# Non-compliance in the European Union as a Monetary Policy Substitute

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***Abstract***

In this paper, I analyze how economic crisis and the interplay between domestic interests and European institutions create incentives for the governments of European Union (EU) member states to violate EU law and to resist pressure by the European Commission and the European Court of Justice (ECJ) to (re)establish compliance.

While the Lisbon Treaty provides the EU's institutions with powerful tools to make sure that all member states fulfill their obligations under the treaties (cf. Articles 258-260 of the Treaty on the Functioning of the European Union), we observe large variation in compliance rates both between member states and within individual member states over time. What explains this variation? How can we account for variation in compliance in light of economic shocks like the one that started out as a global financial crisis in 2008 and has since then evolved into what is widely known as the Euro crisis?

I show that institutional changes that go back to the introduction of the Euro affect European governments' ability to assist domestic industries in times of crisis. While the advent of Economic and Monetary Union robbed Eurozone governments of exchange rate manipulation as a policy instrument, the Euro has not reduced member states' exposure to the downside whims of the global market, the demand for government support and protection during economic downturns, or the responsiveness of reelection-minded governments to the demands of special interest groups that provide campaign contributions in exchange for government interventions on their behalf.

Using original data on official infringement cases in which the European Commission issued so-called Reasoned Opinions to member states and that were referred to the ECJ under Articles 258-260 TFEU, I show that Eurozone governments are significantly more likely to engage in violations of state aid regulation and treaty provisions on the free movement of goods and services in times of economic crisis than their non-Eurozone counterparts. When their hands are bound by the firm institutional framework of the EU, governments substitute no longer available legal economic policy instruments with infringements on EU law. They (ab)use the EU's enforcement mechanism as a flexibility provision that grants them temporary relive from the twin pressures of economic crisis and an ever closer-woven corset of European laws and institutions.

# Non-compliance in the European Union as a Monetary Policy Substitute

*Bank of England Governor Mervyn King said the bank will "do all it can" to pull the economy out of recession, signaling further bond purchases using freshly created money*

Wall Street Journal, August 8, 2012

*If Greece had its own currency, it could try to offset this contraction with an expansionary monetary policy – including a devaluation to gain export competitiveness. As long as it's in the euro, however, Greece can do nothing to limit the macroeconomic costs of fiscal contraction.*

New York Times, May 1, 2010

Research on Economic and Monetary Union as a natural experiment of a multi-country currency union has been plentiful within the last decade. Of the many outcomes of the introduction of the euro as the European single currency, its impact on trade between its member states has been studied most extensively. The decision of eleven member states of the European Union to adopt a single European currency has widely been interpreted as a step towards completion of the Single European Market and the long-proposed level playing field for companies and businesses in Europe.

However, thirteen years on, with six additional adopters, and at a time when the future of the Euro seems less certain than ever, attention has shifted away from the trade effects of EMU and the completion of the Single European Market and to the constrains that the euro has put on member states' macroeconomic policy autonomy. While the fiscal policy constraints of the

Stability and Growth Pact were the focus of attention in the early years of the Eurozone, attention has recently shifted to the euro's effects on monetary policy autonomy. While economists have been aware of the so-called Mundell-Fleming trilemma (Fleming 1962, Mundell 1962, Frenkel and Razin 1987) for decades, the general public has only recently become aware – in the context of the ongoing economic crisis – that a fixed exchange rate, free capital movement, and independent monetary policy cannot simultaneously be attained or maintained. As the opening quotes highlight, the United Kingdom can still use monetary policy to stimulate its economy, while Greece is 'trapped' in the Eurozone. Its companies and businesses, its overall domestic economy might be in better shape today if there still was a Greek drachma to be devalued. But what does this have to do with non-compliance?

I argue that the introduction of the euro has led to an increase in the number of violations of European legislation committed by Eurozone member states. Non-compliance is an indirect and unanticipated effect of the euro, but how and why? Since January 1, 1999, the domestic industries of Eurozone member states find themselves in a more challenging competitive environment than ever. As the euro has removed the currency risk that used to be involved in buying goods from producers abroad, the competitive position of domestic industries vis-à-vis their intra-Eurozone competitors has been weakened. At the same time, the euro has also reduced the number of (legal) economic policy instruments that Eurozone member states can use to manage their domestic economies and to assist ailing industries. In the absence of an autonomous monetary policy, Eurozone governments can no longer improve the competitive position of domestic industries via currency devaluation. Of course, this does not stop industries from lobbying their government for support when exposed to rising import penetration. I claim that when faced with an increase in the

demand for protection, Eurozone governments, taking into account their political support functions, have few options but to decide to supply protection outside the bounds set by EU law. When their domestic industries are faced with strong import-competition, the members of the Eurozone commit more violations of articles 28, 30, 34, and 36 TFEU now than they used to before the introduction of the euro. As the governments of non-Eurozone EU member states still have monetary policy at their disposal, their compliance records are better than those of their Eurozone counterparts.

Empirical evidence strongly supports this theoretical claim. I can show that the seemingly counter-intuitive relation between the euro and non-compliance is the consequence of a shift from monetary policy autonomy and 'natural' barriers to trade – such as exchange rate volatilities and transaction costs – to 'artificial' barriers created by violations of European law. Controlling for all other major explanations of trade policy and compliance, I show that being part of the Eurozone goes hand in hand with a particularly strong increase in the numbers of infringements when import penetration is high.

The remainder of this paper is structured as follows. Following this introduction, I embed my argument in the broader literature on Economic and Monetary Union. This is followed by a section that develops the theoretical model. From the theoretical model, I derive testable hypotheses about the interactive relationship between exchange rate volatility, import penetration, and infringements on European legislation. In the research design section, I discuss the operationalization of my response variable, main covariates, and controls before reporting empirical findings that strongly support the theoretically derived hypotheses. I conclude with a

brief discussion of the results and their implications for the euro, the European Union, and compliance with European law as well as trade and protection in more general terms.

## Paving the Road to Non-compliance

What are the effects of the euro on non-compliance? This research question can be placed within the context of several broader areas of research, which this paper covers in turn. In a first step, I focus on a question that political scientists and economics have separately pondered ever since the ceremonious signing of the Maastricht Treaty on European Union in 1992 and the successful launch of the single currency by eleven EU member states in 1999. This question is the question of the causes of the euro. What political or economic forces lead to the formation of the European currency union? Providing a quick review of the existing literature, I argue that a political economy perspective offers theoretical and empirical surplus in comparison to more traditional arguments based on (real) politics and economic theory. I claim that without studying the role that special interest groups played in the run-up to the introduction of the euro, the decisions of European governments to give up their national currencies in favor of the euro cannot be fully understood. In a second step, I turn to the literature that links currency unions to increases in trade between their member states.

### Causes of EMU

At least since the early to mid-1990s, numerous scholars in the fields of political science and economics have tried to uncover the mechanisms that led 11 EU member states to give up their own currency and monetary policy autonomy. Various driving forces behind this decision have

been analyzed, and several causes for this significant commitment to a common monetary policy have been hypothesized, tested, and confirmed or rejected by numerous studies.

In political science, arguments about functionalist spill-overs running from the Single European Market, the European Monetary System, and the liberalization of capital markets to the EMU have been put forward (cf. Padoa-Schioppa 1994) alongside arguments about Franco-German *realpolitik* that link German reunification to the desire of the French government to further monetary integration (Baun 1995). This latter perspective argues that the German decision to join the monetary union project and give up its own very strong position in the determination of European monetary policy was not made for economic reasons, but merely on political grounds (Garrett 1994, Woolley 1994). However, by exclusively focusing on political processes in the realm of inter-governmental decision-making, these approaches paint an incomplete picture of EMU formation.

Within economics, there exist at least three lines of argument explaining European currency politics. The first argument centers on optimum currency area (OCA) theory (Mundell 1961, McKinnon 1967). A truly optimal currency area maximizes the economic efficiency of the countries involved. In order for this to happen, the economies of a region in question for a currency union have to be closely linked by trade in goods and services, their economic cycles should be in sync, and factor mobility needs to be high. Especially the low labor mobility between EU member states and the differences in their manufacturing structures led many observers to believe that the Eurozone is not an OCA (Eichengreen 1990, Krugman and Obstfeld 2003, and Wyplosz 2006, among others), and the empirical realities of the euro crisis seems to have proven them right.

However, if the Eurozone was not and is not an OCA, it shows that OCA considerations did not play a major role in the formation of EMU. Therefore the disciples of OCA theory and European politicians alike now pose the question of whether the Eurozone can be transformed into an optimal currency area by the euro itself or with the help of a fiscal union (Willett, Permpoon, and Wihlborg 2010).

Another line of argument stipulates that European governments wanted to credibly commit themselves to low inflation by permanently pegging their currencies to the *Deutsch Mark*. In other words, they wanted to import German anti-inflationary credibility (Frieden 2002). Claims by Thomas H. Oatley (1997) go even a step further. He relates the steps towards EMU to efforts by European policy makers to get rid of myopic policies and interest group pressure by putting monetary policy in the hands of a highly independent European Central Bank. Whether policy makers actually believed that they could overcome interest group pressure and had intentions to get rid of myopic policies by forming a currency union or not, I definitely challenge theoretically and empirically below the idea that European monetary integration has or could have helped them achieve such a fatuous objective.

A third argument considers the *real* effects of currency unions on cross-border investment and trade (Frieden 2002). In this view, policy makers have to take political economy factors into account when deciding between exchange rate flexibility and stability. Policy makers have to consider the real distributional consequences and welfare effects of their decision and weight them with the relative importance of those groups in society that gain or lose from the decision. This

argument combines inter-governmental decision-making over macro-political outcomes with the influence and preferences of interest groups.

**Consequences of EMU on Trade**

In the early years following the launch of the euro on January 1, 1999, the scholarly debate was not so much centered on the question of what led to the euro or whether the euro could work for Europe, but instead on how well it had worked so far and on what happened to macroeconomic indicators, such as trade, investment, and inflation, in the wake of its introduction. Did the euro increase trade between member states by eliminating exchange rate volatility? From a theoretical point of view, exchange rate volatility introduces risk. Therefore, risk-averse traders reduce trade volumes if there are unexpected fluctuations in the exchange rate (Cheong, Mehari, and Williams 2006). A currency union removes this barrier to trade, thereby lowering the transaction costs of trade. In turn, this should lead to increases in trading activity between the member states of a currency union.

Empirical research on the effect of currency unions on trade has been dominated by Andrew K. Rose's (2000) finding that pairs of countries that are part of a monetary union have trade flows among themselves that are – on average – 100 % higher than those among pairs of countries that are not part of a monetary union. A large number of econometric studies has tried to replicate and expand on Rose's finding. Some of these studies confirmed those strong effects (Engel and Rose 2000, Frankel and Rose 2002, Alesina, Barro, and Tenreyro 2002, Tenreyro and Barro 2007).[1]

1 See also Rose (2003) for a survey of 19 studies on currency unions and trade.

However, other well-designed econometric studies searching for a trade effect of EMU have found much smaller (Micco, Stein, and Ordonez 2003, de Nardis and Vicarelli 2003) or no (Nitsch and Berger 2005) trade effects at all.

Taking these findings into account, the assumption that the establishment of a monetary union come with an increase in trade seems plausible, but this effect may be temporal and short-lived or at least less pronounced when looking at the medium term (Mancini-Griffoli and Pauwels 2006). As I argue below, several governments of the Eurozone face stronger incentives than ever to shield their non-competitive domestic industries from European competition, thereby lowering the initially beneficial effect of an increase in trade. The euro's positive effects on trade created the very demand for retrenchment from free intra-EU trade. This is in line with the predictions of endogenous tariff theory that increased trade also leads to an increase in the demand of protection.

## The Euro and Non-compliance

Having reviewed the trade effects of the euro and hinted that protectionist interests can hollow out the economic gains from the introduction of a single currency, I now turn to developing an argument of how the euro can lead to an increase in violations of articles 28, 30, 34, and 36 TFEU and other EU laws. Based on standard models of distributive politics (Stigler 1971, Peltzman 1976) and protection (Grossman and Helpman 1994), I argue that research on the trade effect of EMU has to incorporate the topic of hidden protectionism. By linking protectionism to non-compliance, I not only make a new and innovative contribution to the existing literature on the economic consequences of the euro, but also the literature on violations of EU law, which is still very much

dominated by the enforcement versus management debate of the mid-1990s. In the following section, I provide a short overview of the existing compliance research in the EU before introducing my own argument about the surge of non-compliance in Europe following the launch of the Euro.

**Non-compliance in Europe**

Most approaches to the study of compliance in the European Union fall into one of two camps. One highlights enforcement and points to the role of the monitoring, sanctioning, and adjudication mechanisms as means to reducing the net-benefits of infringements. The other assumes that most violations of European law are not deliberate acts of defiance, but caused by incapacity and domestic institutional constrains.

Supporters of the enforcement approach to compliance with EU law follow Robert Keohane's (1984: 99) lead and wonder "why governments, seeking to promote their own interests, ever comply with the rules of international regimes when they view these rules as in conflict with [what they perceive as their] self-interest." They claim that member states infringe on European law if European legislation is not congruent with preexisting domestic legislation and/or the kind of European legislation that was not adopted, but preferred to the adopted legislation by the infringing member state. In other words, if member states of the EU do not get the European legislation they want, the cost of transposing, implementing, and enforcing EU law will outweigh the benefits of non-compliance. Of course, whether member states find themselves confronted with convenient laws or policy misfit is a function of the power that they can bring to the table at the bargaining stage, i.e., within the institutions of the EU – especially the Council of Ministers and

the European Parliament. At the enforcement stage, it depends on member states' power vis-à-vis the institutions of the EU – especially the European Commission and the European Court of Justice – whether these supranational institutions can sway the outcome of member states' cost-benefit calculations towards a positive net-benefit of compliance. Running the risk of oversimplification, the enforcement approach tells us that we need to look at the policy preferences of policy-seeking governments and member states' respective power within and vis-à-vis the institutions of the EU to explain and predict non-compliance by EU member states.

With its focus on involuntary non-compliance, the management approach virtually ignores preferences. EU scholars working in the management tradition, simply assume that the member states of the EU are interested in complying with European law. As a consequence, these scholars try to identify the factors that constrain the behavior of the member states' pro-compliance governments. In particular, they look at how – broadly defined – domestic political and bureaucratic institutions affect the compliance records of EU member states (cf. Giuliani 2003, Hille and Knill 2006, Börzel, Hofmann, Panke, and Sprungk 2010).

**New Protectionism in the Eurozone**

Departing from these traditional approaches to non-compliance in the European Union, I develop a theoretical model that draws on research on the political economy of redistribution. I assume that general policy decisions – such as the decision to violate European law – are centralized in the hands of a survival-maximizing government that can be influenced by organized interest groups (Olson 1965, Persson and Tabellini 2002). Assuming that governments seek to maximize political support (Stigler 1971, Peltzman 1976), I argue that, first, the welfare that interest groups derive

from a policy and, second, the deadweight loss that is imposed on society at large by this very policy, are the crucial arguments entering incumbents political support function (Grossman and Helpman 1994).

To succeed in the coming election, politicians depend on monetary and non-monetary campaign contributions. Organized interest groups can provide these political contributions, and this ability gives them a favored position in the eyes of governments. In exchange for contributions, governments act as the suppliers of the interest groups preferred policies. Within the literature on the endogenous determinants of trade policies, the protection-for-sale model has gained prominence (Grossman and Helpman 1994). It derives much of its beauty from the "relatively simple structure that yields clear-cut empirical predictions, and has been applied in a number of subsequent theoretical analyses" (Goldberg and Maggi 1997: 2).

I argue that two different contexts for lobbying or gaining political influence have been present *before* and *after* the introduction of the euro. These differences are interconnected and have led to a distinct increase in non-compliance rates among Eurozone members. And although I am mostly interested in explaining increased non-compliance following the introduction of the euro, I have to return once more to the formation of EMU in order to give a full explanation of the dynamics leading to this outcome.

**Formation of the EMU**

Arguing along the lines of arguments made by Barry Eichengreen (1993) and Jeffrey A. Frieden (2002), I assume that politico-economic concerns of European decision-makers played an

important role in the decision to adopt the euro. Looking at the implication of monetary union on trade and investment ties, European governments weighted the costs and benefits for their respective societies as a whole and were also exposed to lobbying from domestic producers. But how do lobbying groups and governments interact within the process of decision-making on such policy issues as fixed exchange rates and full monetary union?

I assume that the objective of politicians lies in the maximization of total political contributions from lobby groups and aggregate social welfare. Following Grossman and Helpman (1994), lobbying can be seen as a two-stage process. First, each organized interest group confronts the government with a contribution schedule, which translates each policy the government might chose (such as tariffs, subsidies, and other non-tariff barriers to trade) into a level of contribution given to the government. On the basis of these contribution schedules or menus, the government decides on a policy vector and collects the contributions from each lobby group accordingly. An equilibrium of such a common agency problem, i.e., a situation in which several principals simultaneously and independently attempt to influence a common agent (Bernheim and Winston 1986), is "a set of contribution schedules such that each lobby's schedule maximizes the aggregate utility of the lobby's members, taking as given the schedules of the other lobby groups" (Grossman and Helpman 1994: 116). Herein, the lobbies are aware that politicians ultimately set the policy according to their own welfare concerns. This protection-for-sale framework serves as a background on how I presume that the decision on monetary union was shaped by interest groups.[2]

[2] I only consider national level lobbying and decision-making. Of course, a multitude of influences on the supranational and intergovernmental level were also present in the run-up to monetary union.

Given the outcome we have observed ex-post, i.e., the introduction of the euro, and assuming the above-mentioned influence of special interests on policy-making, we can suppose that a majority of pressure groups were actively lobbying in favor of EMU. At the time the decision of introducing the euro was made, organized interest groups used all the available information about the European collective decision-making process and the economic consequences of EMU to forecast and then achieve their favorite policy outcome. However, even the most rational and forward-looking agents cannot escape the considerable uncertainty about future policies that is involved in such forward-looking decisions. The relation between policy formation in the late 1980s and early 1990s and policy outcomes today may thus be quite complex to say the least, and when "information is incomplete […] dynamic feedbacks due to political uncertainty about the future significantly complicate the effects of current policy on outcomes" (Drazen 2000: 39).

In sum, as the context in which decisions on the introduction of the Euro were made was one of great uncertainty about future outcomes, the repercussions on individual welfare and the distributional effects of EMU (not just in an exceptional situation like the economic crisis since 2008) were not fully predictable. As the context changed and the effects of EMU kicked in, new lobbying coalitions formed and – due to a situation of lock-in – other policies were asked for.

**Reactions to the changed rules of the game**

Since 1999, EMU has been a *fait accompli*. It has emerged as a new institution governing the monetary policies for the Eurozone and thereby it exerts a great influence on economic variables such as cross-border trade and investment. Along the lines of Grossman and Helpman (1994: 13), I argue that such a change in the "international rules of the game […] would affect government's

willingness and ability to protect particular sectoral interests, but would not affect politicians' weighting of campaign contributions relative to general voter dissatisfaction." I set out to investigate this institutional change, i.e., the introduction of the single currency, more closely in order to see how it influences equilibrium policies.

Due to the euro being essentially locked in, special interests in favor of currency union no longer have to make their voices heard on this issue. Even in light of current calls for Greece and others to leave the Eurozone, special interest groups can consider the participation of their countries in the EMU as essentially given. Leaving the Eurozone would be associated with high political and economic cost, and as we can observe, office-seeking governments refrain from such costly action as long as possible. Therefore, the groups that seek governments' support in this changed situation are those groups that have experienced a loss of competitiveness due to the new institutional arrangements.

Who are these groups? Who loses out from monetary union? According to theory, import-competing producers will feel the tougher winds of competition in particular. Therefore, they will be the ones demanding new forms of protection from the increases in free trade (Anderson and Baldwin 1987). These assumptions about the demand for protection are also in line with empirical findings about the supply. For instance, Marvel and Ray (1983) find that protection is usually given to politically important industries and industries that are penetrated by imports. By contrast, healthy, competitive, and politically less relevant industries receive less protection.

With the advent of EMU, import-competing producers in EMU member states have seen themselves in a more pronounced competition than before. As there is no longer a currency risk involved in buying the same goods and services from producers in a different euro country, the competitive position of domestic producers is weakened. To restore this position and the lost rents, domestic industries are hypothesized to demand protection from the government as the supplier of policies. National governments, in view of their political support functions, then may decide upon the level of protection within certain bounds. Governments of countries that face more intense import-competition provide – *ceteris paribus* – more protection, but how?

While the governments of EU member state have not been allowed to use standard tariff and non-tariff barriers to protect their import-competing industries, exchange rate volatility still effectively functioned as a stumbling block to free trade in Europe. With the introduction of the euro, this stumbling block was removed at least between the EMU members. In addition, governments can no longer make use of monetary policy to improve the competitive position of domestic industries vis-à-vis their European competitors.[3] Therefore, in the context of the EMU, there are two different starting points left to conceptualize the ways to (successful) lobbying for protection and the provision of protection.[4] One way is to think of governments as bargain within the institutions of the European Union to *legally* protect national import-competing companies

[3] Cristina Bodea (2012) shows that European governments frequently engaged in currency realignments, i.e., devaluation, under the European Monetary System that preceded the introduction of the euro.

4 A third way of successful lobbying would be to go directly through EU institutions. Although lobbying increasingly takes place on the EU level (cf. *Journal of European Public Policy* special issue on lobbying in the EU, April 2007), the domestic arena still predominates as far as the lobbying efforts of national producers are concerned.

through non-tariff barriers, such as the increase in regulative standards, which only their national producers meet. However, this way to protection takes time and does not guarantee success. A second possibility is that governments unilaterally and *illegally* protect national industries via the violation of provisions governing the free movement of goods in the EU. This leads to the hypothesis that at least in times of crisis, i.e., when domestic industries are under attack, Eurozone governments violate articles 28, 30, 34, and 36 TFEU and other European law as a means of protection.

> *Hypothesis:* The governments of the Eurozone, which can no longer rely on natural barriers to trade and monetary policy for protection, revert to infringements on provision governing intra-EU trade as an artificial and somewhat hidden means to achieve their protectionist objectives when domestic industries face increased import competition.

To rephrase this hypothesis in other words, while we can expect all members of the European Union and import-competing countries to provide protectionist policies to their producers in times of crisis, I expect import penetration to have a unique non-compliance-increasing effect for countries that are no longer protected by currency risk and the transaction costs that come with cross-border economic activity between countries with different currencies and that can no longer use monetary policy to prop up their ailing industries. Conditional on membership in the Eurozone, more import competition comes with more infringements on European law.

The seemingly counter-intuitive relationship between EMU and protection is supposed to work through a shift from monetary policy and natural barriers to trade (such as exchange rate

volatilities and other kinds of transaction costs) to illegal and artificial barriers to trade in the form of violations of EU legislation. I thus claim that the euro has only relocated and disguised the bumps instead of truly leveled the playing field for businesses in the EU. Before EU membership and the European currency union, national governments had different instruments to shield non-competitive producers from competition from abroad, e.g., by tariffs, quotas, and other NTBs. Now, being part of the Single European Market and moving from quasi-flexible exchange rates to full monetary union makes rigidities in domestic factor mobility, wages, and price behavior even more costly (Willett 2001), and without the monetary policy instruments at their or their national central banks' disposal, decision-makers in non-competitive economies have to make their choice between painful structural reforms or support of the non-competitive parts of their economies. In line with the standard political economy literature, I presume that politicians are interested in winning the next election and are less worried about the economic and legal repercussions later on in their careers (Alesina and Tabellini 2004). Even if structural reform represents the avenue down in which there is long-term competitiveness and the European Commission and European Court of Justice will eventually catch up with violators of European legislation, if no visible improvement can be achieved in the short-term, myopic politicians are supposed to opt for alternatives that are effective in the short-term. One such short-term instrument may be violations of articles 28, 30, 34, and 36 TFEU, which help ailing producers by protecting them from European market forces. Therefore, and repeating what I wrote above, I expect an increase in infringements on EU law following the adoption of the euro, conditional on the severity of the import penetration of national economies.

As detailed above, I argue that EMU might not have truly leveled the playing field for companies and businesses in the European Union, but led to other sorts of protectionism. I claim that these erosions diminish the benefits from the European currency union as governments revert to short-sighted violations of EU law instead of allowing for full-scale structural reform where it is most dearly needed. Similar arguments about canceling out one barrier of trade for another have been made before. Jagdish Bhagwati (1988: 53) has even phrased a term for this protectionist switcheroo: "the law of constant protection." For example, in their study of tariff- and NTB-levels in the United States, Canada, Japan, and the European Community, Howard P. Marvel and Edward J. Ray (1984) found that although governments had lowered tariff rates over time, NTBs were used to compensate industries affected by reduced tariffs. Furthermore, Daniel Y. Kono (2006) argues that the variation in complexity of trade policy instruments leads to differences in policy transparency, which then determine politicians' incentives to employ different forms of protection in democracies and non-democracies. Optimal obfuscation or protection in disguise within democracies leads to the empirically observable result that more democratic countries have lower tariffs, but higher quality barriers to trade, such as subsidies and product standards (Kono 2006). A central implication for the understanding of trade policy, which derives from this finding, is that other determinants of trade policy can have asymmetric effects on different policy instruments, just like democracy. In line with this implication, I also argue that institutions – in this case EMU – affect policy by "changing politicians' relative responsiveness to mass public and interest-group pressures" (Kono 2006: 382).

## Research Design

Having made claims about the interaction of EMU and trade with respect to non-compliance in Europe above, I now take my hypothesis to the empirical test. For this I use a panel dataset of the EU 15 member states and the 29 years from 1978 to 2007. Following a brief review of the response and covariates, I present quantitative evidence that supports the hypothesis that when import penetration is high, Eurozone member states violate EU law more frequently than their non-Eurozone counterparts.

### Response Variable

To test my theoretical argument of the effects of import penetration and the euro on compliance, I use the response variable $Infringements_{i,t}$. There are six variants of this variable. The first variant focuses exclusively on infringements on articles 28, 30, 34, and 36 TFEU. The second variant of the response variable captures all infringements on articles and secondary legislation that have been identified by the European Commission as falling into the single market policy area. The third alternative of the response variable captures not only violations of articles 28, 30, 34, and 36 TFEU, but all treaty articles from *Part Three: Union Policies and Internal Actions, Title II: Free Movement of Goods* of the consolidated version of the TFEU. These are articles 28 to 37 TFEU. They obviously include articles 28, 30, 34, and 36 TFEU, but also deal with issues like the common external customs tariff of the EU, the free movement of goods from third-country producers, state monopolies, and export restrictions. The infringement variables four and five are fairly similar. Both variables exclusively look at violations of secondary legislation, i.e., directives, regulations, and decisions. However, the classification as being single market or free trade-related legislation

is based on two different sources. Indicator four relies on the policy sector classification from the *Directory of European Union Legislation in Force* that identifies all legislation in chapter 13 as regulating industrial policy and the internal market. The fifth variant of the response variable focuses on the violated legislation's legal basis. It takes all infringement cases into account where a legal act is violated that is based on any article from what is now Part Three: Union Policies and Internal Actions, Title II: Free Movement of Goods of the TFEU. The sixth and final variant of the response variable simply measures all violations of all European legal acts, i.e., the *acquis communautaire*.

The six operationalizations of the response variable are all measures of the member states' annual number of violations of European law that are similar, but not identical. Using these different variants allows me to make sure my results are not just a fluke that is driven by the choice of compliance variable

**Covariates**

My main explanatory variables are $Euro_{i,t-1}$, $Import\ competition_{i,t-1}$, and their interaction term. The euro variable is simply a dummy that identifies Eurozone member states as such. Out of all the EU 15 member states and years between 1978 and 2007, it takes on the value one for Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain following the launch of the Euro in 1999. It is also one for Greece following the Greece's admission to the euro club in 2001, which happened just in time for the introduction of the Euro coins and notes in 2002. The variable has the value zero for all these countries before they joined

the Eurozone as well as for Denmark, Sweden, and the United Kingdom as they have resisted the temptation to become full members of the EMU so far.

*Import competition*$_{i,t-1}$ is an indicator for the intensity of the preferences and political demands of pro-protection pressure groups. A higher degree of import penetration means that domestic producers are getting squeezed out of their home market by foreign competitors. It is operationalized as the ratio between the value of imports and total domestic demand. The larger this import penetration ratio is, the stronger is the competition for domestic import-competing industries and the more likely it is that these industries organize and turn to the government in hope for protection. I generate this covariate using annual data on member states' GDP, imports of goods and services from only the EU member states, and trade with the rest of the world. The data are from the World Bank (2012) and Eurostat (2012) and cross-checked using the International Monetary Fund's (2012) *Direction of Trade Statistics* database.

In addition to these main independent variables, I employ a number of controls. These other covariates are taken from the trade policy literature and EU compliance studies. They primarily control for the effects of general macroeconomic conditions as well as the influence of traditional enforcement and management variables on violations of European law. Some of these variables are used exclusively in either the trade or compliance literature, others are used in both – if not necessarily for the same reasons. While I estimated my empirical models with various controls, I only report findings the effects of two power indicators, two capacity variables, and the institutional variable *Access Points*$_{i,t-1}$.[5]

[5] Summary statistics of the control variables are provided in Table 3.

The first power indicator account for the economic power of a member state that allows it to defy the European Commission's enforcement pressure (Martin 1992, Moravcsik 1998, Steinberg 2002). I use the log of the real $GDP_{i,t}$ in constant 1995 US$ to measure economic power. Data for this covariate come from the World Bank (2012). The idea is that it influences the sensitivity towards material costs of financial penalties or the withholding of EU subsidies. The second power indicator measures direct EU-specific political power. The *Shapley Shubik index*$_{i,t}$ measures the proportion of times a member state is pivotal (and can, thus, turn a losing into a winning coalition) under qualified majority voting in the Council of Ministers (Shapley and Shubik 1954, Rodden 2002). Politically powerful member states can afford to violate EU law as they are less vulnerable to losses in reputation and can (threaten to) cause havoc in the decision-making process if not handled with kids gloves by the European enforcement agencies, i.e., the Commission and the European Court of Justice. Other power sources, such as military capabilities, are either irrelevant in the context of the EU or (indirectly) captured by the two economic and political power indicators.

To test for the influence of capacity on compliance, I include two – one economic and one political – capacity indicators in my empirical models. *GDP per capita*$_{i,t}$ is a measure of a member state's economic wealth and the pool of economic resources that it can draw on to ensure compliance (Brautigam 1996, Knill and Tosun 2009). It is also widely accepted that wealthier countries are less protectionist (Milner and Kubota 2005) and should therefore commit less protections violations of European law. The data also come from the Word Bank (2012). To test the argument that weak, incompetent, and ineffective bureaucracies are to blame for member

state's infringements on European legislation, the second capacity variable is an indicator of bureaucratic quality from the World Bank's *Worldwide Governance Indicators* (Kaufmann, Kraay, and Mastruzzi 2010) that measures the independence, professionalism, accountability, and transparency of the civil service. Member states with a good bureaucracy should be able to mobilize the resources needed for the successful implementation of EU law even when those resources are scarce.

The final control that is included in the regression tables below is the institutions index developed by Sean D. Ehrlich (2009). *Access Points*$_{i,t-1}$ measures the standardized number of policy-makers that represent a distinct constituency and have independent power in the area of trade policy. As these access points empower domestic pressure groups where and when they demand protection from their intra-EU competitors, the expectation is that EU member states with many of these access points are more prone to violations of articles 28, 30, 34, and 36 TFEU and other EU laws.

**Analysis and Results**

Having discussed the operationalization of my covariates, response variables, and controls, I can now turn to analyzing the interactive effect of the euro and import competition on the compliance records of EU member states. The main findings are presented in Tables 7 and 8.[6] Overall, there

[6] All the empirical models were estimated with the statistics software package StataMP 14.1. I used generalized Poisson or negative binomial regression as all variants of the response variable are counts (Wooldridge 2001). Problems of heteroscedasticity were counteracted by the use of robust standard errors with clustering on member states (Wooldridge 2001, White 1980).

is strong empirical support for my argument that the euro has stripped member states of legal macroeconomic policy instruments. Without an autonomous monetary policy and the possibility to devaluate an overvalued currency, member state governments have no choice but to violate articles 28, 30, 34, and 36 TFEU and other free trade and internal market-related EU policies if they want to assist import-competing industries. Not only has the euro made the supply of legal protection next to impossible, but by removing currency risk and transaction costs within the Eurozone, it has also increased the exposure of domestic industries to international trade and, as a consequence, the overall demands of protectionist interests.

Taking a quick look at the empirical findings in Table 7, one result stands out. The data clearly support the hypothesis of a conditional effect of the euro and import penetration on violations of articles 28, 30, 34, and 36 TFEU in all empirical models 1-5. Not only do import penetration and the euro have independent effects on non-compliance, but the interaction effect is highly positive and significant. While all EU member states seem to violate European law more frequently when import competition is high, it is the Eurozone members, who are more exposed to intra-EU trade and have fewer legal policy instruments at their disposal. As a consequence, they commit particularly many violations when faced with increasing import penetration.

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I tested for first- and higher order serial correlation, but none was found. As to unobserved unit heterogeneity, I decided against a fixed effect specification as it would have impeded the inclusion of the largely time-invariant *Access Pointsi,$_{t-1}$* and disregarded the important cross-country information in the data (cf. Plümper, Manow, and Tröger 2005).

**Table 1: The Effects of the Euro on Infringements**

| | (1) | (2) | (3) | (4) | (5) |
|---|---|---|---|---|---|
| *Import competition*$_{i,t-1}$ | 1.0130*** | 1.6678*** | 1.6262*** | 1.4529*** | 1.5746*** |
| | (0.384) | (0.363) | (0.389) | (0.333) | (0.378) |
| *Euro*$_{i,t-1}$ | 0.4928*** | 0.4165*** | 0.4560*** | 0.4244*** | 0.3859*** |
| | (0.119) | (0.109) | (0.126) | (0.099) | (0.116) |
| *Import comp.*$_{i,t\,1}$ * *Euro*$_{i,t-1}$ | | 0.0472*** | 0.0444*** | 0.0410*** | 0.0396*** |
| | | (0.007) | (0.009) | (0.007) | (0.009) |
| *GDP*$_{i,t-1}$ | | | 0.0001*** | | 0.0000 |
| | | | (0.000) | | (0.000) |
| *GDP per capita*$_{i,t-1}$ | | | -0.0000*** | | -0.0000** |
| | | | (0.000) | | (0.000) |
| *Shapley Shubik index*$_{i,t-1}$ | | | | 0.8337* | 0.8015* |
| | | | | (0.445) | (0.482) |
| *Bureaucratic quality*$_{i,t-1}$ | | | | -0.0166*** | -0.0089** |
| | | | | (0.003) | (0.003) |
| *Access Points*$_{i,t-1}$ | | | | | 0.7107*** |
| | | | | | (0.080) |
| *Constant* | 1.3183*** | 4.4452*** | 4.1832*** | 2.2539*** | 2.5227*** |
| | (0.147) | (0.500) | (0.565) | (0.554) | (0.831) |
| *Ln alpha* | -1.3423*** | -1.8614*** | -1.7395*** | -2.6630*** | -2.5942*** |
| | (0.233) | (0.305) | (0.310) | (0.536) | (0.566) |
| *Pseudo r2* | 0.02 | 0.07 | 0.08 | 0.12 | 0.14 |
| *Observations* | 379 | 379 | 379 | 379 | 379 |

Dependent variable is the number of reasoned opinions per member state and year for violations of articles 28, 30, 34, and 36 TFEU in all models. Robust standard errors (clustered on member states) are in parentheses. Year fixed effects are not reported, but included in all models. *p < 0.1, **p > 0.05, and ***p > .01 (two-tailed).

**Table 2: The Effects of the Euro on Different Infringement Measures**

| | (6) | (7) | (8) | (9) | (10) |
|---|---|---|---|---|---|
| | DG MARKT cases | Title 2 TFEU | Directory, chapter 13 | Title 2 TFEU, legal basis | Acquis |
| *Import competition*$_{i,t-1}$ | 0.7774*** | 1.6678*** | 0.1764* | 1.4529*** | 0.5653*** |
| | (0.210) | (0.363) | (0.103) | (0.333) | (0.091) |
| *Euro*$_{i,t-1}$ | 0.3635*** | 0.5452*** | 0.3570*** | 0.4498*** | 0.4244*** |
| | (0.026) | (0.122) | (0.026) | (0.114) | (0.099) |
| *Import comp.*$_{i,t\,1}$ * *Euro*$_{i,t-1}$ | 0.0472*** | 0.0387*** | 0.0034* | 0.0385*** | 0.0393*** |
| | (0.007) | (0.009) | (0.002) | (0.008) | (0.012) |
| *GDP*$_{i,t-1}$ | 0.0095 | 0.5574*** | 0.0172 | 0.5985*** | 0.0215 |
| | (0.024) | (0.118) | (0.025) | (0.100) | (0.151) |
| *GDP per capita*$_{i,t-1}$ | -1.0521*** | -1.8958 | -0.8786*** | -2.0731* | -1.0865 |
| | (0.244) | (1.208) | (0.263) | (1.146) | (1.601) |
| *Shapley Shubik index*$_{i,t-1}$ | 0.0111*** | 0.0246** | 0.0105*** | 0.0142 | 0.0235 |
| | (0.002) | (0.012) | (0.003) | (0.011) | (0.016) |
| *Bureaucratic quality*$_{i,t-1}$ | -0.0008 | -0.1383*** | -0.0016 | -0.1417*** | -0.0497 |
| | (0.009) | (0.045) | (0.010) | (0.042) | (0.060) |
| *Access Points*$_{i,t-1}$ | 0.0127*** | 0.0077 | 0.0141*** | 0.0030 | 0.0042 |
| | (0.003) | (0.014) | (0.003) | (0.014) | (0.019) |
| *Constant* | 4.2891*** | 2.3680*** | 4.5407*** | 2.0319** | -2.2528** |
| | (0.117) | (0.848) | (0.182) | (0.804) | (1.131) |
| *Ln alpha* | -17.6379 | -3.0631*** | -19.6767 | -2.9821*** | -26.9029 |
| | (272.773) | (0.851) | (399.949) | (0.755) | (0.000) |
| *Pseudo r2* | 0.17 | 0.14 | 0.17 | 0.14 | 0.11 |
| *Observations* | 379 | 379 | 379 | 379 | 379 |

Dependent variables are the number of reasoned opinions per member state and year. Robust standard errors (clustered on member states) are in parentheses. Year fixed effects are not reported, but included in all models. *$p$ < 0.1, **$p$ > 0.05, and ***$p$ > .01 (two-tailed).

The effects of the control variables are overall as expected. Power, as measured by GDP and the Shapley Shubik index, increases the number of violation, while capacity, as captured by GDP per capita and bureaucratic quality, helps to avoid them. However, this effect varies a bit depending on the operationalization of the response variable. In Table 8 we can see that all the controls have the correct algebraic sign, but none of the coefficients is statistically significant in all models 6-10. On the other hand, my own hypothesis seems to work not only for violations of articles 28, 30, 34, and 36 TFEU, but for all variants of infringements. Eurozone member states do not seem to discriminate between different types of European law when they engage in non-compliance in response to import competition. While import-competing industries certainly demand violations of the core free trade articles, they also benefit from infringements on a wider range of single market and trade-related legal acts.

## Conclusion and Outlook

This paper contributes to our understanding of politico-economic processes that can distort the benefits from economically efficient institutions or policies. I have analyzed how the interplay between domestic interests and European institutions create incentives for the governments of European Union member states to violate EU law and to resist pressure by the European Commission and the ECJ to (re)establish compliance. I have argued that EMU might not have leveled the playing field for companies and businesses in Europe, but put Eurozone governments in a position where infringements on European legislation are their only policy option if they want or need to protect the losers of monetary integration. As import-competing producers are no longer protected from foreign competition by currency risk and transaction costs and as governments no

longer having legal monetary policy instruments at their disposal, they turn to violations of articles 28, 30, 34, and 36 TFEU and other EU laws as a policy tool.

Putting these claims to the empirical test, I find strong support for the argument. Not only do import penetration and Eurozone membership go hand in hand with less compliance, but the hypothesized positive conditional effect of monetary integration and import penetration is supported by the data. Higher import penetration increases the provision of non-compliance particularly among the Euro countries. Eurozone governments are significantly more likely to engage in violations of treaty provisions on the free movement of goods in times of excessive import penetration than their non-Eurozone counterparts. When their hands are bound by the firm institutional framework of the EU, governments substitute no longer available legal economic policy instruments with infringements on EU law. They (ab)use the EU's enforcement mechanism as a flexibility provision that grants them temporary relief from the twin pressures of economic crisis and an ever closer-woven corset of European laws and institutions (cf. Rosendorff and Milner 2001).

Despite the clear findings, it is not so clear what the implications of the analysis are for the EU institutions and governance. I would be going too far if I argued that currency union and steps towards deeper European integration are doomed to lead to more violations of EU law and higher protective walls among their members. However, it is also clear that creating a single currency, harmonizing the laws of EU member states, signing and ratifying new treaties, etc. are not a magic bullet to take rent-seeking interest groups, myopic policies, and office-seeking politicians with short time horizons out of European politics and out of the domestic politics of EU member states.

Integration does not suspend the domestic policy process, but it is an institutional change that affects "equilibrium policies *by endogenously changing the shape of the political-support function*" (Grossman and Helpman 2002: 113, emphasis in the original).

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