stabilization policies would be ill advised. All Member States should participate and the same rules should apply to all.

Some EU policies might be perceived as a threat to national identities. They might be unacceptable even if they are efficient. Chapter 7 highlighted that the salience of national identity depends on the distance between values and norms in one country and another, in respect of some policy. According to the literature, transnational party lines are more salient than national interests in the EP. It appears, then, that a stronger mandate for the EP could reduce inefficient policy outcomes. Furthermore, identity effects are strong because basic political ideologies and institutional attitudes are formed in childhood and early adolescence. Therefore, underlining EU values and norms through education and highlighting the commonalities between Member States could reduce saliency of national identities in the Union.

8.4 Further research

There are several avenues for further research. Firstly, empirical research should focus on economic and social convergence between Member States. Investigations should provide more clarity on the impact of more than half a century of EU integration on the views of individuals. Secondly, to keep the analysis in this study manageable, migration was not discussed in the study. However, migration within the EU is increasing and therefore likely to have to have an impact on national identities. It is important to see how migration affects the views and preferences of policy makers. Thirdly, survey data may enable us to ascertain whether views in the EU are converging. Survey such as the Eurobarometer or the European Values Survey would be valuable.

The research presented in this study discussed coalition building and its impact on common policies. It did not explain how national identities develop or how formal institutions, such as laws, affect them. Further research needs to show that laws and institutions can mitigate the adverse effects of identity. Law and economics research could focus on how laws and institutions form national and supranational identities.

The analysis followed the traditional citizen candidate model. Nothing was said of situations in which politicians do not act in line with the wishes of their constituencies. This could allow the behaviour of hyper-nationalist politicians to be measured. Further research could focus on the interaction between national identities, selfish politicians and the resulting policies.

Identity and national identities have been shown to impact preferences over redistribution and legislation. Modelling has shown to be useful in exploring relationships between identity, law, and policy. Beyond nationalism, identity economics is a valuable tool to analyse relationships in public choice.

Lastly, the analysis took a very nuanced view on national identities. However, it made no inference on the question whether it results in an improvement or decline in overall welfare. More research is needed in order to be able to make any inference about the overall impact of identity and how it impacts overall macroeconomic outcomes.

8.5 Final remarks

This study opened new avenues for law and economics to get a better understanding of the impact of national identities on common EU policies. The main contribution of this study is conceptual, it provided one way of combining that traditional models of centralisation with a behavioural theory. Through socialization individuals learn how institutions work and learn an image of how institutions are supposed to be designed. This does shape preferences over institutions as well as the political understanding. As a consequence it impacts whom individuals can relate to, what in turn shapes dynamics in policy making in general and EU politics in particular.

These dynamics impact the degree of solidarity between different states and the degree of cooperation between them. This study has applied the concepts to EU social and employment policies, in particular to setting labour standards in the internal market, to coordination policies and to macroeconomic stabilization policies. The analysis has shown that the impact of identity is situational dependent. Therefore its impact on different policy outcomes differs according to different policies. To get a more complete picture of national identities on common EU policies and their stability, more research is necessary. However, with this study, some progress has already been made.

Chapter 9

Epilogue: Identity and challenges faced by the EU after the COVID-19 health crisis

This study discussed EU labour market and social policies. The COVID-19 pandemic is fuelling one of the worst postwar recessions.[1] In that recession, EU policies will matter even more. Two of the relevant policies bear a close relation to those discussed here. (Labour) income replacement instruments will remain relevant as long as social distance measures are acute. Structural adjustment policies are needed to dampen the potential long-run impact of the COVID-19 crisis. This epilogue will review recent policy developments. It also explains how (i) the results of the present study explain the course of the negotiations and (ii) how the institutional design of the policy responses needs to be adapted.

[1] https://www.worldbank.org/en/news/press-release/2020/06/08/covid-19-to-plunge-global-economy-into-worst-recession-since-world-war-ii (last access: 12.10.2020).

In chapters 2, 5 and 7 several arguments for common policies were highlighted. In theory, the EU is well placed to raise capital for macroeconomic stabilization. Favourable interest rates in the financial markets augur well for intervention. In addition, public expenditure in one Member State can have positive benefits on other Member States, in terms of both demand and output. Economic stability abroad is also important for maintaining stable demand for domestic products. The common budget ensures investment can be financed during the downturn.[2] Moreover, if the national economy is in a bad state, the common budget can relieve national public budgets. The following review will show that considerations of this kind have engendered greater acceptance of EU measures as compared to the Great Recession. Consequently, there is now a greater degree of solidarity between Member States.

National identities can constrain EU policy-making, as they influences voters' appraisal of salience. This undermines EU policies, irrespective of their advantages. Chapter 6 discussed how common cultural narratives lead to common identities, defined as ethnical and civic attributes – history as well as values and norms. Political views are formed during childhood, and through socialisation and education they are shaped by national institutions. This explains why for many EU citizens, EU identity is secondary to national identity. In political discussions of new EU policies, representatives always have national constituencies as their reference point.

In chapter 7, it was said that negotiations are shaped by several factors: the specificities of the policy to be negotiated, the resulting benefits, as well as the views and norms shared by those who negotiate the policies. The salience of national identities is impacted by the degree to which views and values differ – the greater the difference, the higher the importance of individual identities. Yet, if the benefits from common

[2] As exemplified above by the ESF.

policies are sufficiently high, the weight attached to differences is reduced. The review that follows shows how the theoretical framework developed in the preceding pages may explain the political decisions taken during the COVID-19 pandemic. The discussion focuses on the impact of national identities on the political decision making process, and under what circumstances such impacts may be more or less pronounced pronounced. Some suggestions are made for reducing the potential behavioural bias due to national identity and thus getting closer to the optimal outcome.

In line with the preceding discussions, the following review focuses on the Member States and their representatives in shaping political outcomes at the EU level. The theoretical analysis, on which the discussion of EU politics in the present study is based, assumed that the national representatives act in line with the preferences of their voters. In practice, other stakeholders such as interest groups from (inter-) national industries, as well as EU bureaucrats play a role in the political outcomes. Given the focus of the present study on national identity, their impact is not explicitly discussed. Hence, this limits the discussion and related suggestions to limit the impact of national identity on national decision makers. This epilogue discussed how national identities can impact the negotiations - although a political proposal may be beneficial, identity can constitute a psychological cost, which has to be considered on top of other political economic factors. These considerations are made in what follows.

9.1 From a health crisis to an economic recession

In March 2020, an unprecedented health crisis shook the world. COVID-19 halted economic activity worldwide. Countries such as China and Italy, which faced COVID-19 outbreaks earlier than others, showed health care systems could come under enormous strain. It is obviously imperative that hospitals should not become overburdened. To limit the spread of the disease, governments across the EU introduced measures to reduce social interaction. Economies were closed down, workers were prevented from working, and consumers could not consume anymore. The entire EU economy seemed to have come to a standstill.[3] Limiting the spread of COVID-19 was of the utmost importance. Once it is contained, limiting the economic recession will be equally important.

The economic recession is a supply and demand shock. In many economic sectors, firms were kept from producing and consumers from consuming. Closing the economy was the price to pay to contain the pandemic. Supply chains were severed and there was no demand for many services and products. The economic impact of the health crisis differed by sector. In Luxembourg, the construction sector was put on hold, which led in March to an increase in the unemployment of workers on short-term work contracts.[4] In other sectors, work could continue remotely. By contrast, tourism and hospitality shut down completely. In Greece, Croatia and Cyprus, the tourism sector makes up for more than 20% of GDP. Tourism aside, in October 2020 the European Commission forecast that EU GDP will have declined by 7.4% in 2020. The situation is expected to be the worst in Spain, with a 12.4% GDP decrease compared to the previous year. The outlook for Sweden has been the most positive of all EU Member States, with an

[3] https://voxeu.org/article/supply-side-matters-guns-versus-butter-covid-style (last access: 12.10.2020).

[4] https://adem.public.lu/fr/actualites/adem/2020/04/chiffres-cles-2020-03.html (last access: 10.10.2020).

expected GDP decrease of 5.4%, (European Commission, 2020b). GDP growth is not expected to bounce back to pre-crisis levels before the second half of 2021.[5]

One of the priorities during the lock-down was to ensure that the companies could withstand the economy inactivity and that they become operational again as soon as restrictions were lifted. Governments adopted a mix of policies. The German government recapitalized companies by buying equity and financed short-time work schemes, whereby companies would reduce working time instead of laying off workers. The employer would pay the effective working time, whereas the government would cover 60% of the workers' normal salaries.[6] The German stimulus packages amounted to 284.4 billion Euros, or 8.3% of GDP.[7] Italy provided an immediate fiscal stimulus of 61.3 billion Euros, or about 3.4% of GDP, together with several other measures, such as liquidity and guarantee measures, summing up to 571 billion Euros.[8] Between April and June, up to 6 million people took up short-time work in Germany (European Commission, 2020c). The European Commission (2020c) finds that the German scheme cushioned the rise in unemployment. France and Austria also adopted short-time work schemes. As of July 2020, in Italy, Spain, France and Germany payments under short-time work schemes exceeded those made during the financial crisis 2008/9.[9] Such schemes will remain important. Some Member States have more resources to finance fiscal stimuli than others. Political cohesion and cooperation between the Member States will be crucial for the future economic recovery. In the first weeks of the outbreak, all government action was national. However, during the second quarter of 2020, the EU took unprecedented

[5]These estimates from the EC's autumn forecast are susceptible to changes. The development of the pandemic and necessity of further containment measures, such as lockdowns, can substantially impact these estimates.

[6]https://www.eurofound.europa.eu/observatories/emcc/erm/support-instrument/short-time-working-allowance (last access: 27.10.20).

[7]https://www.bruegel.org/publications/datasets/covid-national-dataset/#germany (last access: 27.10.20).

[8]See https://www.bruegel.org/publications/datasets/covid-national-dataset/#italy. (last access: 27.10.20) - GDP for 2019.

[9]https://www.ceps.eu/sure/#_ftn2 (last access: 27.10.20).

action. Whereas EU policy focused on the importance of fiscal consolidation during the great recession, the current approach is counter cyclical.

9.2 Common policies in the aftermath of the health crisis

In February 2020, public authorities were still inactive. Soon, the heads of the Member States became aware of the severity of the situation. Initially, there was no common European response. Italy was the first EU Member State hit by the virus. In early March 2020, Italy requested help from the EU 'civil protection mechanism' and asked other Member States for basic supplies. In the face of scarcity of medical supplies, comity between the Member States was lacking.[10] Then, in the first weeks of March, lockdowns were put in place by many Member States. Cross-border movement was severely restricted. Immediate reactions to the COVID-19 crisis centred on the national level and were uncoordinated. The Commission launched initiatives to increase the availability of medical supplies. Initiatives comprised a call for tenders for medical supplies, measures to increase production capacities, stockpiling, and distribution. Later, these measures were complemented by common strategies for the development of a vaccine against COVID-19.[11] Initially, it looked like the Member States were on their own. Later, the EU responded. The EU put together various rescue packages. Initially, the Commission proposed to commit the cohesion funds to projects that could mitigate the impact of COVID-19. Many of these projects were related to health measures.[12]

Whereas fiscal discipline was a core issue in the 2008 crisis, fiscal consolidation only

[10] For a more complete overview over the development of the health crisis see:https://www.politico.eu/article/coronavirus-europe-failed-the-test/ (last access: 05.10.2020).

[11] https://ec.europa.eu/info/live-work-travel-eu/health/coronavirus-response/public-health_en#ensuring-the-availability-of-supplies-and-equipment (last access: 10.11.2020)

[12] For an overview with the respective projects see: https://ec.europa.eu/regional_policy/en/newsroom/coronavirus-response/(last access: 28.10.2020).

played a subordinate role in the COVID-19 health crisis. On 20 March, the European Commission proposed to suspend the rules of the Stability and Growth Pact by drawing on the general escape clause.[13] A few days later, EU finance ministers ratified the proposal.[14] This gave the Member States more flexibility to increase their national debt in order to mitigate the socio-economic consequences of the health crisis.

In April, the European Commission, the European Investment Bank (EIB) and the European Stability Mechanism (ESM) proposed concerted action. The EIB provided about 200 billion Euros of guarantees to small and medium enterprises. The ESM established a credit line of about 240 billion to provide liquidity to eurozone.[15] The European Commission proposed a program to finance national short-time work schemes, in the framework of temporary Support to mitigate Unemployment Risks in an Emergency (SURE). This program is endowed with 100 billion Euros to finance short-time work schemes and the like. The EC will provide the support in the form of loans to Members States in need, and it will finance these loans by borrowing on the financial markets.[16] Member States with high public debt pay higher interest rates at the financial markets. The procedures for applying are also simpler than under other EU schemes, like the ESM. In this way, the SURE program provides incentives to Member States to prolong and initiate short-time work schemes.[17] At the time of writing, the European Council had already agreed to pay out 87.4 billion Euros to Member States in need.[18] The SURE program is a step towards European unemployment insurance. However, the program is intended for the health crisis and not as a permanent instrument. The Member States at

[13] https://ec.europa.eu/commission/presscorner/detail/en/ip_20_499

[14] https://www.consilium.europa.eu/en/press/press-releases/2020/03/23/statement-of-eu-ministers-of-finance-on-the-stability-and-growth-pact-in-light-of-the-covid-19-crisis/ (last access: 10.11.2020)

[15] https://www.eib.org/de/stories/economy-covid-19. (last access: 10.11.2020)

[16] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32020R0672. (last access: 15.11.2020)

[17] https://www.bruegel.org/2020/05/the-european-unions-sure-plan-to-safeguard//-employment-a-small-step-forward/. (last access: 28.10.2020)

[18] https://ec.europa.eu/commission/presscorner/detail/en/mex_20_1761#2

the receiving end have to wait for approval by the other Member States.[19] The Council approved the Commission's proposal for rather quickly, which seems like an immediate act of solidarity solidarity.[20]

When the severity of the crisis became clear, the European Commission proposed an extended recovery budget. In May 2020, the European Commission published its proposal of an EU package of recovery instruments, building on the earlier negotiation of the multi-annual budget. Initially, the Commission proposed to endow this instrument with 750 billion Euros, which together with the multi-annual budget would have summed up to a 7-year budget of 1.85 trillion Euros for the years 2021 to 2028. The major novelty with this budget was the proposal to borrow the additional 750 billion from the financial markets. Out of that 750 billion, the Commission proposed a recovery and resilience facility. In July 2020, there were intense discussions in the European Council. Heads of state agreed to increase the EU's resources to 2% of GDP. For the recovery, a budget of 672.5 billion will become available, out of which 312.5 billion Euros were to become available in the form of grants and 360 billions as loans.[21] Bonds issued by the EU Commission would fund the proposed actions, with service of the debt guaranteed and financed by the EU. That would necessitate fresh funding from, among others, environmental taxes on plastic. In the framework of the Next Generation EU, the Commission will lend money to the Member States. This will benefit the Member States with a high debt-to-GDP ratio, for whom borrowing on the financial markets is prohibitively expensive.

[19] https://www.ceps.eu/sure/

[20] https://www.consilium.europa.eu/de/press/press-releases/2020/05/19/covid-19-\council-reaches-political-agreement-on-temporary//-support-to-mitigate-unemployment-risks-in-an-emergency-sure/. (last access: 29.10.2020)

[21] https://www.consilium.europa.eu/en/press/press-releases/2020/07/23/this-is-historic-we-renewed-our-marriage-vows-for-30-years-//europe-is-there-strong-standing-tall-report-by-president\-charles-michel-at-the-european-parliament-on-the-special-european-council-of-17-21-july-2020/. (last access: 10.11.2020)

The next-generation EU strategy rests on several budgets to supports specific aspects of the recovery. The main instrument is the Recovery and Resilience Facility (RRF), at a total of 560 billion.[22] The RRF funding supports Member States' investments in increasing competitiveness and boosting recovery while focusing on the Green Deal. To be eligible, Member States have to submit plans. These have to be in line with the political priorities of the Commission, outlined in the Green Deal. Member States receive the money from the RRF in addition to the funding they usually receive in the framework of the MMF. The additional financial support will help Member States to enact structural reforms towards a greener economy. However, the Next Generation EU instrument cannot be described as a real shock absorber. Allocations depend on ex ante projections of unemployment and GDP growth. Daniel Gros argues that the funds should instead be allocated in line with the actual severity of shocks and flow in line with their severity.[23] Failure to invest now could exacerbate economic inequalities between Member States. The macroeconomic impact of the RRF should not be underestimated.[24] It can increase demand for labour, particularly through investments in the green transition (Hepburn et al., 2020).

At the end of October 2020, the European Commission tabled a proposal for a European minimum wage.[25] In the proposed Directive, the European Commission proposes a framework and minimum standards that national minimum wage laws or collective bargaining should fulfill. The provisions anticipate that national collective bargaining coverage should reach at least 70% of the workers. In Member States where minimum wages are set by statutory law, the minimum wages should be updated on a regular basis. The Directive prescribes that national social partners should be involved in this

[22] 310 billion will be available as grants and 250 billion as loans.
[23] https://www.ceps.eu/next-generation-eu-2/ (last access: 12.10.2020).
[24] https://voxeu.org/article/next-generation-eu-recovery-plan-europe. (last access: 10.10.2020)
[25] https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1968. (last access: 10.11.2020)

wage setting framework. According to the Commission's social partner consultation document, a minimum wage would generate upward convergence within the EU. The framework regulates the race to the bottom.[26] In line with the policies discussed in the body of the thesis, the Directive could alleviate pressure on labour standards and boost competitiveness through technological innovation and skills instead of labour-cost competition.

9.3 The political economy of COVID-19 policies

Initial reactions to the crisis were strictly national. The organisation and delivery of public health care is a Member State responsibility.[27] Economic shock was common to all Member States, in contrast to the previous crisis. The common peril seems to have encouraged solidarity. Chapter 7 have described solidarity as a result of a common identity, or at least identification with others. The differentiation between identity and identification is important: individual voters hold several identities from several social groups at the same time, so that in certain situations they identify more strongly with some groups than with others. These processes impact political views. Views are likely to coalesce among countries with similar institutions and similar costs and benefits from a proposal. The discussion in chapter highlighted how this process of identification impacts politics. Chapter 7 did not discuss the creation of a common identity, but discussed the impact of psychological biases, due to differing identities, on political outcomes. Accordingly, in the suggestions in the following review have to be understood as a mean to reduce the bias due to identity and not as a mean to promote

[26]Under Article 154 TFEU, the European Commission is obliged to consult EU social partner organisation on issues related to employment and social affairs.

[27]https://blogs.lse.ac.uk/europpblog/2020/03/27/
the-european-unions-reaction-to-the-covid-19-pandemic-a-preliminary-assessment/ and
https://ec.europa.eu/info/policies/public-health_en. (last access: 23.10.2020).

the creation of a European Identity.

The COVID-19 pandemic has substantial economic costs. A common reaction can be beneficial for all Member States, including net payers. The COVID-19 shock was symmetrical. Yet some states were hit harder than others, especially those with a large tourism and hospitality sector. Some Member States have a higher fiscal capacity to sustain prolonged public spending than do others. Southern Member States, such as Italy and Spain, are therefore in a worse situation than northern Member States. They have called for a common debt instrument. However, the move was opposed by the Netherlands, Germany, Austria and Finland. There was a fear that mutualised debt would exacerbate moral hazard problems. Southern countries were thought to be less disciplined than Northern ones.[28] In the aftermath of the Great Recession, Germany set the pace for economic reforms across Europe, demanding balanced budgets from the southern Member States. In 2012, the governments of countries such as Austria, Finland, or the Netherlands appeared to have given into populist tendencies by ceasing to support rescue mechanisms.[29] The Eurocrisis was a struggle between the centre and the periphery, or in other words, between surplus and deficit countries.[30]

These positions were still reflected in the political positions beginning of 2020, especially in the framework of the ongoing MFF discussions. Some Member States, the so-called 'Frugal Four' – the Netherlands, Denmark, Sweden and Austria - were in favour of reducing the budget from the Commission's proposal 1.1% of national GDP to 1% and of refocussing the budget on priorities such as security, migration, innovation and climate

[28] https://blogs.lse.ac.uk/europpblog/2020/05/21/the-eus-southern-member-states-have-set-the-stage-for-european-debt-mutualisation/ (last access: 26.10.2020).

[29] https://www.foreignaffairs.com/articles/germany/2012-10-02/myth-german-hegemony (last access: 26.10.2020).

[30] https://www.foreignaffairs.com/articles/europe/2012-05-01/austerity-and-end-european-model (last access: 26.10.2020).

change. In June 2019, the Dutch Prime Minister said in an interview that he would never support a (macroeconomic) stabilisation mechanism at the European level.[31] While not being part of the coalition of this group, Finland, Belgium, Ireland and Germany have espoused similar views in the past. These states were also in favour of cutting the budget for cohesion policy by 8%, to 12%.[32] On the other hand, southern, central and eastern Member States supported instruments such as the Budgetary Instrument for Convergence and Competitiveness and the Just Transition fund. In addition, these Member States favoured keeping the expenditure for Cohesion policy stable.[33] One prominent issue in the negotiations was the suspension of payments in the case of a breach of the rule of law. The Council Conclusions of July 2020 foresee that in case of a breach of the rule of law by a Member State, the Commission would propose measures that the Council would adopt through a qualified majority. This was accepted by the European Parliament.[34] Yet, at the time of writing, Poland and Hungary had decided to veto the MFF and the recovery plans due to this rule of law mechanism.[35] There is consensus about the budget, but views differ about the need for a mechanism to safeguard the application of the rule of law at national level.

As chapters 5 and 7 pointed out, the comparative advantage of the eastern Member States was based on relatively low wages and productivity improvements financed by foreign direct investments. In times of major recessions, reliance on high FDIs and foreign direct investments makes over reliant economies vulnerable[36]. In line with chapter

[31] https://www.euractiv.com/section/eu-elections-2019/video/rutte-no-emerging-consensus-on-eus-top-jobs/ (last access: 26.10.2020).

[32] https://www.euractiv.com/section/economy-jobs/linksdossier/eu-faces-tough-post-brexit-test-with-2021-2027-budget/ (last access: 26.10.2020).

[33] https://www.euractiv.com/section/economy-jobs/news/in-portugal-15-cohesion-countries-call-for-stronger-eu-budget/ (last access: 26.10.2020).

[34] https://www.euractiv.com/section/all/news/eu-institutions-strike-deal-on-rule-of-law-mechanism/ (last access: 12.11.2020).

[35] https://www.euractiv.com/section/economy-jobs/news/hungary-and-poland-veto-stimulus-against-pandemic/ (last access: 15.11.2020).

[36] https://voxeu.org/article/eastern-europe-s-adjustment-tale (last access: 12.11.2020).

7, this also explains why southern and eastern Member States have a similar view on the Cohesion policy and its importance. For these countries, policies to improve competitiveness are of the utmost importance. Indeed, according to the review in chapter 4, some of the eastern Member States show relatively high wage growth, suggesting that betting on low wage costs is unsustainable. In addition, in the aftermath of the past recession, eastern Member States aimed to restore competitiveness by currency depreciation, a strategy not unlike that of the southern Member States before the adoption of the euro.[37] These 'common' vulnerabilities explain in part the support that southern, central and eastern European Member States lend to common policies that support competitiveness or to initiatives aimed at buttressing shocks. In February 2020, 15 out of the 17 'friends for Cohesion' signed a joint declaration, calling for a stronger EU budget.[38]

This anecdotal evidence suggests that there were, broadly speaking, two camps. On the one hand, there are those in favour of a large budget for cohesion policy, redistribution, and macroeconomic stabilization instruments. On the other hand, there were the Member States which prefer smaller budgets and less redistribution. In terms of the structural conditions and issues to be tackled, countries have more similarities with the countries in their camp than with the countries from the opposite camp. In addition, the groups reflect distances on the institutional dimension described in chapter 4.[39] The model in chapter 7 would predict that, given these similarities, the countries' representatives are more likely to identify with one another and therefore to build coalitions accordingly.

[37] https://www.euractiv.com/section/economy-jobs/opinion/can-eastern-europe-escape-the-eurozone-crisis/ (last access: 12.11.2020).

[38] Bulgaria, Cyprus, Czech Republic, Estonia, Greece, Hungary, Latvia, Lithuania, Malta, Poland, Portugal, Romania, Slovakia, Slovenia, and Spain. Italy and Croatia did not sign – Italy could not because they had other priorities and Croatia did not because they were holding the presidency of the European Council.

[39] See for example figure 4.2.

The recent negotiations on the MFF and Next Generation EU have shown that there are several trade-offs in finding policies which determine the majority's preferred outcome. Compared to the Great Recession, the views of many actors have changed. Some actors changed their position after the COVID-19 outbreak. The obvious explanation is that the cost of inactivity would have been too high. The actual costs of a common macroeconomic stabilization policy differ for different Member States. Some Member States are likely to receive more from the funds, which are needs-based. The allocation is based on the ratio of per capita income relative to EU average income and pre-crisis unemployment rates. In addition, the MFF will be financed by national contributions, which are proportional to national GDP.[40] For Member States burdened by high public debt, the benefits of the Next Generation EU instruments are likely to be higher than for Member States with more balanced public budgets. For Member States burdened with a high debt, raising finance in the markets can be cumbersome. Therefore, the actual costs and benefits of a common macroeconomic stabilization policy differ for different Member States (Alicidi et al., 2020).[41] For Member States which are less dependent on common schemes, the political costs of inaction could be prohibitively high.

The EU benefits the Member States, especially Northern ones. Mion & Ponattu (2019) estimate that, on average, the per capita benefit from access to the single market stands at 840 Euro per year. These benefits are higher for the countries in the core, such as Germany, the Netherlands or Denmark, and lower for countries in the south. Not agreeing to a common rescue fund could have led to political turmoil, a political crisis and considerable economic costs. Research shows that restrictive fiscal measures contributed to the popularity of Brexit (Fetzer, 2019). In the aftermath of the COVID-19 pandemic, conservative economic policies could have fuelled similar tendencies in other Member

[40] Alcidi et al. (2020).

[41] See for example the Member States' balance of revenues from and payments to the EU's budget: https://ec.europa.eu/budget/graphs/revenue_expediture.html (last access: 12.11.2020).

States. 'Either the EU does what it needs to be done or it will end' said the Portuguese Prime Minister, Antonio Costa by the end of March 2020.[42] Reticence by the Northern Member States or the imposition of stringent conditions could have resulted in a political disaster.[43] The Dutch government has always been against mutualisation of debt, but in March 2020 the Prime Minister Marc Rutte changed track.[44] The benefits from a common scheme, such as the Next Generation EU discussed above, appear to be sufficiently high to overcome the identity costs discussed in chapter 7 and shown in equation 7.4. At the same time, Poland's and Hungary's veto show the importance of non-pecuniary factors, such as values, to negotiations.

The proposed Directive on minimum wages also touches upon national traditions and values. Nordic countries, where minimum wages are set by collective bargaining, reacted critically to the proposal. According the Swedish European Affairs Minister, wage setting must remain a matter for trade unions and employers.[45] Across the EU, there are different preference about such minimum standards and their definition. At the same time, ensuring a decent income to all citizens should be an aim for all Member States. Common values like these could increase political cohesion among Member States and thus make the passage of the Directive more likely.[46]

[42] https://www.politico.eu/article/netherlands-try-to-calm/ /-storm-over-repugnant-finance-ministers-comments/ (last access: 12.11.2020).

[43] https://www.politico.eu/article/coronavirus-/ /covid19-public-health-crisis-could-break-the-eu-european-union/ (last access: 12.11.2020).

[44] https://www.euractiv.com/section/economy-jobs/news/ germany-and-netherlands-open-to-consider-coronabonds/ (last access: 12.11.2020).

[45] https://www.euronews.com/2020/10/28/sweden/ /-opposes-brussels-proposal-for-eu-minimum-wage-guarantee (last access: 12.11.2020).

[46] Proposal for a Directive of the European Parliament and of the Council on adequate minimum wages in the European Union COM/2020/682 final.

9.4 The economic recovery after COVID-19

Economic theory recommends a strong common policy framework to ensure macroeconomic stability at the EU level.[47] Schemes to replace foregone incomes could support demand across Member States and thereby hold output at high levels. In the specific case of the COVID-19 crisis, such schemes also help companies retain their employees even when there is no production. The review here has shown that after an initial phase of individual, national reactions, the EU Member States moved towards concerted action. Although some Member States were reluctant to share the burden of the economic crisis, they eventually changed their position. Proposition 8 presented in chapter 7 contributes to the explanation of this change of mind. If the benefits from a common policy are sufficiently high, national differences and national identity do not play an important role. The threat of political turmoil within the EU could have easily been actuated. Those Member States which were initially hostile towards redistributive policies, such as the Cohesion policy or a higher EU budget, are also those states which stood to lose the most from the decay of the common market. 'Positive political externalities' stood to be internalised, making the cognitive bias from identity fade away. In other words, ensuring the political cohesion in the EU has been more important than the overshadowing identity concerns - at least for the Northern Member States In addition to these externalities, this study has discussed several other benefits from common insurance – overall economic stability, lower financing costs, and optimised funding.

Even before the current crisis, several Member States were in need of structural reform. The latest data shows that in 7 Member States, less than 50% of individuals aged between 16 and 74 years have basic digital skills. In Member States such Italy, Spain

[47] As suggested in section 2.3 and 2.4.

and Greece, youth unemployment still remains an issue.[48] High debt-to-GDP ratios impede these Member States from raising new capital to invest in recovery policies. Leaving these countries to their own devices is risky, as investors could begin to question their solvency (Alessina and Giavazzi, 2020). The RRF will be an important source of support for these economies in the future.

At the same time, the New Generation EU facilities are mostly intended for structural investments. At the time of writing this more than 80% of the budget of the SURE mechanism have already been allocated. Despite the current wave of solidarity, there is no budget (or procedure) for future economic contractions. A more permanent EU system to support individual incomes should be put in place. The expected benefits from the adoption of such a system need to be sufficiently high for all Member States. Different countries have different welfare systems, which reflect different values.[49] Such differences impact voters and politicians and may foreclose the adoption of common policies. The MMF negotiations have shown that values beyond the utilitarian affect negotiations. Higher net benefits reduce the saliency of differences between the Member States and, with that, the overall saliency of national identities. When the benefits from a proposal are sufficiently high, political differences play only a subordinate role.

Earmarking and effective monitoring can help form coalitions. The proposed Next Generation EU is structured with a view to both. In the framework of the Recovery and Resilience Facility, the Member States must explain how they plan to use the funds. The allocation of the funds has to be in line with specific priorities, such as investments into greening, skills or digitalization.[50] These plans will be scrutinized by the Commission, which should then start allocating the funds in the second half of 2021.

[48] See statistical annex of European Commission (2020c).
[49] See examples given in section 4.5.
[50] See European Commission (2020d).

Despite everything, there are no permanent EU mechanisms dedicated to income replacement in times of macroeconomic shock. Several approaches are conceivable. For instance, the SURE mechanism could be extended to support national schemes. Moral hazard by national decision makers needs to be avoided by establishing ex-ante rules for transfers from the EU budget. National fiscal discipline can be maintained through the European Semester and by making payments contingent on CSRs.

The major part of this study has been written before the outbreak of the health study. Chapter 5 and chapter 7 in particular reflect on the political discussion which was ongoing in 2019. At that time, commentators were of the view that the next multiannual EU budget is likely to decrease. This epilogue has provided an overview over explanations, why this has changed.

The EU reacted with financial support for the national short-time work schemes. This aid helped Member States to absorb the initial economic shock and to avoid large increase in unemployment. There has not been a proposal for a permanent scheme, but the Member States reacted with a decision on recovery funds. These recovery funds is a major development fo the EU, considering the amount of EU public debt it entails and size of the grants to be paid to the Member States.

While the main goals, such as structural policies to tackle digitalization and climate neutrality, are specified by the Commission, Member States will take part in designing the recovery investment plans. The analysis in chapter 5 supports this approach - it allows to take into account national structural issues and to address these. These funds can thus alleviate the financial burden of those Member States hardest hit. In addition, a taking into account national specificities in the case of recovery plans, as well as the proposal for a minimum wage Directive, will reduce saliency of national identity issues, or the potential 'threat' to national traditions, and thereby increase acceptance for these initiatives.[51] Such efforts would reduce potential bias stemming from identity and thereby make a political outcome more likely. Identities and the respective values on which they are based have to be considered as a part of the negotiations, on top of other considerations, such as the direct costs and benefits of the policies. This post scriptum aimed to show how values and norms, shaping identities, may impact negotiations. As suggested in the models above, the costs and benefits of policies also play a role, next to other factors. Aiming to reduce the indentitarian consideration is not a guarantee for an outcome.

The political quandary with Poland and Hungary, due to the rule of law clause shows the importance of having a common view on values. A lack of a common understanding leads to a high cognitive cost, sufficiently high that elected representatives of the people consider to reject future EU funds. The goal of the recovery funds is to strengthen national economies and to support internal demand. Therefore a 'differentiated approach' to recovery, where those not willing to agree on specific terms and conditions are excluded, should be avoided. Yet, chapter 7 concluded that if the benefits of a policy do not depend on large scale participation, then a differentiated approach should be encouraged over identitarian concerns. Members of the European Parliament proposed to go ahead with the recovery plans without Poland and Hungary.[52] However, this would mean that the basic goals of cohesion policy would be put into question.

[51] Proposal for a Directive of the European Parliament and of the Council on adequate minimum wages in the European Union COM/2020/682 final.

[52] https://euobserver.com/opinion/150103?fbclid=IwAR2-LLEm6SHjDLyNFzsizx7I3ogv9Oc1thyHTEehHRp4w-S4f4x9TArC_64 (last access: 08.12.2020).

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Appendices

Appendix A

The political economy of centralization

The models on centralization (Alesina et al., 2001a; 2001b; 2005; Cheikbossian, 2000) start from a utility function of the form:

$$\pi_i(x_i, g_i) = x_i + \alpha_i H(g_i) \tag{A.1}$$

$\alpha_i H(g_i)$ denotes the benefits derived from the public good. The benefit is linearly increasing in the consumption of the private good. The benefit of the consumption of the public good is marginally decreasing, given that $\frac{\partial H}{\partial g} > 0$ and $\frac{\partial H}{\partial^2 g} < 0$. For the calculations in this chapter and chapter 5, $H(\cdot)$ will be specified as: $H(g) = \frac{1}{1-\theta} g^{1-\theta}$, for the special case $\theta = \frac{1}{2}$. These preferences represent marginally decreasing utility over the public good. θ determines the elasticity of the marginal benefit, i.e. by how much does the marginal benefit changes for an additional change in the size of the public good. The main characteristics of the utility function remain unchanged and the results remain equally generalizable. In the specification of the payoff function above, every parameter is the same for any representative, except for the preference parameter α_i. Together with the single-peakedness of the utility, this explains why it was argued in section 5.2 that the solution to the majority voting problem is that the median country's preferred policy is chosen by voting over the proposed provisions.

A.1 Voting over Public Goods

The outcome under a voter equilibrium must be majority preferred, that is, it must maximize the utility of the median voter. The optimal amount of the public good for the median voter can be found by maximizing the utility as defined in 5.1 over g_i for the median country, from which we get the following first order condition:

$$\alpha_m g_m (1 + \beta(n-1)) = \frac{1}{1 + \beta(n-1)} \tag{A.2}$$

where α_m denotes the benefit parameter of the median country within the union of countries among which the centralized provision is decided. Solving this expression for g_m, the majority's preferred centralized provision of the public good within the union of n countries is given by: $g^c = \alpha_m^2(1 + \beta(N-1))$.

For a country to join the union, the benefit from the centralized provision of the public good has to be larger than the benefit from the decentralized provision of public, g^d. The latter can be found by maximizing the benefit given by equation 5.1, which does not include a spillover, given that the respective countries provide the goods on their own and that, by assumption, no country can benefit from the other countries' provisions.

Considering the form of the of p_i given in equation 5.1, which is marginally decreasing in g_i, pi_i a solution to the maximization of pi_i with regard to g_i exists. From this maximization problem, the following first order condition arises:

$$\alpha_i(g_i)^{-\frac{1}{2}} = 1 \tag{A.3}$$

Solving this expression for g, we get $g^d = \alpha_i^2$. Similarly to the forgoing case, the provision is increasing in α.

A.2 The Surplus from centralization

In order for any representative to agree to centralization, it must make them better off than local provision. Therefore, it is assumed that the public good is centrally provided if the surplus Δ_i from doing so is positive. The surplus is defined as:

$$\Delta_i = \pi_i(g^d) - \pi_i(g^c) \tag{A.4}$$

Using the definition of the utility given by 5.2, the size of the centralized and decentralized provision can be written as: $g^d = \alpha_i^2$ and $g^c = \alpha_m^2(1 + \beta(n-1))$. Hence the utilities from the respective provisions are given by: $\pi_i(g^d) = y_i + \alpha_i^2$ and by $\pi_i(g^c) = y_i - \alpha_m^2(1+\beta(n-1)) + 2\alpha_i\alpha_m(1+\beta(n-1))$. From this, the following surplus can be calculated:

$$\Delta_i = 2\alpha_i\alpha_m(1+\beta(n-1)) - \alpha_i^2 - \alpha_m^2(1+\beta(n-1)) \tag{A.5}$$

Lemma: The surplus as defined in equation is an inverted u-shaped curve.

Proof:

Solving the quadratic expression for a given α_m, we find that $\Delta_i = 0$ for those countries with $\alpha_1 = \alpha_m(1+\beta(n-1) - \sqrt{(1+\beta(n-1))^2 - (1+\beta(N-1))})$ and for $\alpha_2 = \alpha_m(1+\beta(n-1)) + \sqrt{(1+\beta(n-1))^2 - (1+\beta(n-1))})$. The surplus is maximized when $\alpha_i = \alpha_m(1+\beta(n-1))$ [1] As can be seen from the first order conditions given by A.2, for given preferences, a voter would ideally vote for a smaller provision in his country, given that centralization under the conditions outlined in chapter 5 above will lead to the internalization of spillovers. Therefore, the median voter's ideal provision is supplied according to some α_i, such that $\alpha_m = \frac{\alpha_i}{(1+\beta(n-1))r}$. For the **graphical representation above**, we denote this by α_{m*} . In addition, $\frac{\partial \Delta_i}{\partial \alpha_m} > 0$ for $\alpha_i < \alpha_m(1+\beta(n-1))$ and $\frac{\partial \Delta_i}{\partial \alpha_m} < 0$ for $\alpha_i < \alpha_m(1+\beta(n-1))$. Taken together, we can infer that the surplus is an inverted U-shaped curve, an insight which is needed to determine the size of the equilibrium union.

A.3 A note on Equilibrium Unions

Bernheim et al. (1987) argue that in certain non-cooperative environments, one can assume that players can easily communicate their strategies, without, however, being able to make binding commitments. In case no communication is possible, it is enough for players to eliminate incentives for unilateral deviations. However, if one admits the possibility of communication, any relevant agreement must prescribe a best-response strategy for each player to the strategies indicated by the other players. This means the agreement must be a Nash equilibrium. Due to the possibility of communication,

[1] Which follows from the FOC: $\frac{\partial \Delta_i}{\partial \alpha_m} = 0$

coalitions may form, which means that some players within a coalition might deviate from the Nash equilibrium. Therefore a meaningful agreement must be stable against deviations by all potential coalitions. Hence, the original set of players is concerned about finding a coalition which is self-enforcing, i.e. a coalition for which no subset of players has an incentive to deviate. Bernheim et al. (1987) explain that this is a refinement of a strong Nash Equilibrium, i.e.: 'An equilibrium is strong if no coalition, taking the action of its complement as given, can cooperatively deviate in a way that benefits all of its members'.[2] The problem they identify with this definition is that it that this equilibrium is too restrictive, in the sense that it requires self-enforceability from the original players, but not from the deviating coalitions. Therefore, Bernheim et al's definition of a coalition-proof equilibrium requires any deviating sub-coalition to also be self-enforcing, that is, any deviation of a subset of players must make all the deviating players better off. The authors highlight an important aspect of their notion of self-enforceability: once a deviation occurs, only members from the deviating coalition can consider deviations from the deviation. This rules out the possibility that these deviating players will form a coalition with players from the original coalition, as these players lack information about the deviating players, which others in the sub-coalition might have.

Based on these insights, Alesina et al. (2001a) define a stable equilibrium union. With regard to the formation of the union outlined in chapter 5, the concept of a coalition-proof union can be formalized. As outlined above, an equilibrium union, where the policy is chosen by majority voting is composed of countries such that for any country i within the union:

[2]See Bernheim et al. (1987), p. 2.

$$\pi_i^{in}(\alpha_m, N) > \pi_i^{out} \quad \text{(A.6)}$$

Therefore, voting for a specific proposal must make the respective country better off. In addition, not voting in favour a specific provision must make the respective country better off than doing the opposite. So for any country k outside the union, the following must hold[3]:

$$\pi_k^{in}(\alpha_m, N) \leq \pi_k^{out} \quad \text{(A.7)}$$

As explained above, a union is self-enforcing if there is no sub-coalition of countries for which would be better off by deviating from the agreement. So, an equilibrium union is coalition-proof if in the set of countries outside the union, there is nosubset of S countries $\Gamma(S)$, such that:

$$\pi_k^{in}(\alpha_m, N + S) \leq \pi_k^{out} \quad \text{(A.8)}$$

Proof of proposition 1:

The proposition follows from the definition of a coalition-proof union A.3 given above and the definition of the surplus Δ. As shown above, the surplus $\Delta_i > 0$ as a function

[3]For a given, fixed median. In Alesina et al. (2001), the median depends on the preference of all the members of the group and changes with additional members. However, here we have voting over fixed proposals, so a country would only join if the proposal itself was beneficial for that country as well.

of α_i is an inverted u-shaped function which is negative for values smaller α_1 and larger than α_2 and is increasing for $\alpha_i^{(1)} \leq \alpha_i < \alpha_i^{(2)}$. So for any country with $\alpha_i < \alpha_i^{(1)}$ or $\alpha_i^{(2)} < \alpha_i$ the surplus would be negative. In other words, for any country for which the majority's preferred provision differs too strongly from its preferred provision, the surplus form centralization would be negative. Thus, any country outside the union would not benefit from joining. On the other hand, to those countries for which $\Delta_i > 0$, the majority's preferred provision is close enough to their preferred provision, which is why these countries are better off joining. Therefore, the union of countries should be composed of countries with contingent preferences. In this case, the union would be stable in the sense that there would be no one within the union who would be better off outside, and vice versa. As Alesina et al. (2001b) point out, the size of the union increases with the size of the spillover and decreases with the in the heterogeneity of preferences, i.e. **the variance of the parameter α**.

Proof of proposition 2

This proposition is essentially an implication of 1. As can be seen from the definition of surplus Δ_i and the arguments from the previous proof the surplus, for a given median-preferred provision and a given spillover, the surplus for country i is larger the closer its median preferred provision is to that of the median country. The further away the preferred provision, i.e. the more preferences differ, the lower the surplus. However, for a larger β, the surplus increases. Therefore, the larger β, the more likely centralization becomes, but as the differences between α_m and α_i grow larger, centralization becomes less feasible. For a given difference between both, the surplus is increasing with β. Therefore, the larger the gains from efficiency, the larger the benefits to individual countries and therefore the size of the union increases with economic efficiency.

Appendix B

The diversity and Commonalities of Social and Economic Models

B.1 Variables included in the factor analysis

B.1.1 Skills, education and mismatch indicators

The first indicator of Table 2 for skills mismatch, denoted by SMI, is defined as 'the weighted absolute de-viation between the share of education groups in employment and their share in the population'. It measures the degree to which employed people's skill-composition deviates from what is found amongst the entire population. The stronger the difference the higher would be the mismatch as skills in demand would not match supply. A second macro-indicator for skills mismatch restricts the samesimilar information to highly educated workers. It is denoted SMI HIGH ED and measures the number of the highly educated (ISCED level 5 and higher) unemployed workers as a proportion of all unemployed workers.

Apart from those macro-level mismatch indicators, the factor analysis also uses variables that describe a skills mismatch at individual level, for example: the share of low-achieving students in the disciplines Maths, Reading and Sciences. These indicators are based on the OECD PISA study . Furthermore, the anal-ysis includes the qualification mismatch indicator by the OECD (2015). Further variables that describe skills/education and matching are:

- the share of young people having left school early (without graduating),
- the share of individuals aged 30-34 having a tertiary education,
- the share of tertiary graduates with a degree in science and technology (aged 20 to 29),
- individuals aged 15-24 not in employment, education or training (NEET).
- the share of adults (aged 25-64), participating in education and training, men and women separately.

B.1.2 Indicators related to collective bargaining and social dialogue

As of labour market institutions, those institutions related to the welfare system and those linked to collective bargaining and social dialogue are measured. For the latter (taken from Visser, 2015):

- Collective bargaining coverage rate (WCB): The share of workers covered by collective agreements.
- Union centralisation (CENT): Summary measure of centralisation of wage bargaining.

- Formal trade union authority (AUTH): Summary measure of formal authority of unions regarding wage setting at peak and sectoral level.

- Statutory Minimum Wage (NMW): The indicator ranges from 0 (no statutory minimum wage) to 2 (statutory cross-sectoral minimum wages exist).

- Minimum Wage Setting Centralised (NMS): The indicator ranges from 0 to 8 (0: no statutory minimum wage, 4: minimum wage set through tripartite negotiations, 8: minimum wage set by government).

- Union density (UD): Union density rate, net union membership as a proportion of wage and salary earners in employment.

- Union role at sectoral level (Unagr): The value is 2 if the union negotiates enforceable agreements at the sectoral level and has veto power over company agreements; its value is 1 if it negotiates agreements at sector level and allows for limited variation between companies; a value of 0 implies that unions do not negotiate sectoral agreements at all.

B.2 Factor Analysis Outcomes

	Factors		
	Institutions, training and innovation support wages & productivity (INST)	Good skills, good employment, good social outcomes (LABM)	Mismatches depress wage growth and increase unemployment (MATCH)
Education and Matching			
SMI			
SMI_HIGH_ED			,622
Lifelong Learning	,703		
NEET 15-24		-,782	
Tertiary30-34		,611	
Share of low-educated people 25-64		-,584	
Share of low-educated people 30-34		-,698	
Low reading scores in PISA		-,625	
Low maths scores in PISA		-,707	
Low sciences scores in PISA		-,647	
Individuals who have basic or above basic overall digital skills	,607	,644	
Tertiary graduates in science and technology per 1000 of population aged 20-29 2012			
Percentage of adult population participating in education and training (aged 25-64) - men	,741		
Percentage of adult population participating in education and training (aged 25-64) - women	,670		
Annual expenditure in primary (ISCED 1) and secondary (ISCED 2-4) education per capita age group 6-18 (2011)			
Overqualified graduates (%) by age group 25-34 for high educational level possessed across countries in 2016			,618
Share of over-qualified (EWCS)			
Share of under-qualified (EWCS)			
Skills matching index (ESI)			-,821
Qualification mismatch indicator (OECD)			,629
Early leavers from education and training (LFS)		-,684	
Services: Horizontal mismatch rate (field of study mismatch), age 15-34, at least upper secondary education (LFS)			-,543
Social Sciences: Horizontal mismatch rate (field of study mismatch), age 15-34, at least upper secondary education (LFS)			
Science, Maths, Computing: Horizontal mismatch rate (field of study mismatch), age 15-34, at least upper secondary education (LFS)	-,523		
Engineering: Horizontal mismatch rate (field of study mismatch), age 15-34, at least upper secondary education (LFS)		-,648	
Productivity and Competitiveness			
GDP per capita, % of EU28 (NA)	,738		
Wage growth (NA)			-,752
Compensation per employee (NA)	,807		
Compensation of employees per hour worked (NA)	,831		
Percentage of EU28 total (based on million purchasing power standards), current prices Nominal labour productivity per worker (NA)	,530		
Percentage of EU28 total (based on million purchasing power standards), current prices Nominal labour productivity per hour worked (NA)	,653		
Nominal unit labour cost based on persons t / t-10 (NA)			-,837
Nominal unit labour cost based on hours worked t / t-10 (NA)			-,825
Real Unit Labour Costs, chance since 2010 (NA)			-,732
Institutions			
Collective bargaining, coverage rate (ICTWSS)	,883		
Union_Centralisation (ICTWSS, variable 'cent')			
Formal authority of trade unions (ICTWSS)	,663		
Collective bargaining, comp level (ECS)			
Collective bargaining, sectoral/regional level (ECS)	**,779**		
Collective bargaining for given occupation (ECS)	**,550**		**,506**
Collective bargaining, cross sectoral (ECS)			
Minimum Wage Setting centralised nms	-,580		
Statutory Minimum Wage (ICTWSS)	-,578		
Union Density (ICTWSS)	,653		
Union role at sectoral level (ICTWSS)			
Child care 2016	,787		
Inactivity due to personal and family responsibilities - women			
Tax wedge on labour cost (tax rate on low wage earners)			-,601
Inactivity trap for the second member of a couple: marginal effective tax rate on labour income from a second member of a couple moving from social assistance to work			
Social protection expenditure by function (% of GDP) - Total 2015	,790		
People at-risk-of poverty or social exclusion - total		-,733	
Labour Market Policies	,639		
Functioning of the Labour Market			
Unemployment rate (LFS)		-,520	,611
In-Work Poverty risk 2016 (SILC)		-,733	
Employment impact of parenthood 2017			-,552
Empl Share innovative services	,579		
Job vacancy rate		,559	
Newly Employed (%)		,521	
Share of employees working in involuntary fixed-term or part-time contracts -women			,568
Enterprises providing ICT training (%)	,629	,504	
Human Resources in sciences and tech (%)	,720	,580	
Connectivity dimension of the Digital Economy and Society Index (DESI)	,558	,557	
Employment Rate 2017		,765	
Activivy Rate 2017		,679	
Employment gender pap 2017		-,517	
Share of employees in highly qualified occupations		,626	
Share of employees in Elementary Occupation			

Figure B.1: 70 variables and their factors loadings on 3 main dimensions of social and labour market conditions. Source: Rieff & Peschner (2020)

Appendix C

A Social Identity Analysis of Centralization

C.1 Social Identity groups

As explained above, the initial groups of countries are assumed to be formed so that there is one group favouring each of the proposals. Both groups are assumed to initially include those individuals with the lowest, or highest preference, respectively. A minimum requirement is that positive benefits accrue to those representatives willing to join the union. The surpluses from centralization within the respective unions are defined in the following.

Surpluses from centralization within different groups

λ is the share of individuals l of all the countries. The total number of countries among which centralization may potentially happen is N. The benefit from centralization within L would be given by:

$$\pi_l = y_l + 2\alpha_l\alpha_L(1 + \beta(N-1)\lambda) - \alpha_L^2(1 + \beta(N-1)\lambda) \tag{C.1}$$

Where α_L denotes the size of the public good actually provided. For group H, the benefit from centralization is given by:

$$\pi_h = y_h + 2\alpha_h\alpha_H(1 + \beta(N-1)(1-\lambda)) - \alpha_H^2(1 + \beta(n-1)(1-\lambda)) \tag{C.2}$$

The benefit from the decentralized provision of the public good is similar to the one defined in chapter 5 and accompanying appendices. The surplus from centralization within L is given by:

$$\Delta_l^L = \pi(g_l^c) - \pi(g_l^d) = 2\alpha_l\alpha_L(1 + \beta(N-1)\lambda) - \alpha_l^2 - \alpha_L^2(1 + \beta(N-1)\lambda) \tag{C.3}$$

The surplus from centralization within H is given by:

$$\Delta_h^H = \pi(g_h^c) - \pi(g_h^d) = 2\alpha_h\alpha_H(1+\beta(N-1)(1-\lambda) - \alpha_l^2 - \alpha_H^2(1+\beta(N-1)(1-\lambda)) \tag{C.4}$$

As explained above, the union composed of individuals from L and H is denoted by F. The share of those $N(1-\lambda)$ in H switching to F is denoted by ϵ. Then, for any representative in F, the benefit from centralization is given by:

$$\pi_h(g_F^c) = y_h + 2\alpha_h\alpha_L(1 + \beta(N-1)\lambda - \alpha_i^2(1 + \beta(n-1)\lambda) \quad \text{(C.5)}$$

And the surplus for any representative in F is given by:

$$\Delta_h^H = \pi(g^c) - \pi(g^d) = 2\alpha_L\alpha_i(1 + \beta(N-1)\lambda - \alpha_i^2 - \alpha_L^2(1 + \beta(N-1)\lambda) \quad \text{(C.6)}$$

Lemma

The surplus defined by the previous three equations is an inverted u-shaped function. The definition of the surpluses follows that of 5.4 given in chapter 5, except that the number of countries in the respective unions changed. Hence, the proof is the same as that given in A.2

C.2 Distance Function

With regard to the perceived distance, there can be three different cases: (i) $d_{hF} - d_{hH} > 0$; (ii) $d_{hF} - d_{hH} = 0$ and (iii) $d_{hF} - d_{hH} < 0$. Where H stands for either L or H

Case (i)

In this case, the perceived distances between i and H are smaller than those between i and the union as a whole. This means that F is overall less homogeneous with regard to attributes than the subgroup H. In the set $F \setminus H$, there are individuals which differ from all the others in F and thus change the composition of the prototype of the group.

Case (ii)

In this case, the determination of identification solely depends on the surpluses generated through centralization within the respective groups.

Case (iii)

If F is relatively more homogeneous than H, then there are some individuals within H which differ from the prototype of that group. The respective attributes from (7.1) can be represented as binary variables.[1] If in $F \setminus H$ all individuals have this attribute, but some in H do not, then the value of the prototype in H is lower than the value of the prototype within H. Those individuals within the group H not being characterized by the attribute, the perceived distance between the individual and the group are similar as in case (i). If subgroup H is the majority within F and if only a minority within H does not have the attribute, then individuals in H will identify with F if (7.2.3) holds. For the minority within H without the attribute, centralization within the group identifying only with H would now result in a much lower surplus $\tilde{\Delta}_i^H$, such that they will identify with F as well. If a high share of individuals within H does not have this attribute, then this majority might be large enough to provide the good only among H and create a surplus $\tilde{\Delta}_i^H > \Delta_i^{F(H)}$. For ease of analysis, it will be assumed that variations of the prototype of the subgroup stem from a differing minority. Analytically, this suffices to change the respective distances.

[1] Which means an individual has a certain feature or not.

C.3 Equilibrium Union with National Identities

The equilibrium concept used in chapter 5 is refined in order to include the influence of identity. Following Shayo (2009), representatives vote for proposal, given their identities, the votes (preferences) and the identities of the other representatives. Taking this into consideration, a union of countries is stable given the identification of its members with other group members and the resulting material benefits from membership.

$$\pi_i^{in}(\alpha_m, z_i, z_{-i}, N) > \pi_i^{out} \tag{C.7}$$

For any country k outside the union the following must hold[2]:

$$\pi_k^{in}(\alpha_m, z_i, z_{-i}, N) \leq \pi_k^{out} \tag{C.8}$$

An equilibrium union is the coalition-proof if in the set of countries outside the union, there is not a subset of s countries $\Gamma(S)$, such that:

$$\pi_k^{in}(\alpha_m, z_i, n+s) \leq \pi_k^{out} \tag{C.9}$$

[2]For a given, fixed median. In Alesina et al. (2001), the median depends on the preference of all the members of the group and changes with additional members. However, here we have voting over fixed proposals, so a country would only join if the proposal itself was beneficial for that country as well.

C.4 Existence of Identity Equilibrium Unions

In an identity equilibrium, the unions are uniquely determined and may either result in efficient or inefficient centralization, in terms of material surplus.

Case 1

The above definition of an equilibrium union follows the definition of the union given in appendix A. However, the difference is that above, representatives vote not only for their material preferences, but also for their identities. Therefore, in an identity equilibrium, the representatives need to have a positive surplus, but also identities have to match. The condition for identification was given above by:

$$\Delta_h^F - d_{hF} \& > \Delta_i^H - d_{hH} \Delta_h^F - \Delta_h^H \& > d_{hF} - d_{hH} \tag{C.10}$$

Plugging in and rearranging, one can find the following condition

$$\lambda(2\alpha_h \alpha_L - \alpha_L^2) - (1-\lambda)(2\alpha_h \alpha_H - \alpha_H^2) > \frac{d_{hF} - d_{hH}}{(1+\beta(N-1))} \tag{C.11}$$

Identification with F by a representative in H is induced if the net benefits from centralization within F are larger than the net benefits within H and if the perceived distance to H is large compared to the perceived distance to F. When is this the case? If within the set F, which includes all the countries, the subset H includes a larger share of countries, i.e. $\lambda \geq \frac{1}{2}$, then a majority of countries would vote in favour of α_H. For simplicity, it is assumed that λ is close to $\frac{1}{2}$. Given that representative of type H are the majority,

Δ_h^F cannot be larger then Δ_h^H, if all representative vote for their material preferences. Therefore equation 7.2.3 can only hold if $d_{hF} - d_{hH} < 0$, i.e. if the perceived difference to the group with similar material preferences is higher than the perceived difference with the overall group. In this case, the status of the group plays no role and those who have material preferences close enough to the α_L will vote in favour of the latter proposal. If the share of those who switch is such that a majority would vote in favour α_L, this proposal will be implemented. Solely considering the material benefits this outcome is not efficient. Those country representatives in H which switch to vote for α_L, would have a higher surplus when voting for α_H.

Case 2

In the case where $d_{hF} - d_{hH} > 0$ or $d_{hF} - d_{hH} = 0$, the countries would vote according to their material preferences, i.e. α_H. In this case countries from L which are close enough would also join the union if the following condition is fulfilled, similarly to the case for H:

$$\Delta_l^F - d_{lF} > \Delta_i^L - d_{lL} \Delta_l^F - \Delta_l^L \, d_{lF} - d_{lL} \tag{C.12}$$

This hold either if $d_{lF} - d_{lL} < 0$ (i) or $d_{lF} - d_{lL} = 0$ (ii) in other words if the perceived distance are to overall group of countries is small. Additionally, it has to be considered that, in this case, the number of representatives in L is smaller than the number of representatives in H. Hence, for most of these countries Δ_l^F is larger than Δ_l^L. Hence the status of F is larger for most representatives l than the status of L. As discussed above, if the group is homogeneous in terms of identities (attributes), then the respective group will also have higher status and identification is more likely to occur. This holds in both case (i) and (ii) and it is line with the social identity theories that argue that the more homogeneous the group in terms of preferences, the higher its perceived status. Given that this would maximize the surplus for all the members, as it maximized the size of the spill-over, this would be the efficient solution, similar to that found in chapter 5. In case (iii) where $d_{lF} - d_{lL} > 0$ the perceived distance to H countries is larger than the group with similar material benefits. This means that l representatives would not switch to vote for α_H and the outcome would also be inefficient, i.e. the overall surplus would not be maximized.

Summary

The last decade of EU politics has been marked by major economic shocks, which have involved the Member States in political quandaries to establish common EU mechanisms to cope with economic downturns. The ties between European Union Member States have grown strongly over the last decades and so did demands for solidarity between them. After the outbreak of the COVID-19 pandemic, political pressure to react in concerted action to mitigate the socio-economic impact of the COVID-19 pandemic has been rising. The present study offers a new Law and Economics view on EU integration and the factors shaping it.

According to criteria identified by federalism economics, integration should be shaped by economic gains, which can be reaped easily where the status quo of national policy frameworks only diverges to a limited extent. Yet, social and employment policies, which are important components for economic recovery after shocks, show that the predictions do not always hold. The application of standard predictions of the political economy of EU integration to social and employment policies shows that these do not always hold in reality. Economic theories consider nations mostly as an administrative entity, overlooking that nations are communities and citizens identify with them. National identity is a marker for a group, and psychologists and sociologists alike have argued on many occasions that such markers impact an individual's decision. The present study explores how national identity can impact Member States' decisions to agree on common EU policies.

Identity can be a further motivation for politicians and citizens alike to favour some outcomes over others. Such incentives are not taken into account by existing theories of federalism economics, and this limits their explanatory power. Based on a

multi-disciplinary framework, the present research discusses the relevance of adopting a behavioural approach to the economics of federalism to enrich the theoretical debate. The implications of national identity for EU politics are presented and these show the relevance for altering the behavioural assumptions of the existing neoclassical approaches to the questions of the allocation of policy prerogatives to different levels of governance. Drawing on identity economics, a framework is developed, which alters the behavioural assumptions of the rational actor's model to investigate the implications of national identity. National identity creates cognitive biases for voters and politicians alike. The impact of national identity is situational dependent, it can prohibit efficient centralization among Member States, but in certain situation also encourage common policies.

The present research shows that a behavioural approach to the economics of federalism does not refute existing theories, but that it rather strengthens and supports at least some of the arguments of the existing theories. At the same time, it explains why the predictions from those theories are do not necessarily materialize. Hence, the approach presented in this work provides a more nuanced way to the economic analysis of EU politics and legislation.

This study builds on Law and Economics to discuss the relevance of EU employment and social policy. This study is also about identity and it provides a framework to further existing economic theories. By taking a multidisciplinary approach, the study provides insights for policy discussion and furthers foundational research.

Samenvatting

Het EU-beleid van de afgelopen tien jaar werd geconfronteerd met grote economische schokken, die de lidstaten in de moeilijke politieke situatie hebben gebracht om gemeenschappelijke EU-mechanismen in het leven te roepen die het hoofd bieden aan economische crises. De banden tussen de lidstaten van de Europese Unie hebben zich in de afgelopen decennia sterk ontwikkeld, evenals de behoefte aan onderlinge solidariteit. Na het uitbreken van de COVID-19-pandemie is de politieke druk toegenomen om gezamenlijk op te treden om de sociaal-economische gevolgen van deze crisis te beheersen. Het onderhavige onderzoek biedt een nieuwe juridische en economische kijk op EU-integratie en de factoren die deze vormgeven.

Overeenkomstig de door de economische theorie van federalisme vastgestelde criteria moet integratie worden vormgegeven door het genereren van economische opbrengst, die alleen gemakkelijk kan worden geoogst als de status quo van nationale beleidskaders slechts in beperkte mate verschilt. Het sociaal- en werkgelegenheidsbeleid, een belangrijk onderdeel van het economisch herstel na schokken, laat echter zien dat de standaardvoorspellingen van de politieke economie kunnen worden gefalsificeerd. De toepassing van deze assumpties op het EU-integratiebeleid op het vlak van sociale politiek en werkgelegenheidsbeleid toont aan dat deze in werkelijkheid niet altijd standhouden. Economische theorieën beschouwen staten meestal als eenadministratieve entiteit, eraan voorbijgaand dat staten ook gemeenschappen zijn en burgers zich met hen identificeren. Nationale identiteit fungeert als een ankerpunt voor een groep; zowel psychologen als sociologen hebben vaak aangevoerd dat dit de beslissing van individuen beïnvloedt. In het onderhavige onderzoek wordt onderzocht hoe nationale identiteit invloed kan hebben op beslissingen van lidstaten om in te stemmen met gemeenschappelijk EU-beleid.

Identiteit kan zowel voor politici als voor burgers ook een motivatie zijn om bepaalde resultaten te verkiezen boven andere. Met deze prikkels wordt geen rekening gehouden in de bestaande theorieën van economisch federalisme en dit beperkt hun verklarende kracht. Op basis van een multidisciplinair kader bespreekt het onderhavige onderzoek het belang van een gedragsbenadering ter verrijking van het theoretisch debat. De consequenties van nationale identiteit voor het EU-beleid worden gepresenteerd en laten het belang zien van wijziging van de gedragsaannames uit de bestaande neoklassieke benaderingen van de vragen naar de toekenning van beleidsprivileges aan verschillende bestuursniveaus. Geïnspireerd door inzichten uit de identiteitseconomie wordt een kader ontwikkeld dat de gedragsaannames van het rationele actormodel wijzigt om de consequenties van nationale identiteit te onderzoeken. Nationale identiteit creëert cognitieve vooroordelen voor zowel kiezers als politici. De invloed van nationale identiteit is afhankelijk van de situatie en kan efficiënte centralisatie van het beleid van lidstaten beletten, maar in bepaalde situaties ook gemeenschappelijk beleid aanmoedigen.

Het onderhavige onderzoek laat zien dat een gedragsbenadering met betrekking tot het economisch federalisme de bestaande theorieën niet noodzakelijkerwijze weerlegt maar sommige argumenten van deze theorieën versterkt en ondersteunt. Tegelijkertijd wordt verklaard waarom de voorspellingen van de klassieke theorieën niet worden gerealiseerd. Daarom biedt de in het onderhavige onderzoek gepresenteerde benadering een meer genuanceerde manier voor de economische analyse van EU-beleid en -wetgeving.

Dit onderzoek gebruikt rechtseconomische inzichten om het belang van het EU werkgelegenheids - en sociaal beleid te bespreken. Dit onderzoek gaat ook over identiteit en het biedt een kader voor het stimuleren van bestaande economische theorieën. Door een multidisciplinaire benadering te kiezen, biedt het onderzoek inzichten voor beleidsdiscussie en wordt fundamenteel onderzoek gestimuleerd.

European Doctorate in Law & Economics

Curriculum vitae

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Short bio	
Joé Rieff holds a Master's degree in Economics from the University of Vienna and a Master's degree in Law and Economics from the Universities of Rotterdam, Bologna and Vienna. Prior to pursuing his PhD, he has worked in the Vienna Centre of Experimental Economics. In his research, Joé Rieff deals with European integration and the impact of national identity. He is interested in employment and social policy. His methodological focus lies on the application of public choice theory and statistical inference.	
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Work experience	
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Publications	
Determinants of skills matching - The role of institutions, Employment and Social Developments in Europe Working Paper Series, Luxembourg publication office	2020
Deepening versus widening the EU: where to go? In Madi, M.F., Reyes & R. Bagnoli. (eds): 'Public law and economics after the crisis'. World Economics Association Book Series. 2020.	2020

European Doctorate in Law & Economics

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Behavioural Game Theory 2015	2015
Economic Analysis of Law	2015
Experimental Law & Economics	2015
Game Theory	2015
Specific courses	***year***
Seminar 'How to write a PhD'	2015
Academic Writing Skills for PhD students (Rotterdam)	2015
Seminar Series 'Empirical Legal Studies'	2015
Hamburg Summer School in Law and Economics	2015
Seminars and workshops	***year***
Bologna November seminar (attendance)	2014
BACT seminar series (attendance)	2015 - 2017
EGSL lunch seminars (attendance)	2015 - 2017
Intensive seminar series	2015 - 2016
Joint Seminar 'The Future of Law and Economics'	2015
Rotterdam Fall seminar series (peer feedback)	2015 - 2017
Rotterdam Winter seminar series (peer feedback)	2015 - 2017
Netherlands Institute for Advanced Studies – Workshop: Voting, Power and Decision Making	2016
Presentations	***year***
Bologna March seminar	2015
Hamburg June seminar	2015
European Association of Law and Economics	2015
Rotterdam Fall seminar series	2015
Rotterdam Winter seminar series	2015
Joint Seminar 'The Future of Law and Economics'	2016
German Law and Economics Association	2016
European Association of Law and Economics	2016

Bologna November seminar	2016
European Association of Law and Economics	2017
Attendance (international) conferences	***year***
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Tax Justice Network Conference: "Tax Justice to Promote Social Justice", University of Vienna	2014
Eighth Annual Tax Conference – AIJA TLC Conference, Venice	2015
Workshop – Dutch Social Choice Colloquium	2017
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Microeconomics Tutorial, European Master in Law and Economics	2016
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