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THE BREXIT FIASCO AND THE FAILURE OF ARTICLE 50 OF THE TREATY ON THE FUNCTIONING OF THE EUROPEAN UNION

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ABSTRACT

Modern game theory and the economic theory of federalism may offer an alternative view on the Brexit fiasco, in which the British government should not bear exclusive responsibility for current disaster. Moreover, the design of Article 50 of the Treaty on the Functioning of the European Union (TFEU) contains an intrinsic dysfunctional mechanism that generates irrational strategies. Article 50 is underdeveloped and should be redrafted. The two-year deadline provision should be replaced with a reasonable time period and should provide for a third-party dispute resolution mechanism in instances where free negotiations between the EU and the withdrawing Member State in the reasonable time period fail to achieve a win-win solution. This article also argues that the current sub-optimal institutional framework on the vertical and horizontal division of competences might be an additional generator of Euroscepticism. In order to prevent the decline of public support the EU should do less in current fields and should do much more in fields where it failed to exercise its authority and which cannot be addressed effectively at the local levels. The EU should redesign itself as an

institution that mitigates broad potential sources of negative externalities, reinforcing the rule of law, protecting liberal democracy with all related civil liberties, reinforcing its political-global dimension, protecting its common cultural heritage, and combating destructive nationalisms, isolationisms and cultural introspections.

KEYWORDS

Brexit, game theory, Treaty on the Functioning of the European Union (TFEU), economics of federalism, optimal EU constitutional framework

INTRODUCTION

Brexit is definitely a disaster and the entire continent is wondering how this policy fiasco came about both for Britain and the EU. Current chaotic negotiations on the UK's exit from the EU, threats of retaliation, take-it-or-leave-it strategies and related uncertainty will have unprecedented effects on the entire continent and has unleashed a deep institutional crisis of the European Union. This institutional downfall, consequential impoverishment of EU institutional capacities, growing Euroscepticism and the rise of destructive nationalisms across the continent may indeed represent the beginning of a vicious cycle.

However, was the Brexit fiasco indeed such a surprising event? Or, should it instead be seen as the inevitable outcome of the long history of Britain's discontent with its membership and with the institutional structure of the EU? The issue of why the referendum occurred and produced the decision for Brexit has been extensively studied and has produced an impressive amount of scholarship. Wincott, Peterson and Convery, for example, provide a general explanation of the result and an assessment of political consequences of Brexit.¹ Thompson argues that the Brexit was clearly generated by the UK's position as a non-euro member while possessing the offshore financial centre of the euro-zone and UK's eschewal in 2004 of transition arrangements on freedom of movement for that year's accession states.² Hopkin views Brexit as part of a wide, new anti-system politics accumulating as an expression of social anxiety at the upheavals wrought by inadequately regulated markets.³ Moreover, Henderson, Jeffery, Wincott and Wyn Jones in their empirical investigation show that immigration concerns actually played a major role in the Brexit referendum, alongside a general willingness to take risks, right-wing views, older age, and English national identity.⁴ Boin, McConnell and t'Hart investigate EU political and policy impacts of framing contests,⁵ whereas Bovens and t'Hart,⁶ and Oppermann and Spencer⁷ explore debacles in the EU public policy and foreign policy. Richardson examines the key role of the EU itself in the creation of the current crisis

¹ Daniel Wincott, John Peterson, and Alan Convery, "Introduction: Studying Brexit's Causes and Consequences," *British Journal of Politics and International relations* 19:3 (2017).

² Helen Thompson, "Inevitability and Contingency: The Political Economy of Brexit," *British Journal of Politics and International relations* 19:3 (2017).

³ Jonathan Hopkin, "When Polanyi met Farage: Market Fundamentalism, Economic Nationalism, and Britain's Exit from the European Union," *British Journal of Politics and International Relations* 19:3 (2017).

⁴ Ailsa Henderson, Charlie Jeffery, Daniel Wincott, and Richard Wyn Jones, "How Brexit was made in England," *British Journal of Politics and International Relations* 19:4 (2017).

⁵ Arjen Boin, Allan McConnell, and Paul t'Hart, "Crisis exploitation: political and policy impacts of framing contests," *Journal of European Public Policy* 16:1 (2009).

⁶ Mark Bovens and Paul t'Hart, "Revisiting the study of policy failures," *Journal of European Public Policy* 23:5 (2016).

⁷ Kai Oppermann and Alexander Spencer, "Fiascos in Public Policy and Foreign Policy," *Journal of European Public Policy* 23:5 (2016).

within the EU.⁸ The construction of an EU policy-making state has run far ahead of what voters at the national level want, leading to a central paradox within the EU, namely that the European elite which runs the EU has introduced some very beneficial public policies, yet that elite has become increasingly out of touch with its peoples.⁹ In addition, Sampson discusses the economic consequences of Brexit and argues that Brexit will lead to significant losses of per capita income (on the both sides of the channel), and to new barriers to trade and migration between UK and the EU.¹⁰ Hix predicts that the most likely outcome – the equilibrium in the bargaining game between the UK and the EU27 – is a basic free trade agreement, mainly covering trade in goods with not much on trade in services.¹¹

This article joins this scholarly debate and attempts to show that game theory and the economics of federalism may provide an additional, insightful toolkit in structuring current discussion on the Brexit and related ruinous politicization of the EU. Modern game theory and the economic theory of federalism offer an alternative explanation of the causes of this crisis and might offer several substantive insights on the economic impacts of the Brexit for the future of the European Union. The Brexit vote should be seen as a call for a broad, wealth maximizing institutional reform of the EU. In other words, current EU institutional and constitutional structure, inefficient vertical allocation of competences and complete ignorance of the economic principles on the optimal interpretation of the subsidiarity principle might be one of the additional sources of current institutional breakdown and growing Euroscepticism.

The traditional literature shows that questions concerning centralization/harmonization cannot be answered in absolutely clear and unambiguous statements.¹² In addition, this paper suggests that the concept of the efficient allocation of rulemaking should also encompass potential negative externalities and market failures. In other words, the EU should not be viewed solely through the lens of a narrowly defined “efficiency” (as defined in traditional economics of federalism literature) but should be conceptualised as an institution that mitigates broad potential sources of negative externalities. In order to regain

⁸ Jeremy Richardson, “Brexit: The EU Policy-Making State Hits the Populist Buffers,” *Political Quarterly* 89:1 (2018).

⁹ *Ibid.*: 119.

¹⁰ Thomas Sampson, “Brexit: The Economics of International Disintegration,” *Journal of Economic Perspectives* 31:4 (2017).

¹¹ Simon Hix, “Brexit: Where is the EU-UK Relationship Heading?” *Journal of Common Market Studies* 56:4 (2018).

¹² See e.g. Charles M. Tiebout, “A Pure Theory of Local Expenditures,” *Journal of Political Economy* 64:5 (1956); Wallace E. Oates, *Fiscal federalism* (London: Harcourt Brace Jovanovich, 1972); Eli Noam, “The Choice of Governmental Level in Regulation,” *Kyklos* 35:2 (1982); Daniel Wincott, “Federalism and the European Union: The Scope and Limits of the Treaty of Maastricht,” *International Political Science Review* 17:4 (1996); Lee Miles and John Redmond, “Enlarging the European Union: The Erosion of Federalism?” *Cooperation and Conflict* 31:3 (1996); Roland Vaubel, “Principal-agent Problems in International Organizations,” *The Review of International Organisations* 1:2 (2006); and Philippe Pochet and Christophe Degryse, “Monetary union and the stakes for democracy and social policy,” *European Review of Labour and Research* 19:1 (2013).

public support the EU should do less in fields that currently represent the majority of its actions (and that can be achieved more effectively at national levels) and should do more in fields where it failed to exercise its authority and which cannot be addressed effectively at the local levels (e.g. protection of external borders).

Additionally, this paper argues that the current design of Article 50 of the Treaty on the Functioning of the European Union (TFEU), which treats withdrawal from the EU, contains unintended intrinsic incentive channels that generate a ruinous chicken-game situation between the UK and the EU, which leads to negotiation gridlock, destruction of wealth (minus-sum game) and the “everyone worse off” outcome.

Throughout this article, the analysis is as positive as it is normative. Moreover, the analytical approach combines game theory¹³ with the analytical methods and concepts used in the economics of federalism.¹⁴

However, several caveats should be stated. A first caveat relates to the limited research sample, which may present a limitation of the provided study. A second caveat concerns the scientific authority that should be attributed to the findings. Other unaddressed variables (e.g. political, sociological, behavioral factors), all sorts of spin-strategies and psychological channels, might have influenced current chaos and observed effects. Further investigation could reveal possible additional variables, and a broader sample of cases would have helped to clarify the issues investigated.

The first part of the article summarizes the main insights from game theory and provides a clear-cut game theoretical explanation on why the Brexit vote should not be seen as a surprising event. This part also offers a game-theoretical analysis of Article 50 of the TFEU. In the second part, the key concepts of the economics of federalism are presented. These include criteria for an optimal vertical division of competences and potential political real-life distortions that are influencing the current institutional structure of the EU. This part also argues that current scope of centralization in the EU is far beyond the optimal point and may be regarded as a source of current institutional crisis. Conclusions are then drawn as a means of summarizing and synthesizing the prior analyses.

1. GAME THEORY, THE YOU-QUIT-FIRST GAME, AND THE BREXIT OUTCOME

In many situations people decide on an action based in part how others are likely to act. In politics, business, legal and social interactions parties frequently take

¹³ See e.g. Avinash K. Dixit and Barry J. Nalebuff, *Thinking Strategically: The Competitive Edge in Business, Politics and Everyday Life* (New York: Norton, 1991).

¹⁴ See e.g. Richard A. Posner, *Economic Analysis of Law*, 8th ed. (Wolters Kluwer International, 2011); Jim Leitzel, *Concepts in Law and Economics: A Guide for the Curious* (Oxford: Oxford University Press, 2015); and Jonathan Klick, *The Law and Economics of Federalism* (Cheltenham: Edward Elgar, 2017).

into account the anticipated behaviour of others when making their decisions.¹⁵ Game theory deals with such situations.¹⁶ Modern game theory, now highly developed, is a general, analytical theory of rational choice in strategic interactions and provides a useful, flexible way to organize thinking about strategic decision making.¹⁷ It enhances our understanding of different types of rules and institutions and focuses on decision-making situations that are characterized by strategic interdependence which occur when the actor has to take this interdependence into account when making a rational choice.¹⁸ In order to be able to isolate specific aspects of human decision-making (and then perform formal analysis) it employs mathematical models that deliberately ignore the real-world variety of situations and focuses on the strategic behaviour among two or more parties.¹⁹ This strategic behaviour arises when two or more individuals interact and each individual's decision turns on what that individual expects the other individual to do.²⁰ Game theory, in its broad conceptualization, works by simplifying a given social situation and stepping back from the many details that are irrelevant to the problem at hand.²¹ A review of all of different types of the best known paradigms of game theory exceeds the scope of this paper and can be found elsewhere.²² However, two particular games are of the utmost significance – the so called “you quit first game” and “chicken game.” The “you quit first game” is instrumental in explaining the Brexit fiasco and current negotiations' gridlock.

1.1. THE CHICKEN GAME AND ARTICLE 50 OF THE TFEU: UNINTENDED EFFECTS AND CONSEQUENCES

Games between completely concurrent and completely opposed interests are called games with mixed motives.²³ These games model situations in which the interests in various ways partly concur and are partly opposed. Magen also emphasizes that the main feature of such coordination games is mixed equilibria that

¹⁵ Howell Jackson, Louis Kaplow, Steven Shavell, Kip Viscusi, and David Cope, *Analytical Methods for Lawyers*, 2nd ed. (New York: Foundation Press, 2010).

¹⁶ Thomas Schelling, *The Strategy of Conflict* (Cambridge: Harvard University Press, 1960).

¹⁷ See e.g. Avinash K. Dixit and Barry J. Nalebuff, *supra* note 13.

¹⁸ Stefan Magen, “Game theory and collective goods”: 61; in: Emanuel V. Towfigh and Niels Petersen, eds., *Economic Methods for Lawyers* (Cambridge: Edward Elgar, 2015).

¹⁹ Eric Rasmusen, *Games and Information: An Introduction to Game Theory*, 4th ed. (Victoria: Blackwell Publishing, 2007).

²⁰ Douglas G. Biard, Robert H. Gertner, and Randal C. Picker, *Game Theory and the Law* (Boston: Harvard University Press, 1994), 7.

²¹ Eric Rasmusen, *supra* note 19, 20.

²² See e.g. Steven Tadelis, *Game Theory: An Introduction* (Princeton University Press, 2013); Emanuel N. Barron, *Game Theory: An Introduction*, 2nd ed. (New Jersey: Wiley, 2013); Nolan McCarty, *Political Game Theory: An Introduction* (Cambridge: Cambridge University Press, 2014); and Stephen Schechter and Herbert Gintis, *Game Theory in Action: An Introduction to Classical and Evolutionary Models* (New Jersey: Princeton University Press, 2016).

²³ Stefan Magen, *supra* note 18: 74.

jeopardizes coordination and the entire interaction ends up with a result that is unfavourable both individually and collectively (i.e. coordination failure).²⁴ These problems become all the more urgent, the higher the losses are in the case of an escalation. In game theoretical literature such games are modelled with high negative payoffs and are qualified as so-called "chicken games."

In the original chicken game, two men have to drive towards each other at high speed. If, at any moment, one of them gets scared and goes to the right, he is the loser, the chicken. He loses respect, while the other one wins the admiration of the girls. If, however, both keep driving straight ahead, they crash and both lose a leg, arm, or even their lives.

In the "chicken games" which are now, during the Brexit negotiations, played among EU Commission and UK's government the strangest thing is that the biggest fool has the greatest chance to win. If, for example, UK's government can convince the EU that they are so crazy as to leave the EU without any agreement (and potentially sustain huge economic losses) anyway, then they will win. In such games, it is in a sense rational to behave, or at least to give the other party the impression that you are completely irrational.²⁵ Yet, such games are usually catastrophic ones. The outcome is in the best scenario a zero-sum solution (zero-sum game) and in the worst case it is a minus-sum outcome, which means that wealth is destroyed (minus-sum game) and everyone is worse off. The question is why a rational party would ever agree to play such a destructive game. The answer is that in the real world we do not always have free choice.

If one applies modern game theoretical insights to the current Article 50 of the Treaty on the Functioning of the European Union (hereinafter as TFEU)²⁶ it becomes evident that this provision contains an unintended intrinsic perverse incentive mechanism that generates a catastrophic chicken game situation between the UK and the EU. Article 50 of TFEU, paragraph one, states that "any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements." In paragraph three it also states that "the Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, *two years* after the notification.....unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period."²⁷ The two year deadline requirement that automatically triggers exclusion of a Member State that attempts to withdraw (unless the rest of MS

²⁴ *Ibid.*: 75.

²⁵ See e.g. Douglas G. Biard, Robert H. Gertner, and Randal C. Picker, *supra* note 20, 122; and Eric Rasmusen, *supra* note 19, 22.

²⁶ *Treaty on the Functioning of the European Union*, Official Journal C 326, 26/10/2012 P. 0001 – 0390.

²⁷ *Ibid.*, Article 50.

unanimously decide to extend it) might be a source of opportunism, a hold up problem, and a moral hazard. This final two-year deadline may actually destroy the balance between parties, creating a superior bargaining position for one party and shifting the negotiation position to the detriment of a weaker party (his bargaining position is weakened).

A party's negotiation position is determined by two elements. First, and most importantly, what happens when negotiations fail. The second element is related to time. As negotiations last longer, the opportunity costs of negotiating increase. These costs include all kind of economic losses, foregone opportunities (to contract with other parties), interest rates on capital, etc. These costs can also include the cost of destructive behaviour (i.e. the You Quit First game). As time goes by, the cooperation surplus may shrink, but not necessarily in a symmetrical way. Hence, the party that has the least to lose (and those are usually club members that remain in the club) is in the strongest, superior bargaining position (*ceteris paribus*) and can extract rents and unjustified gains.

The two-years-deadline requirement of Article 50 of the TFEU has three further backdrops. First is the fact that renegotiations are costly in time and effort. Second, in a mandatory renegotiation process a danger of the so called "hold up problem" occurs when one of the parties might enjoy an advantage over the other by taking that party for a ride in the renegotiation by demanding for example an unreasonable payment, acceptance of unreasonable concessions, or fulfilment of special conditions. Hence, the deadline contained in Article 50 might be open to criticism since it may open the doors to hold up problems, to different forms of extortions, moral hazard and might deter cooperation, and diminish certainty and over all good faith among parties. Third, instead of inducing, by creating a co-operation game in the withdrawal process the two-year deadline provision actually generates a non-cooperative environment that channels parties towards refusal to co-operate, where the optimal strategy to win the negotiations is completely irrational behaviour (or at least to give to the other party impression, that you are completely irrational). In such circumstances a co-operative scenario becomes highly unlikely and parties might in the end collude by refusing to cooperate (this might be as shown also the most rational strategy). Such an irrational strategy, induced by Article 50, might result in non-cooperative, destructive outcomes. Thus, Article 50 should be redrafted, should not contain the two-year deadline provision (could for example contain the reasonable time period) and should provide for a third-party dispute resolution mechanism (international court or arbitration) in instances where free negotiations between EU and the withdrawing MS in the reasonable time period fail to achieve a win-win solution.

In sum, Article 50 of the TFEU contains an unintended intrinsic incentive mechanism that generates a devastating chicken game situation, leading to a complete negotiation gridlock, mutual blockades and ultimatums. This implies the destruction of wealth (minus-sum game), which leaves everyone worse off.

1.2. BREXIT AND YOU QUIT FIRST GAME

The extension and further refinement of such a destructive chicken game is the so called "you quit first" game. In this game two men have been arrested by the police. Assume that the police officer knows that one of them is a sadist and that the other person is an innocent person. The only problem is that he does not know who the good boy is and who the bad boy is. The two men know who is who, of course, but they keep on pretending that each is the other one. Therefore, the police officer decides to put them both in one cell and tells them they are not allowed to leave before they reveal who is the sadist. There is enough food for the next 30 years. Should one of them decide to leave the room before the agreement is reached, that person will be considered the sadist. The one who quits last will be considered the good guy. Both men will play a game: "please, you quit first", "no, you quit first." They may threaten never to quit.

What is the outcome of this game? Though both outcomes are possible, the chances are higher that the good man will quit first – and thus the legal system (and public opinion) sanctions the wrong person. The reason is as follows. The sadist is quite happy in that room: he can mistreat the good boy. For the good boy, the stay is a less pleasant one. Of course, the good boy can try to win the game by threatening never to quit, but his threat is less (or not at all) credible than that of the sadist. So who wins this "you quit game"? Actually, the party with the best negative externality generating capabilities or the party for whom (even in the absence of this destructive behaviour) the cooperation was least rewarding. If party A keeps his promises but party B breaches them (though non-verifiable by 3rd party), staying in the relationship is least attractive for party A. Consequently, and somewhat paradoxically, the non-breacher (i.e. the good boy) is most likely to quit first.

This "you quit first" procedure looks indeed like a very irrational technique to find out who is responsible for the failure of a common household and to find out who is guilty (i.e. who is the bad boy). One can hardly imagine that legal systems (or society at large) would ever use such a procedure. Yet, for example fault-based divorce law systems sanction the one who quits first. Fault is difficult to prove and therefore legal systems may look at indirect signs and for instance consider the party

who first left the house or who first started another relationship as the one who is responsible for breaking up the marriage.

Extrapolation of the “you quit first” game out to the current Brexit vote and the decision to leave the common household (i.e. EU) suggests that the British voters and/or British government under David Cameron should not be exclusively responsible for the current disaster. It would be very short sighted to reduce the outcome of the UK referendum to unhappiness about migration of cheap workers from central EU Member States (Van den Bergh, 2018).²⁸ For many years and even decades, the UK government, scholars, merchants, entrepreneurs and businesses have shown (and as we all know publicly express it numerous times) their discomfort with the regulatory approach of the EU, and publicly expressed their discomfort with a regulatory structure of the common household.

As emphasized by Van den Bergh and Richardson, the “dirigiste” approach of EU technocrats designing the relevant EU legislation and the vast EU bureaucracy created a significant potential for political distortions which made impossible an efficient (any by the UK’s government advocated) vertical allocation of competences in the EU.²⁹ To the contrary, the EU has neglected almost all suggestions on the efficient allocation of competences that law and economics of federalism can offer (which will be discussed in the next section) and instead offered an overzealous centralization, destructive politicization and broadened its regulatory powers beyond what is needed to maximize welfare in the Member States. Moreover, as Van den Bergh convincingly shows, the EU has not been able to exercise its authority for tackling problems that cannot be sufficiently dealt with at the lower levels of government.³⁰ The ever growing politicization and related rent-seeking by powerful interest groups have actually shaped the vertical allocation of competences in the EU which stand at odd with the law and economics insights on the efficient allocation/separation of powers.

The UK government (leaving aside all potential political and behavioural causes) has eventually – after decades of discomfort and attempts to convince the EU to take action, only when it can be shown that centralization enjoys substantial economic advantages compared to decentralization – quit first and left the common household. Chances are high that public opinion on the continent condemns the wrong party or that responsibility for current disaster is not such a unilateral one. As already stated, somewhat paradoxically the non-breaches may be, in line with the game theory

²⁸ Roger van den Bergh, “Farewell Utopia? Why the European Union should take the Economics of Federalism Seriously,” *Maastricht Journal of International and European Law* 23:6 (2016).

²⁹ *Ibid.*: 939; and Jeremy Richardson, *supra* note 8: 119.

³⁰ Roger van den Bergh, *supra* note 28.

insights, most likely to quit first. Regrettably, for the rest of the Member States a unique opportunity for a fundamental institutional reform of the EU has been missed.

2. THE ECONOMICS OF FEDERALISM, PUBLIC CHOICE, AND EUROSCEPTICISM

All regulatory systems require a number of tasks to be performed and while performing all of these different tasks important structural issues arise in determining how these tasks are to be allocated to different institutions. The law and economics of federalism actually inform us to which the institutional arrangements can assist the implementation of the public interest goals of regulation and the extent to which they offer protection against the subversion (politicization) of the law to meet the demands of private interests.³¹ Moreover, the law and economics of federalism offers guidance on the question of whether the appropriate source of regulatory rule-making should be in Brussels or in London. In other words, the economic theory of federalism has become the starting point for most scholarly and policy discussions as to how best to organize the federal state.³² The goal is to correct market failures through government action, and its guiding principle is to assign policy responsibility to the smallest level of government that can accomplish the task. The principle has been formalized by Oates as the decentralization theorem and with respect to the European Community as the principle of subsidiarity.³³ From the perspective of economic efficiency, determining which level of government is best suited to manage governmental functions requires balancing the benefits and costs of decentralized and centralized political structures.³⁴

If for example the citizens' preferences across Europe are homogenous across the market and if there are no political obstacles, detailed uniform rules should be made at the Community level.³⁵ The homogeneity also implies that there are common market failures, common commitment to redistribution and other non-economic justification for regulation. Under such assumptions, as Ogus and Pelkmans convincingly show, there would be economies of scale in having a single set of regulatory rules and the absence of different national regulatory requirements would facilitate intra-EU trade and remove anti-competitive obstacles.³⁶ Thus, reasons to

³¹ See Richard A. Posner, *supra* note 14, 891; and Anthony Ogus, *Regulation: Legal Form and Economic Theory*, (Cambridge: Hart Publishing, 2004), 58.

³² Robert P. Inman and Daniel L. Rubinfeld, "Rethinking Federalism," *Journal of Economic Perspectives* 11:4 (1997a).

³³ Wallace E. Oates, *supra* note 12.

³⁴ Robert P. Inman and Daniel L. Rubinfeld, *supra* note 32: 45; and Robert P. Inman and Daniel L. Rubinfeld, "The Political Economy of Federalism": 77; in: Dennis C. Mueller, ed., *Perspectives on Public Choice: A Handbook* (Cambridge: Cambridge University Press, 1997b).

³⁵ Anthony Ogus, *supra* note 31, 101.

³⁶ *Ibid.*, 102; and Jacques Pelkmans, "The Assignment of Public Functions in Economics Integration," *Journal of Common Market Studies* 21:2 (1982).

support complete centralization include: the existence of externalities across jurisdictions,³⁷ scale economies,³⁸ promotion of coordination and prevention of prisoner dilemma's games,³⁹ and the risk of destructive competition between legal rules – the so called race-to-the-bottom effect.⁴⁰

However, such conditions will never exist – certainly not in a completely opposite situation (i.e. Tiebout's world) where complete decentralization would be the optimal regulatory solution.⁴¹ The main reasons supporting decentralization are: diverging preferences of citizens, information advantages at lower levels of government, accountability (i.e. regulators should be answerable for the manner in which they exercise their powers), monopoly problems on the side of central government,⁴² and the importance of learning process.⁴³ In relation to the optimal government levels one may argue that local governments will have better information than distant central government about local conditions and preferences and also greater incentives to satisfy them. Hence, zooming should typically be left to local government (i.e. Member States), while defence should be left to the central government (i.e. EU Commission).

Wittman suggests that federal structures (like the EU) are like multi-layered firms that will not function effectively unless incentives are properly structured.⁴⁴ Hence, the central design question is how to structure incentives that local politicians have strong incentives to serve their constituents, while minimizing incentives and opportunities to shift costs on other constituencies. Wittman emphasizes the maintenance of free trade among member states, reduction of cost shifting unto other member states, and making territory the basis for rule-of-law choice as the three key pillars of a successful federation.⁴⁵

Economic arguments do not always offer a clear-cut answer but offer an insightful tool-kit for finding the optimal regulatory mix between centralization and decentralization. For example, law and economics principles suggest decentralization in instances where one deals with a larger number of states involved, increased diverging preferences across regions, information benefits at decentralization

³⁷ Roger van den Bergh, "The Subsidiarity Principle in European Community Law. Some Insights from Law and Economics," *Maastricht Journal of European and Comparative Law* 1:2 (1994).

³⁸ Roland Coase, "The Nature of the Firm," *Economica* 4:16 (1937). See also Anthony Ogus, *Cost and Cautionary Tales: Economic Insights for the Law* (Folly Bridge: Hart Publishing, 2006).

³⁹ Donald Wittman, *Economic Foundation of Law and Organization* (Cambridge: Cambridge University Press, 2006).

⁴⁰ Roger Van den Bergh, *supra* note 37.

⁴¹ Charles M. Tiebout, *supra* note 12: 418.

⁴² Donald Wittman, *supra* note 39, 350.

⁴³ See Wallace E. Oates, "An Essay on Fiscal Federalism," *Journal of Economic Literature* 37:1 (1999); Friedrich A. von Hayek, "Competition as a Discovery Procedure": 57; in: Friedrich A. von Hayek, *New Studies in Philosophy, Politics, Economics and the History of Idea* (Chicago: University of Chicago Press, 1978); and Charles M. Tiebout, *supra* note 12: 420 *et seq.*

⁴⁴ Donald Wittman, *supra* note 39, 253.

⁴⁵ Donald Wittman, *supra* note 39, 350.

decision levels, increased scope for innovation through regulatory competition and accountability issues. In other words, the ill-designed vertical division of powers undermines the conditions for economic growth, prosperity, and peaceful coexistence.⁴⁶

Ultimately, Ilman and Rubinfeld argue that the choice of an “optimal” level of decentralization depends on the relative importance one places upon economic efficiency and the potentially competing values of political participation, economic fairness, and personal rights and liberties.⁴⁷

2.1. PUBLIC CHOICE THEORY AND GROWING POLITICIZATION

Almost 20 years ago professors Wincott,⁴⁸ Miles and Redmond,⁴⁹ Faure,⁵⁰ Ogus⁵¹ and Van den Bergh⁵² expressed serious concerns with the EU’s levels at which different rules and standards have been set. The key aspect of the division of powers that undermines the optimal vertical allocation of EU regulatory structure is private interest considerations.

Public choice theory⁵³ contends that private interest groups interested in a certain area of regulation will have preferences for the rules being formulated at the level at which its strength is greatest relative to that of other groups with a divergent interest in the same area.⁵⁴ For example, Ogus offers an example of the German eco-sensitive industries: competing with a powerful Green lobby within their own country, strive for regulation at the EU level, where they can find allies from industries in other MS and where the strength of local environmentalists is much diluted.⁵⁵ In this respect Ogus argues that the further removed the lobbying, political arena is from local groups, the greater the relative power of sectional interests over ideological interests.⁵⁶ This is because costs of organization for local interests

⁴⁶ Roger van den Bergh, *supra* note 37: 338 *et seq.*

⁴⁷ Robert P. Inman and Daniel L. Rubinfeld, “Economics of Federalism”; in: Francesco Parisi, ed. *The Oxford Handbook of Law and Economics, Volume 3: Public Law and Legal Institutions* (Oxford: Oxford University Press, 2017).

⁴⁸ Daniel Wincott, *supra* note 12.

⁴⁹ Lee Miles and John Redmond, *supra* note 12.

⁵⁰ Michael Faure, “Harmonisation of Environmental Law and Market Integration: Harmonising for the Wrong Reasons?” *European Environmental Law Review* 7:6 (1998).

⁵¹ Anthony Ogus, “Competition between National Legal Systems: A Contribution of Economic Analysis to Comparative Law,” *International and Comparative Law Quarterly* 48:2 (1999).

⁵² Roger Van den Bergh, “Economic Criteria for Applying the Subsidiarity Principle in the European Community: The Case of Competition Policy,” *International Review of Law and Economics* 16:3 (1996); and Roger Van den Bergh, “Towards an Institutional Legal Framework for regulatory Competition in Europe,” *Kyklos* 53:4 (2000).

⁵³ See e.g. Mancur Olson, *The Logic of Collective Action* (Boston: Harvard University Press, 1965); Iain McLean, *Public Choice – An Introduction*, 1st ed. (New Jersey: Wiley-Blackwell, 1991); and Patrick Dunleavy, *Bureaucracy and Public Choice: Economic Explanation in Political Science* (London: Harvester, Wheatsheaf, 1991).

⁵⁴ See e.g. Eli Noam, *supra* note 12; Wyn Grant, *Pressure Groups, Politics and Democracy in Britain* (London: Philip Allan, 1989); and Anthony Ogus, *supra* note 31, 101.

⁵⁵ *Ibid.*, 70.

⁵⁶ *Ibid.*

increase much more dramatically, as regional and even national diversity of interests have to be accommodated.⁵⁷ Moreover, Public choice theory also suggests that private interests groups (which may be observed in growing politicization of the EU), rather than welfare considerations, might be the main force behind the current centralization of the EU. Van den Bergh and Niskanen argue that this may cause the following types of political distortions: a) the political majority may impede the adoption of legislation at the optimal governmental level; b) an optimal vertical allocation of competences may be distorted by effective lobbyists; c) increased bureaucrats' self-interest in budget maximization, power and prestige.⁵⁸ In relation to the later Niskanen and Downs argue that the behaviour of bureaucrats may be explained by assuming that they pursue their self-interest, which includes higher salary, more attractive terms, job security, decreasing workload, public appreciation and status, reputation and power.⁵⁹

Finally, a general lesson from Public Choice theory is that due to their homogenous nature and free-rider prevention capacity, organized groups (political, industrial) will be more powerful lobbyists than consumer or any other citizen's groups. Public choice theory also assumes that a) the allocation of resources will be determined by the political process; b) the political process can be explained as a strategic interaction between the participating groups (voters, politicians and the public administration); and c) every actor seeks to maximize his individual utility - voters try to maximize their utility in accordance with standard rational choice theory, while politicians usually attempt to maximize votes in electoral ballots, and bureaucrats tend to maximize their budget.⁶⁰

In order to mitigate these welfare reducing outcomes, accountability, independence, and transparency should be introduced as key principles in the operation of modern administrations and regulatory performance. In other words, as Van den Bergh suggests, EU regulators should be responsible for the consequences of their decisions; they should be independent from the interest groups they are supposed to control, and decisions processes should be transparent to citizens of the EU.⁶¹ He also argues that taking into account potential political distortions caused by interest groups and due to the severe agent-principal problem European bureaucrats

⁵⁷ *Ibid.*, 103.

⁵⁸ Roger Van den Bergh, *supra* note 28; and William A. Niskanen, *Bureaucracy and Public Economics* (Cheltenham: Edward Elgar, 1994).

⁵⁹ William A. Niskanen, *Bureaucracy and Representative Government* (Chicago: Aldine, 1971); Anthony Downs, *Inside Bureaucracy* (New York: Little, Brown and Company, 1967); and William A. Niskanen, *supra* note 58.

⁶⁰ Dennis C. Mueller, *Public Choice III* (Cambridge: Cambridge University Press, 2003).

⁶¹ Roger Van den Bergh, *supra* note 28: 951 *et seq.*

might tend to favour centralization and harmonization of laws since these are ways to maximize their power and prestige.⁶²

2.2. TOWARDS AN OPTIMAL REGULATORY FRAMEWORK

Public choice theory suggests that politicians in principle tend to maximize their material welfare, and some of them draw utility from helping to make the world a better place, while others are generally motivated by gaining power.⁶³ However, their common motivation is to stay in the office and attain their goals. According to Public choice theory they are trying to capture votes by promising benefits (sometimes unrealistic or even fiscally harmful) to the voters and indeed they tend to maximize their material welfare, prestige and power.⁶⁴ Thus, increased politicization in Europe might be seen as increased attempt of politicians to pursue their special interests. They might have incentives to promote special interests even if this is harmful to the public good.

Consequently, some political decisions have a strong positive outcome for merely one particular group, whereas negative effects are socialized among the rest of population of Europe. Such pursuit of special interests is for politicians much easier at the central Brussels' level since there they can exploit rational ignorance of remote local voters in Member States far more effectively than at the local, national level. For example, as Faure and Johnston argue, the degree of pollution and the effectiveness of particular anti-pollution measures may be better assessed by local authorities (such as rules regarding the quality of drinking water and the disposal of municipal waste).⁶⁵ Another example can be found in the area of food law. Van den Bergh argues that many EU Directives look "like cook books with recipes of poor quality" (e.g. Directive 2000/36/EC of 23 June 2000),⁶⁶ including the rules on the composition of chocolate (Directive 2000/36/EC of 23 June 2000),⁶⁷ jam (Directive 2001/113/EC of 20 December 2001),⁶⁸ and fruit juices⁶⁹ (Directive 2012/12/EU of 19 April 2012).⁷⁰ These Directives cannot be explained by welfare considerations but

⁶² *Ibid.*

⁶³ Emanuel V. Towfigh and Niels Petersen, "Public and Social Choice Theory": 123; in: Emanuel V. Towfigh and Niels Petersen, eds., *Economic Methods for Lawyers* (Cambridge: Edward Elgar, 2015).

⁶⁴ Dennis C. Mueller, *supra* note 60.

⁶⁵ Michael Faure and Jason S. Johnston, "The Law and Economics of Environmental Federalism: Europe and the United States Compared," *Virginia Environmental Law Journal* 27:3 (2009). See also Michael Faure, *supra* note 50.

⁶⁶ *Council Directive 2000/36/EC of the European Parliament and of the Council of 23 June 2000 relating to cocoa and chocolate products intended for human consumption*, OJ L 197, 3.8.2000.

⁶⁷ *Ibid.*

⁶⁸ *Council Directive 2001/113/EC of 20 December 2001 relating to fruit jams, jellies and marmalades and sweetened chestnut purée intended for human consumption*, OJ L 10, 12.1.2002.

⁶⁹ *Council Directive 2012/12/EU of the European Parliament and of the Council of 19 April 2012 amending Council Directive 2001/112/EC relating to fruit juices and certain similar products intended for human consumption*, OJ L 115, 27.4.2012.

⁷⁰ Roger Van den Bergh, *supra* note 28: 952 *et seq.*

rather as the result of a growing politicization, lobby pressures from industry, and attempts to preserve the existing European market unspoiled.

Global warming, safety and security, common defense forces (formation of the real EU army), protection of property rights, common police (like FBI), protection of external EU borders, increased protection of consumers, common education standards, and fiscal policy, are obvious candidates for centralization in order to internalize significant interstate externalities. Here the previously presented arguments call for a centralized action by the EU.

As to the optimal regulatory mixture, the starting point in economics of federalism is that decentralization is preferred in certain, previously discussed areas, since it may better satisfy the divergent preferences of EU citizens, economize on information advantages, introduce accountability and prevent rent-seeking and moral hazard, and enable learning effects and healthy competition among different MS regulatory regimes. But centralization offers still other advantages. Scale economies, reduction of transaction costs, internalization of negative spill overs and cross-border negative externalities, free market and prevention of destructive, race-to-the-bottom competition among legal regimes – these are just a few reasons for an increased centralization.

That said, one may indeed argue that the EU's current inefficient institutional framework on the vertical and horizontal allocation of competences and complete ignorance of the economic principles on the optimal interpretation of the subsidiarity principle might be one of the additional, until now generally overlooked, generators, intrinsic instrumental channels of current institutional breakdown, increased politicization and consequent disintegration.

CONCLUSIONS

This paper shows that game theory and law and the economics of federalism may be instrumental in providing an insightful toolkit in structuring our discussion of the Brexit fiasco. Extrapolation of the "you quit first" game on the current Brexit outcome suggests that the British voters and/or British government under David Cameron should not be exclusively responsible for the Brexit outcome. The Brexit vote should not be seen as an unexpected incident. Instead, it should be regarded as a call for a broad, wealth maximizing institutional reform of the EU which should address the necessary changes and growing, destructive politicization. The article also argues that Article 50 of the TFEU is underdeveloped and contains an unintended intrinsic incentive mechanism that might be generating a destructive chicken game situation between the UK and the EU, which is leading to complete negotiation

gridlock, destruction of resources, and is leaving everyone worse off. In other words, Article 50 should be redrafted. It should not contain the two-year deadline provision (instead, the classic “reasonable time” period should be introduced) and should provide for a third-party dispute resolution mechanism (international court or arbitration) in instances where free negotiations between the EU and the withdrawing MS in the reasonable time period fail to achieve a win-win solution.

The EU’s current inefficient institutional framework on the vertical and horizontal allocation of competences and complete ignorance of the economic principles on the optimal interpretation of the subsidiarity principle might be one of the generators, intrinsic instrumental channels of current institutional breakdown, increased politicization and consequent growing outright hostility to the EU. In this respect, game theory insights and the role of efficient allocation of rulemaking are instrumental.

The concept of the efficient allocation of rulemaking should also encompass potential negative externalities and market failures. The EU should not be conceptualized via a narrowly defined “cost-benefit-efficiency” framework as perceived in the traditional economics of federalism literature. In order to prevent the decline of public support and Euroscepticism, the EU should actually do less in current fields of inefficient regulatory intervention and should do much more in fields where it failed to exercise its authority and which cannot be addressed effectively at the local levels. The EU should institutionally redesign itself and develop legal tools that would mitigate broad potential sources of negative externalities. As an institution it should: a) reinforce and protect the rule of law; b) reinforce and protect liberal democracy with all related civil liberties; c) reinforce its political-global dimension; d) protect and reinforce its common cultural heritage; and e) more aggressively combat destructive nationalisms, isolationisms, and cultural introspections.

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