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**Neo-Functionalism Reassessed: Suggesting a Synthesis of European  
Integration Theory**

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# **Neo-Functionalism Reassessed: Suggesting a Synthesis of European Integration Theory**

## ***Abstract***

*How are we to understand processes of European integration? There are a number of theories that attempt to shed-light on the integration process each considering that a particular variant of social existence provides the best means of interpretation. Intergovernmentalism proposes that the only way to understand European integration is through the actions of nation-states. Neo-functionalism emphasises the role of sectors and sub-national actors in the international economy and the extent to which a supranational authority would engender economic benefit and political acceptance of the process. Consequently, these factors add impetus to further integration in other sectors until a single economy emerges. Indeed, these general theories provide the basis for two models of governance at the European Union (EU) level. State-centricism adheres to intergovernmental understandings of European integration and multilevel governance elements of both neo-functional and intergovernmental propositions. Through a study of the insurance industry this paper investigates the extent of sector involvement in EU decision-making and in doing so, analyses the utilisation of sub-national actors, supranationality and spillover in the process of European integration.*

## *Introduction*

This paper explores whether the intergovernmental approach and state-centric governance are able to fully explain European integration. Because of the historical changes during the 1980s and 1990s this paper argues that if European integration is to be fully understood a reassessment of neo-functionalism is necessary.

In the aftermath of the Single European Act (SEA), the Single European Market (SEM) and the initiation of Economic and Monetary Union (EMU), it became evident that financial service industries needed to involve themselves in the creation of the European Union (EU). Consequently, through an empirical study of the European insurance industry this paper investigates the extent of sector involvement in the European decision-making process, and in doing so, analyses neo-functionalism intergovernmentalism, state-centric and multilevel governance. The empirical study incorporates an interview programme with individuals involved in the creation of insurance legislation (these include, interest group representatives, Commission representatives, Permanent Representatives and national officials). Through the interviews a model is constructed and a generalisation relating to spillover is posited.

## *Theories of European Integration*

During the 1960s neo-functionalism and intergovernmentalism were the two main contending European integration theories and by the 1970s it seemed that intergovernmentalism provided the most appropriate interpretation. However, the 1980s and 1990s saw a resurgence in European integration and this paper argues that because of the renewed effort to create a European common market, attention needed to be turned toward neo-functionalism. “The Single European Act led to a revival of neo-functionalist explanations . . .” with regard to European integration (George, 1994; p 1). Indeed, some

considered that the abandonment of neo-functionalism “. . . left the study of European integration in a theoretical void . . . however, neo-functional concepts are again appearing in the writings of some EC-specialists” (Tranholme-Mikkelsen, 1991; p 2).

Pederson (1992) argued that intergovernmentalism should be combined with elements of neo-functionalism to enable a new framework of analysis. Keohane and Hoffman (1990; 1991) emphasised the pooling of sovereignty rather than its transference from the Member States to supranational institutions. A firmer intergovernmental stance was taken by Moravcsik (1991; 1993) whose analysis of the SEA considered that the dynamics of European integration resides with the Member States alone. A more neo-functional perspective (omitting spillover) is taken by Sandholtz and Zysman (1989) who contended that three groups reshaped the EU: industrial elites (sub-national actors), EU institutions (supranationality) and Member State governments (intergovernmentalism). Furthermore, Sandholtz (1994) investigates why Member States were prepared to give up their currencies and the sovereignty this entails. He contended that membership of the EU defines preference parameters and decisions. That intergovernmentalism alone failed to explain the impact that membership of the EU had on Member State preferences, interests and demands.

Kirchner (1992) argued that neither neo-functionalism nor intergovernmentalism adequately captured “. . . the existing overlap in decision-making between national and Community authorities, the sharing of joint tasks and interests, and the fusion of competencies between the national and Community level” (p 35). Indeed, if European integration was to be fully understood a combination of approaches was necessary. This is a theme that has also been posited by Garrett and Tsebelis (1996), Gehring (1996), George (1994; 1995), Richardson (1996), Tranholme-Mikkelsen (1991), Ugur (1997). Fundamentally, the practicalities of being involved in the EU and the theoretical literature identify that intergovernmentalism alone is no longer an adequate explanation of

European integration. This paper undertakes an empirical analysis to determine the validity of this claim.

*Intergovernmentalism, State-Centricism and European Integration*

Moravcsik (1991) denied neo-functionalism and argued that the primary source of European integration resided with the Member States and the influence they wield in Brussels. In a later work he took this argument further and attempted to illustrate the limitations of neo-functionalism by presenting a theory of liberal intergovernmentalism (Moravcsik, 1993).

Garrett and Tsebelis (1996) argued that intergovernmentalism “. . . tended to focus on the bargaining between national governments over the outcome of treaty negotiations. The epochs that treaties demarcate are considered a function of governments’ preferences and their ability to further those preferences in inter-state bargaining” (p 269). Following the SEA and Qualified Majority Voting (QMV) intergovernmentalists started to look at the mechanics of EU decision-making. However, analysis concentrated on the Council of Ministers and most studies that “. . . focus exclusively on dynamics within the Council of Ministers are likely to misperceive most policy dynamics” (ibid p 293). There are two main problems with the intergovernmental approach: first, an analysis of treaty bargaining only scratches the surface of the process of European integration; secondly, it considers that all decisions are created and made in the Council of Ministers. Both of these problems stem from intergovernmentalism's fundamental premise that “. . . all decisions are products of bargaining among nations” (ibid, p 294).

Intergovernmentalism underpins the state-centric model. This argues that the “. . . overall direction of policy making is consistent with state control” (Hooghe and Marks, 1997; p 22). Furthermore, “(s)tate-centrists contend that EU membership preserves or even strengthens state sovereignty and that European integration is driven by bargains among

member-state governments” (ibid, p 21). However, if the state-centric model is the dominant means of decision-making in the EU, three conditions would need to hold: Member State representatives in the Council of Ministers should be able to impose their understandings and preferences on other European institutions; Member States should always be sovereign in relation to the EU; Member States should be able to control sub-national interests (Hooghe and Marks, 1997).

### *Neo-functionalism , Multi-Level Governance and European Integration*

Haas (1958) provided an outline of neo-functionalism. Political parties and interest groups accept that action should be taken at the supranational level. Interest groups and political parties organise and function beyond the nation-state and define their interests in the new environment. Interest groups and political parties through their interaction sow the seeds of ideological agreement which overtake those based at the national level. There is an adherence to the rule of law by the parties involved and when decisions are opposed dissatisfactions are channelled through legal avenues rather than through aggression or ignoring the situation. Fundamentally Haas provides an analysis of the process and progression of European integration through supranationality, sub-national actors and spillover. For further discussions relating to neo-functionalism, intergovernmentalism and European integration see George (1994, 1995); Haas (1958, 1964, 1968, 1971, 1975, 1976); Heathcote (1966); Keohane and Nye (1990); Keohane and Hoffman (1990, 1991); Lindberg (1963 1967); Lindberg and Scheingold (1970, 1971); Nye (1971); Sandholtz and Zysman (1989); Sandholtz, (1994); Puchalla (1972); Rees (1992); Tranholme-Mikkelsen (1991); Wallace (1990).

Petersen (1995) considered that “. . . the gap remains wide between theoretical models which seek to explain broad patterns of European integration and those which seek to explain the EU's policy-making process” (p 69) However, the debate has turned toward



governance through the arguments initiated by Keohane and Hoffman (1991), Marks (1993), Marks (1995) and Marks *et al* (1996; 1996a).

Hooghe and Marks (1997) link neo-functionalism (through supranational and sub-national actors) to multilevel governance and intergovernmentalism to state-centric governance. They conclude that the state-centric approach is not able of to fully explain European policy making processes; that EU decision-making and policy-making are of a multilevel nature. Multi-level governance recognises the role played by Member States in the decision-making process but argues that elements of control have been passed over to supranational institutions. However, if the multilevel governance model is to be accepted a number of premises must hold. Initially the main supranational institutions (European Parliament and the Commission) should share authority with the Council of Ministers. Secondly, individual Member State executives should be unable to continually stamp their authority on collective decision-making. And finally “. . . that sub-national interests mobilise directly in the European arena” (ibid, p 24).

#### *Supranationality, and Sub-National Actors*

Haas (1958) outlined his concept of supranationality and argued that sub-national actors “. . . in several distinct national settings are persuaded to shift their loyalties, expectations and political activities toward a new centre, whose institutions possess or demand jurisdiction over the pre-existing national states” (p 16). Heathcote (1966) identified supranationality as “. . . an academic notion-predicted rather than experienced, and to be arrived at after a process of evolution” (p 162). Supranationality affects the process of decision-making as it evolves.

Supranationality is not the antithesis of intergovernmentalism, but “. . . a cumulative pattern of accommodation in which the participants refrain from unconditionally vetoing and instead seek to attain agreement by means of compromises upgrading common

interests”(Haas, 1964a; pp 64-66). Indeed, structurally it encompassed “. . . the existence of governmental authorities closer to the archetype of federation than any past international organisation but not yet identical with it” (Haas, 1958; p 59). What it will become is unclear. Supranationality is a process rather than an end and this may be identified by the on going accumulation of European treaties and their integrative affects. This paper considers that supranationality has two levels of epistemology; on the one hand, it is material in that it is the decision-making institutions in existence at a given time; while on the other, it is part of the abstract process of European integration.

### *Sub-National Actors and Supranationality: An Empirical Inquiry*

To identify whether interactions between supranational institutions and sub-national actors exist a series of interviews were undertaken with individuals involved in EU decision-making regarding insurance legislation. The interviews at the both the EU and UK level provide information that may allow the work to deduce a similar process among most Member States.

The individuals interviewed were representatives from the following institutions.

*Directorate-Generale XV (DG XV) (Finance).*

*The Council Permanent Representative for UK in Finance.*

*The Department of Industry and Trade (DTI).*

*Committee for European Assurance (CEA). Paris and Brussels.*

*Bureau International des Producteurs d'Assurance & de Reassurance (BIPAR).*

*Association of British Insurers (ABI).*

*British Insurers International Committee (BIIC)*

*Irish Insurance Federation (IIF).*

*Council Permanent Representative for France in Finance.*

The interviews were conducted on a semi-formal basis and centred around 12 core questions, these were:

*(1) What are the major functions of the CEA/BIPAR/ABI/the Commission/the Council/National Supervisors and how do these fit with each other at;*

*(A) The EU level.*

*(B) The national level.*

*(2) To what extent are decisions made with interest group/COREPER/Commission/National Supervisor in-put.*

*(3) Is it interest groups, national supervisors, the Council of Ministers or the Commission that define decision parameters.*

*(4) Does the Council, the Commission, national legislatures and interest groups reach a compromise prior to a decision reaching the Council.*

*(5) Does an interaction exist between the Council/the Commission/national supervisors and specific interest groups at a national and European level.*

*(6) How does the Council/national supervisor know what to insist upon in respect of national interest.*

*(7) Does an interaction exist between interest groups/Commission/Council/national supervisor and the Insurance Committee*

*(8) Are different Member States looking for specific types of life insurance regulatory environments for the SEM which is different from other member states.*

*(9) Are there differences between the;*

*(a) The French ideal*

*(b) The German ideal*

*(c) The Dutch ideal*

*(d) The UK ideal*

*(e) The Italian ideal*

*Please illustrate these differences.*

*How does your market ideal fit into these?*

*(10) Is a compromise reached between the different national interest groups prior to the Commission initially drawing up draft legislation or is there an interaction between the interest group at the European level and the Commission which takes into consideration a compromise reached by the member state interest groups i.e. ABI through membership of the European interest group CEA/BIPAR.*

*(11) Where possible have compromises been reached between the Council, the Commission and Parliament before the final negotiations to enable a more efficient means of decision-making?*

*(12) What takes precedence in the formulation of a Directive Member State or sector interests?*

### *The Interview Results*

In general, the interviewees acknowledged that many influences went into the drafting of a directive. Since 1988, interaction between industries and the Commission had become more routine. The representative of DG XV considered that ongoing contact with the insurance industry was imperative to legislative input. Most importantly, the interviews illustrate the interactory procedures at work within the creation of legislation and the extent interest groups were used in the process. An understanding of the interviews is illustrated in the Decision-Making Model (see Fig One).

At the European level, there is an interaction between the interests of the different Member State industries and the interests of the European institutions. The interviews indicated that a compromise is reached at the European interest group level through the industries interacting both with one another and with the Commission and Parliament. The proposed legislation that goes through to the Council has been agreed by the Member State sectors/industries who either progressively or subsequently inform their own government of the agreed legislation. This indicates elements of neo-functionalism and a multilevel governance approach. However, during the process there may be

disagreements between the Council and the other institutions. This identifies an interaction between neo-functionalism and intergovernmentalism and provides an example of multilevel rather than state-centric governance.

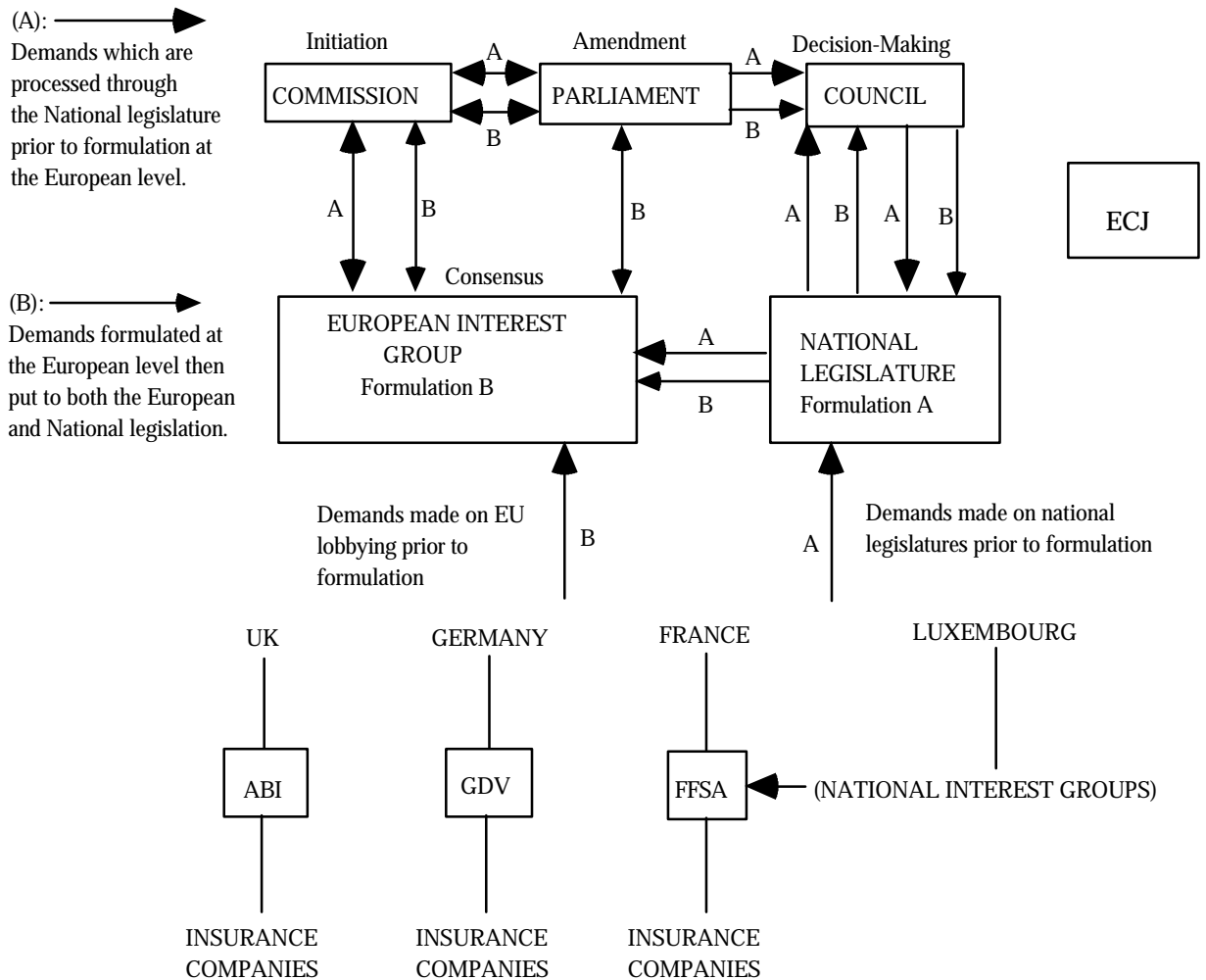
Once the draft legislation is in the realms of the Council, certain agreements may be disposed of, this highlights intergovernmentalism and the state-centric approach. However, it was expected that the main tenets of the legislation would become law because the national sectors/industries would have compromised their positions at an earlier stage (neo-functionalism). Consequently, one would have expected them to lobby their government to accept the proposed legislation (intergovernmentalism/neo-functionalism).

#### *The European Decision-Making Model*

There are a number of issues that need to be explained regarding the model. First, the interviews indicated that national interest groups were affiliated to interest groups at the EU level (mainly the CEA and BIPAR). Secondly, in the formulation of legislation (although Member State interest groups may approach the European institutions), the Commission and European Parliament preferred to deal with European interest groups. These provide a European overview of the situation. Thirdly, because the sector understands what is necessary for the successful operation of the embryonic regulatory environment, it is reasonable that they would confer and reach some agreement prior to Council or intergovernmental interference. Finally, the interviews with the CEA, the ABI, the BIIC and members of EU decision-making institutions substantiated that Member State insurance industries, through interest groups, actively participate in the formulation of EU legislation.

**FIG 1**

**THE EUROPEAN DECISION-MAKING MODEL**



There are two general directions that could be taken regarding decision-making procedures identified on the model (see Fig One). These are indicated by arrows A and B; process A considers that demands are formulated through the national legislature prior to formulation at the EU level, whereas route B illustrates demand formulation being compromised at the EU level prior to the involvement of the national legislature. Route A identifies a more cogent intergovernmental approach whereas route B illustrates more of a neo-functional process. Of course, the situation is not as clear-cut as depicted and elements of both routes were in use, but in general the interviews emphasised route B.

Furthermore, the European interest group rarely had any dealings with the national legislature and interaction between the two was undertaken between the national interest group and the national governmental departments (the DTI in the UK). At this point there is intergovernmental involvement but in most cases the DTI adheres to compromises already made at the European interest group level. More importantly, there is intergovernmental involvement through the Council. However, since the establishment of the SEA and Maastricht, in certain areas, this has diminished.

### *Spillover*

Another central idea to the concept of neo-functionalism is spillover. This is where integration in one industry/sector creates its own impetus and necessitates further integration both in the same, and in other industries/sectors. “Specifically, the term spillover describes the accretion of new powers and tasks to a central institutional structure, based on changing demands and the expectation on the part of such political actors as interest groups, political parties and bureaucracies” (Haas, cited in Kirchner, 1976; p 3). Effectively, there is an interplay between spillover and supranationality in that the “. . . establishment of supranational institutions designed to deal with functionally specific tasks will set in motion economic, social and political processes which generate pressures towards further integration” (Tranholm-Mikkelsen, 1991; p 4).

With the intensification of the integration process in Europe, the spillover process and the supranational composition of the EU is more identifiable than ever. Helen Wallace (1990) considers that due to the internal market programme, “. . . the neo-functionalist concept of spillover is now being vindicated” (p 219).

Spillover is the means by which European integration is achieved. It is where cooperation in one sphere spills into another. Legislation in one sector creates the need for legislation in other sectors and/or further legislation in different areas of the same sector.

In this context, the establishment of a SEM was not an end in itself but a stage in the spillover process. However, the extent to which changing incentives created by spillover allowed an explanation for European integration has been a point of contention. Nye (1971) argued that the functional linkage of tasks has been a less dynamic aspect of European integration than was originally believed to be the case. Indeed, Lindberg and Scheingold (1970) wished to deny that spillover led to the Common Market. Keohane and Hoffman (1990) provide a more sophisticated understanding of 'spillover' one that interacts between domains and sectors<sup>1</sup>. They argue that successful spillover necessitates prior agreements among Member States in terms of the SEA and the Maastricht Treaty etc.

#### *Spillover, Financial Services and European Integration*

This next stage of this paper argues that through the above understanding of the EU decision-making process spillover is identifiable in European integration. It generalises the processes identified by the interviews and extends the model and its theoretical implications. Usually, a qualitative analysis generalises from one situation to another similar situation, rather than from a sample population to the total population. Consequently, this paper posits that, the process taking place regarding insurance is likely to be happening from industry to industry and from sector to sector (Glaser and Strauss, 1967; Glaser, 1978; Charmaz, 1983; Strauss, 1987; Strauss and Corbin, 1990; Corbin and Strauss, 1990; Glaser, 1992; Strauss and Corbin, 1994). Indeed, these methodologists consider that substantive theory may be constructed in relation to pre-existing formal theories. Moving from descriptive theory to abstract theory through ever denser data and logical generalisation.

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<sup>1</sup> The difference between domains and sectors could be perceived as the difference between intergovernmental spillover (domain) and neo-functional spillover (sector). This paper attempts takes this idea further by considering intergovernmental spillover and different forms of neo-functional spillover.



Industries and sectors are isolated entities concerned with their own situation in the wider market place. However, it is through this self interest that they must be aware of what is happening in other industries and sectors this in turn makes them initiators and reactors to the actions of other industries and sectors. Sectors and industries need to involve themselves in the European integration process. They need to ensure their competitive advantage and this means participating in the European decision-making process. Fundamentally, they are the instigators of changes in legislation in both their own and similar industries/sectors. Indeed, on occasion they pressure their Member State governments to bring about new treaties.

There are two main understandings of spillover outlined in this paper:

(a) Spillover occurs because of the impact it has on differentiated actors, including multinationals, interest groupings, the Commission and national organisations. These actors form coalitions to increase EU decision-making in new sectors and enhance integration in sectors where agreements have already been reached.

(b) Spillover is a result of past policies created by Member States. They remain central to the integration process and continue to make crucial policy decisions in the EU. (Member States remain central actors but they are dictated to by past actions).

It is possible to build on the above definitions of spillover and devise a model to illustrate how it is at work in the process of European integration. Spillover may be observed in legislation specific to the insurance industry (vertical neo-functional spillover); between legislation in the services sector e.g. between insurance, banking, pensions etc. (horizontal specific neo-functional spillover); and between sectors e.g. services and capital (horizontal general neo-functional spillover). The paper also recognises that an intergovernmental process of spillover is at work within European integration in the guise of the treaties and their outcomes. Indeed, “. . . spillover requires

prior programmatic agreement among governments, expressed in an intergovernmental bargain. Such a bargain is clearly important in accounting for the Single European Act” (Keohane and Hoffman, 1991; p 17). This is spillover from treaty to treaty which may be labelled intergovernmental spillover and is indicated by definition (b) above. However, wider transnational processes are also providing an impetus for European integration. In this context, the paper contends that intergovernmental spillover is usually confined to providing the environment for further neo-functional spillover (vertical or horizontal) to take place. This is illustrated by definition (a) above. Fundamentally, one may posit, that there is an interaction between neo-functional and intergovernmental spillover which enhances and deepens European integration.

The Spillover Model (Figs Two and Three) outlines the above interactions: intergovernmental spillover is indicated in the left hand column and is made up of intergovernmental agreements and neo-functional spillover is illustrated on the right hand side of the model. As explained above, neo-functional spillover constitutes three processes and the figures attempt to clarify two of these. The crosses on the model represent pieces of legislation that have been passed in relation to the treaties that existed at that time e.g. X1 relates to the Reinsurance Directive and X2 the Co-insurance Directive etc.

The liberalisation of insurance, banking and capital markets is tied closely to the free movements of capital. Indeed, the treaties designate that the liberalisation of the banking and insurance sectors “. . . shall be effected in step with the progressive liberalisation of the movement of capital” (HMSO, 1988; Art 61). This article could be seen as intergovernmental spillover which provides an opportunity for general horizontal neo-functional spillover (sector to sector or services to capital) and specific horizontal neo-functional spillover (industry to industry or banking to insurance) and vertical spillover (within the same industry i.e. insurance). This could be seen as an

example of intergovernmental spillover providing the initial impetus for further neo-functional spillover.

**FIG 2**

Intergovernmental Spillover	NEO-FUNCTIONAL SPILLOVER VERTICAL SPILLOVER (WITHIN SAME INDUSTRY)
EPU ?	
EMU            1999	
SEM            1992	
SEA/QMV      1987	
Direct Elections    1979	
EEC/Euratom    1957	
ECSC            1951	
INSURANCE	

**Neo-Functional Spillover. Vertical Spillover (Within Same Industry)**

- X1. Re-insurance Directive 64/225/EEC
- X2. Co-insurance Directive 78/473/EEC
- X3. First Life Insurance Directive. 79/267/EEC
- X4. Second Life Insurance Directive. 90/ 619/EEC
- X5. Third Life Insurance Directive. 92/96/EEC
- X6. First Non-Life Insurance Directive. 73/239/EEC

X7. Second Non-Life Insurance Directive. 88/357/EEC

X8. Third Non-Life Insurance Directive. 92/49/EEC

**FIG 3**

Intergovernmental Spillover	NEO-FUNCTIONAL SPILLOVER HORIZONTAL SPECIFIC SPILLOVER (INDUSTRY TO INDUSTRY (WITHIN SAME SECTOR))		
EPU ?			
EMU 1999			
SEM 1992			
SEA/QMV 1987			
Direct Elections 1979			
EEC/Euratom 1957			
ECSC 1951	INSURANCE	BANKING	PENSIONS

**Horizontal Specific Spillover (Industry to Industry Within the Same Sector)**

X1. Re-insurance Directive 64/225/EEC

X2. Co-insurance Directive 78/473/EEC

X3. First Life Insurance Directive. 79/267/EEC

X4. Second Life Insurance Directive. 90/ 619/EEC

- X5. Third Life Insurance Directive. 92/96/EEC
- X6. First Non-Life Insurance Directive. 73/239/EEC
- X7. Second Non-Life Insurance Directive. 88/357/EEC
- X8. Third Non-Life Insurance Directive. 92/49/EEC
- X9. First Banking Directive. 77/780/EEC
- X10. Second Banking Directive. 89/646/EEC
- X11. Capital Adequacy Directive. 93/6/EEC
- X12. Solvency Ratio Directive. 94/7/EEC
- X13. Accounts Directive for Banks and Other Credit Institutions. 86/635/EEC
- X14. Directive Concerning Equal Treatment for Men and Women in Occupational Social Security Schemes. 86/378/EEC
- X15. Directive Concerning the Rights of Residence for Self-Employed Persons Who have Ceased Occupational Activity. 90/365/EEC

### *European Insurance Legislation*

Insurance legislation is an example of vertical neo-functional spillover or spillover within the same industry. Initially, there were two general programmes proposed to ensure that both the freedom of services and establishment would be realised in life insurance by the beginning of 1970. This was indicated through five main bi-annual target dates.

1964 Reinsurance. Freedom of establishment and services.

1966 Indemnity insurance. Freedom of establishment.

1968 Life insurance. Freedom of establishment.

1968 Indemnity insurance. Freedom of services.

1970 Life insurance. Freedom of services.

As may be observed, life insurance was to be harmonised in two stages which would have corresponded with the initial plans for EMU. However, international and internal pressures had not demanded intergovernmental spillover and the necessary environment for adherence to the above timetable. This gradually changed and because of international and Member State competitive pressures, between the 1970s and 1990s, the environment was transformed. During the 1970s mutual trust between Member States kept the harmonisation of substantive law to a minimum. The 1980s realised the SEA, QMV and

co-operation procedure and the 1990s witnessed co-decision procedure the Maastricht Treaty and EMU. Indeed, during the 1980s and 1990s intergovernmental spillover provided the environment for the successful completion of the above programmes (see Fig 2 X1 to X8).

In its proposal for a the Third Life Assurance Directive, the Commission emphasised that “. . . the internal market in insurance represents a primary goal . . . in view of the importance of this strongly expanding sector”<sup>2</sup>. The insurance industry considered that it needed priority treatment because it lagged behind the liberalisation of the other economic sectors within the financial services sector (omitting pensions). Directives in securities and banking had already been implemented and as a consequence the insurance industry had been left at a competitive disadvantage in relation to these industries. Indeed, an example of horizontal specific neo-functional spillover (within the same sector; banking to insurance) and with regard to the capital aspects of the legislation, horizontal general neo-functional spillover (from sector to sector; services to capital).

In terms of vertical neo-functional spillover, the adopted insurance directives have taken form in three generations dating from the early 1970s: these are briefly overviewed below. Directives concentrating on more specific areas include the Council directive on measures to facilitate the effective exercise of freedom of establishment and freedom to provide services in respect of the activities of insurance agents and brokers (ex ISIC group 630) and in particular, transitional measures in respect of these activities (77/92/EEC)<sup>3</sup>. Further directives providing the infra-structure for the second generation included the Co-Insurance Directive (78/473/EEC)<sup>4</sup>, the Credit and Suretyship Assurance Directive amending Directive (87/343/EEC)<sup>5</sup>, and the Legal Expenses Directive

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<sup>2</sup> Com 91 57 final SYN 329 p 2

<sup>3</sup> OJ L 26, 31/06/77

<sup>4</sup> OJ L 151, 07/06/84

<sup>5</sup> OJ L 185, 04/07/87

(87/344/EEC)<sup>6</sup>. The infra-structure directives for the third generation include the Council Directive on the Annual Accounts and Consolidated Accounts of Insurance Undertakings (91/674/EEC)<sup>7</sup> and the Council Directive setting up an Insurance Committee (91/675/EEC)<sup>8</sup>. The former of these Directive (91/674/EEC) proposed the harmonisation of EU insurance accounting practices which is necessary if valuation and solvency indicators are to be uniform. Indeed, such is necessary if an integrated capital market is to be achieved. And Directive (91/675/EEC) provided a committee to act as an intermediary between the industry (sub-national actors) and the Commission and to assist in implementation procedures. The committee also examines any questions relating to the application of existing directives and the preparation of new legislation proposals in the insurance sector. Indeed, this could be seen as an example of spillover and supranationality interacting with each other (Kirchner, 1976; Tranholm-Mikkelsen, 1991).

### *The Life Assurance Directives*

As indicated above, the life assurance directives illustrate specific neo-functional spillover (this is spillovers most recognisable form) with each generation creating the need for the next. However, each generation also created the need for further legislation, both in other areas of insurance and financial services. The first generation of directives allowed for the freedom of establishment as long as conditions of contracts and tariffs were approved by the Member State in which the company wished to establish. The First Life Assurance Directive dealt with the need for licensing and the means by which an insurance establishment would be approved and standardised. Additionally, the supervisory responsibility in respect of establishment competence was transferred to the Member State where the principal place of business was situated. However, there was

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<sup>6</sup> OJ L185, 04/07/87

<sup>7</sup> OJ L 374, 31/12/91

<sup>8</sup> OJ L 374/31/91

little legislation regarding freedom of services in this directive and this is what the industry wanted.

The Second Life Assurance Directive (90/619/EEC)<sup>9</sup> provided the means for cross-border business and outlined the active and passive provisions of services. The directive takes the consumer as its starting point and provides for free movement through two regulations. If policy-holders approach an insurer from another Member State, the legislation of the Member State where the insurer has its majority of business applies. However, if the insurer attempts to persuade the policy-holder to take out a policy, the legislative code of the Member State in which the insurer performs a service applies. This aggravated cross-border trade in life insurance and necessitated further harmonisation. This led to the Third Life Assurance Directive through elements of vertical neo-functional spillover.

The Third Life Assurance Directive (92/96/EEC)<sup>10</sup> was adopted on 10 November 1992 and implemented on 1 July 1994. It creates a uniform system of control in that insurers need only to be granted approval where they have their headquarters and control should be administered by their own Member State. It amends both former directives and specifically removes the passive/active clause from the Second Life Assurance Directive. In general terms, host Member State legislation only applies if it is considered to be for the general good - this incorporates the permitted application of host country rules where there is no duplication in the country. The general good should also be applied without national discrimination and proportionate to the objective being pursued.

In attempting to create a European market in insurance products further directives will be necessary and the bulk of Member State legislation harmonised. Each piece of legislation necessitated and created the basis of the next. This process has formed the basis of the

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<sup>9</sup> OJ L 330 29/11/90

<sup>10</sup> OJ L 360 09/12/92



SEM's regulatory structure in insurance and allows an illustration of vertical neo-functional spillover (see the Spillover Model Fig One X1 to X8)

### *European Banking Legislation*

The banking industry has been affected by two co-ordination directives. The First Banking Directive (77/780/EEC)<sup>11</sup> cleared most obstacles to the freedom of establishment for banks and other credit institutions, introduced home country supervision and a common position for the granting of banking licences. However, problems were still apparent and certain obstacles needed to be removed before a genuine single market in banking could be achieved but these were taken up in the Second Banking Directive (89/646/EEC)<sup>12</sup>. This could be considered as an example neo-functional vertical spillover in the banking industry. Indeed, the First Banking Directives led to calls from the insurance industry for a level playing field and the realisation of the first generation of insurance legislation (neo-functional horizontal specific spillover X9 to X6).

The Second Banking Directive aimed at the removal of authorisation problems i.e. 12 different supervisors, a definition of banking activities and cross-border trade. Consequently, the second directive enabled a single banking licence, a list of banking activities and minimum capital levels (5m ECU laid down for new banks). The directive also provided supervisory rules in terms of internal management, audit systems and the amount of control of major shareholders. As before this led to calls for further legislation regarding freedom of services for insurance and the realisation of the second and third generations of insurance directives. A further example of horizontal specific neo-functional spillover (X10 to X7 and X8).

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<sup>11</sup> OJ L 322 17/12/77

<sup>12</sup> OJ L 386 30/12/89

The Directive on Capital Adequacy of Investment Firms and Credit Institutions (CAD) provides the framework for the Investment Services Directive (ISD) (93/22/EEC)<sup>13</sup>. The Commission had been pressurised by investment firms to ensure a level playing field for investment firms and credit institutions. Indeed, the two directives provide an internal market in respect of investment services and give all institutions, whether credit institutions or investment firms, the ability to offer investment services throughout the EU. This had implications for European capital markets and illustrates both vertical and general horizontal neo-functional spillover (within the same industry and sector to sector or services to capital). In this context, the sectors are intrinsically linked.

In general, during the nineties, there have been numerous decisions made by the Commission and Council as well as further directives with regard to the banking sector. For instance, Council Directive (96/13/EC)<sup>14</sup> amends article 2 (2) of (77/780/EEC)<sup>15</sup> in respect of the list of permanent exclusions of certain credit institutions. Directive (96/10/EC)<sup>16</sup> amends directive (89/647/EEC)<sup>17</sup> regarding contractual netting by competent authorities; directives (95/15/EC)<sup>18</sup> and (94/7/EC)<sup>19</sup> amend the directive regarding solvency ratios. Effectively, the last directive in terms of banking that was not an amendment to a previous directive was (93/6/EC)<sup>20</sup> which covered both investment firms and credit institutions and subsequently both security markets and insurance as well. However, each piece of legislation builds on the previous and extends European integration.

Banking legislation and its consequent regulation spills over and necessitates legislation in other financial services industries and other sectors. The interaction between capital

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<sup>13</sup> OJ L 141 11/06/93

<sup>14</sup> OJ L 066 16/03/96

<sup>15</sup> OJ L 322 17/12/77

<sup>16</sup> OJ L 085 03/04/96

<sup>17</sup> OJ L 125 05/05/89

<sup>18</sup> OJ L 125 08/06/95

<sup>19</sup> OJ L 089 06/04/94

<sup>20</sup> OJ L 141 11/06/93

markets and banking and pensions and labour. may be considered examples of neo-functional horizontal general spillover; or spillover from sector to sector. The interaction between banking and insurance can be perceived as an illustration of neo-functional horizontal specific spillover; or spillover from industry to industry. Finally, vertical neo-functional spillover is illustrated by legislation in one area of the industry, e.g. insurance, creating the necessity for further legislation in the same area. The non-life insurance directives are, on the one hand, tied closely to the life insurance directives, while on the other, like their life insurance counterparts, they border banking and security services legislation. In this context, there has been task expansion throughout the sector and one may consider that this encompasses the above forms of spillover.

### *Conclusion*

The interviews illustrate that compromise is sought and achieved at the European interest group level through negotiations with the Commission and Parliament. Indeed, if the legislation is being negotiated by the industry through sub-national actors (interest groups) interacting with supranational institutions (EU decision-makers) the research has uncovered an example of neo-functionalism. If a compromise is not reached at the EU level, then each Member State industry would pursue its own ideal regulatory structure and compromise would be difficult if not impossible to achieve. In achieving successful acceptable legislation at the EU level, the interviews illustrate that both neo-functional and intergovernmental processes need to be at work. Fundamentally, in terms of the use of sub-national actors and supranationality, even if a total neo-functional process is not at work, it is at least a form of multilevel governance. In many cases supranational institutions share authority with the Council of Ministers. Individual Member State executives are unable to continually stamp their authority on collective decision-making and sub-national interests are active in European integration. However, in some instances Member State representatives in the Council of Ministers are able to impose their

understandings and preferences on other European institutions. Consequently, elements of the state-centric model do exist in the process of European integration.

As the interviews with the CEA, the ABI, the BIIC and members of EU decision-making institutions substantiated that Member State insurance industries actively participated in the creation of EU legislation through interest groups. The paper accepts the European Decision-Making Model and posits that through generalising this procedure a spillover process is identifiable in the EU regarding financial services legislation. If Member State industries/sectors need to be involved in the creation of European legislation in one context, other industries/sectors through their own self-interest are drawn into the process. This is identifiable in the interaction between the insurance and banking industries and the services and capital sectors. However, so as to allow neo-functional spillover to take place intergovernmental treaties must have ensured the necessary environment e.g. the SEA and the SEM and the Maastricht Treaty and EMU. The timing of the process is fundamental. Indeed, the need for further treaties may come from external (international competitiveness) or internal forces (industries/sectors). Of course, the motives of separate Member State governments when they involve themselves in the formulation of further intergovernmental spillover are difficult to identify. Indeed, this is an area for further research however, it is beyond the scope of this paper.

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