EXPLAINING THE EUROPEAN FISCAL COMPACT THROUGH THE THEORY OF GRADUAL INSTITUTIONAL CHANGE

By
Elena-Constantina Karagiorgi

Submitted to
Central European University
Department of Public Policy

In partial fulfillment for the degree of Master of Arts in Public Policy

Supervisor: Professor Marie-Pierre Granger

Budapest, Hungary

2012

CEU eTD Collection

ABSTRACT:

This research aims at examining whether the theory of gradual institutional change can be applied in the context of European economic governance in general and in the creation of the Fiscal Compact in particular. It firstly delineates the theoretical framework of new institutionalism from which the theory of gradual institutional change derives and then elaborates on the theory's main assumptions. It continues by portraying the general framework of European economic governance in order to test whether the theory's main assumptions are traceable within this context. Subsequently, it analyzes the Fiscal Compact with regards to the revised Stability and Growth Pact so as to unfold the introduced changes, and hence identify the type of institutional change. This research shows that the theory of gradual institutional change can be applied in this context and demonstrates that the Fiscal Compact is a case of layering. Hence, it provides an explanation of its creation and further enables predictions regarding the trends of European economic and monetary integration.

CEU eTD Collection

TABLE OF CONTENTS

CEU eTD Collection

INTRODUCTION

On 2 March, 2012, all the member states of the European Union – apart from the United Kingdom and the Czech Republic – signed the Fiscal Compact. The Fiscal Compact, formally known as the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), requires the ratification of twelve member states, either through Parliament's vote, President's signature or through referendum (the case of Ireland) in accordance with each member state's Constitution. If ratified, the treaty will enter into force on 1 January, 2013, or on the first day of the month following its ratification by the twelfth country, whose currency is the euro[1]. The treaty's negotiations have started in December 2011 and since then there has been a long debate in the press as to whether this treaty is actually adding something to the already existing provisions that govern European economic policies. Therefore, it is very interesting to explain the creation of the Fiscal Compact within the bigger framework of European economic governance, so as to understand what is added value is.

As a result of European economic governance, the Fiscal Compact is of paramount importance because it is a heavily-discussed issue and - like any other treaty decided within the framework of the European Union - it can help us draw conclusions regarding the institutional change within the EU. The Fiscal Compact, however, should be seen with regards to the bigger framework of European economic governance so as to understand its creation and its added value. The main framework of European economic governance is constituted of the Economic and Monetary Union, created with the Maastricht Treaty, and the Stability and Growth Pact and its reforms of 2005 and 2011 (Six-Pack). The briefly sketched

[1] TSCG, Article 12(2)

CEU eTD Collection

framework of the European economic governance suggests that the Fiscal Compact is merely the result of the economic crisis, as well as an answer of European countries towards the crisis. Nevertheless, it is important to identify this moment as a "critical juncture", a point in time or a new situation that triggers a change. This work does not disregard the triggering effect of the economic crisis towards institutional evolution in the field of European economic governance. However, it moves away from this focus and aims at explaining the creation of the Fiscal Compact not as an answer to the crisis, but rather as the result of a longer, path dependent process of institutional evolution.

There has been a lot of academic work aiming at explaining the institutional change and the evolution of policy ideas. The predominant theoretical approach to institutions and their evolution is the theory of New Institutionalism. Within this approach there are several schools of thought, further presented below. This work is drawing upon the theoretical lines offered by New Institutionalism in order to explain the current developments in the field of European economic governance. More specifically, it uses the Theory of Gradual Institutional Change, presented by Mahoney and Thelen (2010), and aims at explaining the creation of the Fiscal Compact through this theoretical lens. As presented below, the theory of Gradual Institutional Change is built on ideas developed in the field of historical institutionalism (Mahoney and Thelen, 2010: 32). Nevertheless, the same theory can be explored by other schools of thought of New Institutionalism as well. This is also something that makes this explanatory model particularly appealing and pertinent to explaining institutional change.

The main assumption of the Theory of Gradual Institutional change is that changes within an institution happen gradually and slowly and are often hard to identify. However, these gradual changes have an accumulative effect that finally leads to further institutional

CEU eTD Collection

change. The aim of this work is to test whether these assumptions can be identified in the case of the Fiscal Compact and whether the Theory of Gradual Institutional Change can help us explain institutional evolution within the bigger framework of European economic governance.

The first chapter explains the theoretical framework through which the Fiscal Compact will be analyzed. The main schools of thought of new institutionalism will be introduced so as to justify the focus on Historical Institutionalism and the use of the Theory of Gradual Institutional Change. Moreover, the theory's main assumptions that will offer the guiding lines for the subsequent analysis will be further elaborated. In the second chapter the Theory of Gradual Institutional Change will be applied in the broader context of European economic governance, starting from the initiation of the Economic and Monetary Union, to the Stability and Growth Pact and its reforms. The aim will be to identify the main economic policy lines and whether these lines have been sustained and reinforced though the evolution of European economic governance, or whether they have been replaced by new, diverging ones. The third chapter will focus on the Fiscal Compact, in order to identify its added value, especially with regards to the previous Stability and Growth Pact and the Six-Pack. Looking at the changes that are introduced by the Fiscal Compact will help to identify whether the Theory of Gradual Institutional Change is applicable in this case and what conclusions can be drawn regarding future institutional changes in the field of European economic governance. The research will conclude with an answer to whether the main assumptions of the Theory of Gradual Institutional Change can be traced within the framework of European economic governance and the creation of the Fiscal Compact and, if so, with explaining what type of institutional change the Fiscal Compact constitutes.

CEU eTD Collection

CHAPTER I: New Institutionalism Approach and the Theory of Gradual Institutional Change

As stated above, this chapter delineates the types of new institutionalism, in order to validate the focus on Historical Institutionalism and the use of the Theory of Gradual Institutional Change. For this purpose the concept of institutions and institutional change is further elaborated and the theory's main assumptions are analyzed.

1.1. The three 'New Institutionalisms'

The new institutionalism approach is particularly useful when dealing with the issues of institutions and their impact on political and social processes. According to March and Olsen (2006), the term 'institutionalism' suggests "a general approach to the study of political institutions, a set of theoretical ideas and hypotheses concerning the relations between institutional characteristics and political agency, performance, and change" (March and Olsen 2006: 4). Therefore, new institutionalism offers the right theoretical framework for explaining the process under which institutions are created and change. Moreover, it explains the relationship between institutions and the behavior of the actors within an institution. New institutionalism, however, does not constitute a unified body of thought (Hall and Taylor 1996: 936). There are at least three different schools of thought within new institutionalism: sociological institutionalism, rational choice institutionalism and historical institutionalism. Vivien Schmidt (2010) proposes a fourth 'new institutionalism', the discursive institutionalism, whereas Gay Peters (2000) singles out up to seven types of new institutionalism. It is important to note that even within these schools of thought there are also different analytical approaches.

CEU eTD Collection

Sociological institutionalism has been developed within the field of sociology and organization theory. It places its attention on the norms and culture of social agents. Sociological institutionalists follow the 'logic of appropriateness' so as to explain institutional change and actors' behavior. They suggest that through this dynamic of legitimacy or appropriateness the institutions are affecting the action of social agents (Powell and DiMaggio 1991). According to the 'logic of appropriateness', institutions adopt specific institutional forms and rules because these forms and rules "are widely valued within a broader cultural environment" (Hall and Taylor 1996: 946).

Rational institutionalism arose from the study of American congressional behavior (Hall and Taylor 1996: 942), as well as the study of economics. The most famous rational choice institutionalists are economists, such as Douglas North. Rational choice institutionalism places its focus on the actors' behavior. It suggests that actors are rational with fixed preferences and calculate their behavior strategically, so as to maximize their preferences (Schmidt 2010: 4). Rational choice institutionalism shares the rationality assumption, however, it emphasizes "man-made institutional constraints" (Parsons 2007: 67). Just like every other school of thought, rational choice institutionalism also entails internal debates. Hall and Taylor (1996: 945) aptly point out that the distinctive feature of this approach is that actors' behavior is driven not by historical events but by their strategic calculation, which is affected by their perception of how the other actors are most likely to behave. Rational choice institutionalism also developed a distinctive approach as to the creation of institutions. By using deduction rational choice institutionalists specify the functions that the institution performs. They explain its creation by referring to these exact functions and their value for the actors within an institution. Therefore, in rational choice institutionalism the process of institutional creation can be conceptualized in terms of gains from cooperation among actors affected by an institution (Hall and Taylor 1996: 945).

CEU eTD Collection

Historical institutionalism developed in the late 1970s and early 1980s from studies in historical sociology and political economy (Parsons 2007: 86). Hall and Taylor (1996) trace its emergence even earlier, during the 1960s and 1970s, as a response to group theories of politics and structural-functionalism within political science (Hall and Taylor 1996: 937). Historical institutionalism is often described as being in the middle position between rational choice and sociological institutionalism (Parsons 2007: 85). Parsons argues that historical institutionalism, as a school of thought, is more consistent than any other school of thought in building its main assumptions (Ibid). Hall and Taylor (1996: 940) consider historical institutionalism as eclectic, as it draws upon both of the other two approaches to specify the relationship between institutions and action. In historical institutionalism institutions are understood as “formal or informal procedures, routines, norms and conventions embedded in the organizational structure of the polity or political economy” (Hall and Taylor 1996: 938). It focuses on how institutions structure the actors’ behavior and the outcomes of those actions.

Historical institutionalism places emphasis on the path-dependencies and unintended consequences that are embedded within an institution and derive from the institution’s historical development and operation (Hall and Taylor 1996; Thelen 1999; Pierson 2000). This concept of path-dependence emphasizes the impact of the existing institutional structure and norms, as well as the already existing policy lines, on subsequent policy choices. It stresses the way in which past policy lines encourage actors to act along those lines and adopt particular identities and develop policies which are otherwise costly to shift. Historical institutionalism also stresses the inefficiencies generated by the institutions (March and Olsen 1984), unlike rational choice institutionalism that sees institutions as serving a purpose and being efficient (North 1990).

CEU eTD Collection

This exact concept of path-dependency, as well as the unintended consequences and the expected inefficiencies generated by institutions, make the use of the historical institutionalism approach particularly appealing in explaining the recent developments in European economic governance - that is, the creation of the Fiscal Compact. Moreover, the fact that most historical institutionalists take into consideration “critical junctures”, i.e. moments when important institutional change occurs and creates a new path (Hall and Taylor 1996: 942), makes historical institutionalism an appropriate theoretical tool for analyzing the creation of the Fiscal Compact, as it is meaningful to see whether the economic crisis constitutes a “critical juncture” in this case. Furthermore, the fact that historical institutionalism is eclectic and combines elements of sociological institutionalism, such as the relationship between institutions and ideas or beliefs, as well as rational choice institutionalism, to specify the relationship between institutions and action, also makes this approach more inclusive and better suited for the subsequent analysis.

The fact that historical institutionalism draws upon both rational choice and sociological institutionalism in an effort to create “something of an amalgam”, however, does not mean that this approach represents a “fully realized alternative to either of the other two approaches” (Hall 1998: 958). For this reason the Theory of Gradual Institutional Change, proposed by Mahoney and Thelen (2010) and presented below, is more appealing for explaining the creation of the Fiscal Compact, because it draws upon all three new institutionalisms and can be used within the scope of any of the three, even though it was originally built on ideas developed in historical institutionalism (Mahoney and Thelen 2010: 32). However, before explaining the theory of gradual institutional change it is necessary to define the meaning of the word institution in this research, as well as the meaning of institutional change.

CEU eTD Collection

1.2. Defining Institutions and Institutional Change

There are different approaches as to what an institution is. Each one of the abovementioned three institutionalisms defines institutions in different ways. March and Olsen (2006) argue that these approaches differ as to:

> …[how] they understand (a) the nature of institutions, as the organized setting within which modern political actors most typically act; (b) the processes that translate structures and rules into political impacts; and (c) the processes that translate human behavior into structures and rules and establish, sustain, transform, or eliminate institutions.(March and Olsen 2006: 4).

According to March and Olsen (2006: 4) institutions are not just "contracts of equilibrium between rational individual actors or arenas for competing social forces", but they are "collections of structures, rules, and standard operating procedures that have a partly autonomous role in political life". Claus Offe in his public lecture N.9 at the Colleguim Budapest locates institutions "somewhere between social norms and norm-oriented action, on the one hand, and purposive rational or strategic action, on the other." He suggests that institutions "contain and combine elements of both these modes of action" and "inculcate duties and generate outcomes". Graig Parsons (2007) defines institutions as "any enduring pattern of behavior among a group of people" that sometimes acquires a formal organizational structure. Under the same logic, he identifies laws, treaties, or standards as part of the institutional landscape and he further suggests that the notion of institution contains and combines all these "phenomena", from "concrete institutional actors" to traditions or conventions (Parsons 2007: 66).

Definitions of institutions vary, not just in social sciences in general, but also across the different schools of thought of new institutionalism presented above. However, they vary mostly with regards to the point they emphasize, and not with regards to their definition as a whole (Parsons 2006: 67). Among rational choice institutionalists, Douglass North (1990: 4) defines institutions as "any form of constraint that human beings devise to shape human

CEU eTD Collection

interaction", or as "regularities in repetitive interactions … customs and rules that provide a set of incentives and disincentives for individuals." In sociological institutionalism, institutions are seen within a broader context, so as to include not just formal rules, procedures and norms, but also the symbols, cognitive scripts and moral templates that guide human behavior within the institutional setting (Hall and Taylor 1996: 947). In historical institutionalism, institutions are defined as "the formal rules, compliance procedures, and standard operating practices that structure the relationship between individuals in various units of the polity and economy" (Hall 1986: 19). In this work, in an effort to incorporate the above definitions, I use the definition offered by Parsons (2006) that institutions are defined as formal or informal rules, compliance procedures, conventions or practices that structure the relationship of the actors and further enable actors' behavior (Parsons 2006: 67), as it offers a combination of the abovementioned definitions.

In this research institutional change encompasses the evolution and development of institutions, which is the creation of new institutional formal and informal rules, procedures, practices and patterns of behavior, as well as the development of policy ideas within an institution. This definition of institutional change follows the lines of the two types of institutional change identified by Gay Peters (2000). One is the internal evolution and development of an institution or the process of institutionalization, and the second type is the change in the structures and values that characterize the institution (Peters 2000: 7).

This institutional change or evolution, as well as the development of policy ideas within an institution, can be explained through the institutionalist explanatory segments, which according to Parsons (2006: 68) "incorporate feedback between action and constraints", commonly known as "path dependence", that is the unintended consequences of following policies and subsequent action along a particular historical path, because of the

CEU eTD Collection

choice of institutions at previous points. Therefore, according to Parsons (2006: 68) institutionalism claims "emphasize man-made constraints and path dependence". For this reason the theory of gradual institutional change offers the best methodological approach for explaining institutional change within the family of new institutionalism, as it bases its main assumptions exactly on the concept of path dependency and unintended consequences, further analyzed below.

1.3. The Theory of Gradual Institutional Change

In '*Explaining Institutional Change, Ambiguity, Agency and Power*' Mahoney and Thelen (2010) are proposing a new model of institutional change. Their ideas emanate from historical institutionalism to create a model of institutional change, which can be explored by sociological and rational choice institutionalism with equal benefit (Mahoney and Thelen 2010: 32). This model or theory of gradual institutional change proposes that the basic properties of institutions offer institutions the possibility to change (Ibid: 14) and that institutions, once created, are changing over time in *subtle* and *gradual* ways (Ibid: 1). These changes are very slow and piecemeal and sometimes are hard to be traced. Nevertheless, these changes can be equally consequential for forming actors' behavior and for developing substantive political outcomes in a certain way.

Mahoney and Thelen (2010) argue that although institutional analysis has a prominent place in contemporary social science with vast literature and eclectic theories for explaining how institutions are created, replaced with new ones or ended, this institutional analysis is lacking the "useful tools for explaining the more gradual evolution of institutions" (Mahoney and Thelen 2010: 2). This is because institutions do not just emerge and break down, but they

CEU eTD Collection

also develop over time in more subtle ways. Mahoney and Thelen[2] (2010) suggest that these "gradual transformations and incremental shifts" might lead to "fundamental transformations." They argue that the contemporary literature on institutional analysis does not sufficiently deal with the gradual institutional transformations, and for this reason they propose the theory of gradual institutional change.

Their theory suggests that gradual changes are of immense significance because these exact *gradually unfolding changes* have an accumulative effect and may consequentially be the *causes* of future outcomes. This new model of institutional change, presented by Mahoney and Thelen (2010), links particular "modes of incremental change to features of the institutional context" and the "properties of the institutions", which permit specific types of strategies for change and change agents. One of their arguments is that institutional change may occur when problems of rule interpretation and enforcement emerge and enable actors to implement existing rules in new ways. By including these exact concerns, Mahoney and Thelen (2010) create a model that can allow us to observe and theorize the forms of incremental change (Mahoney and Thelen, 2010: 4). In other words they develop a framework, which can help identify and explain the types or modes of institutional change.

The main expectation of the theory of gradual institutional change is the establishment of a link between the political context – as well as the characteristics of the

[2] In their analysis, they first show how the leading approaches to institutional analysis – rational-choice institutionalism, sociological institutionalism and historical institutionalism – face problems in explaining institutional change and they consider how the *power-distributional approach* to institutions, supplemented with attention to issues of compliance, provides a motive force for change (Mahoney and Thelen, 2010: 4). According to Mahoney and Thelen (2010) the distributional approach suggests that "tensions for pressures and change are build into institutions", and they draw attention to the fact that this approach does not, however, specify the different modes of change that those tensions might create. They argue that the distributional approach fails to explain why one type of change takes place instead of another. Therefore, they build on the distributional approach to develop a framework that will identify and explain the types of institutional change. (Mahoney and Thelen, 2010: 14).

CEU eTD Collection

institution – and the type of institutional change. The political context and the characteristics of the institution can influence the type of institutional change, as they form the type of the *dominant change agent,* who will most likely emerge and act within that particular political and institutional context. Mahoney and Thelen (2010), therefore, identify three key causal connections to the type of institutional change. One is the connection between the type of institutional change and the characteristics of the political context and of the institutions. The second causal connection is the link between the type of dominant change agent and the type of institutional change, and the third one is the link between the characteristics of the political context and institution and the type of dominant change agent. These three points help us sketch the framework for identifying the modes of institutional change. When referring to modes of institutional change, Mahoney and Thelen (2010) build upon previous work by Streeck and Thelen (2005) and describe four types of institutional change: *displacement, layering, drift* and *conversion*. Each mode is defined by a diligent exploration of the type of institutional transformation (Mahoney and Thelen, 2010: 15). Each one of the four types is further analyzed below.

Displacement is when existing rules are being removed and new ones are introduced in their place. It can happen in a radical way, when a sudden break down of institutions follows their replacement with new ones[3]. However, displacement can also take place in a gradual way, for example when new rules are introduced and these rules are competing, rather than supplementing the previous ones. These new rules are more likely to be introduced by actors who had the least gains in the previous set of rules. If the supporters of the old rules are not able to stop the adoption of these new competing rules, then displacement will occur in a gradual way (Mahoney and Thelen 2010: 16).

CEU eTD Collection

[3]This radical shift is also evident in the three main institutional theories.

Layering is when new rules are being introduced on top or parallel to the existing ones. It occurs when actors who want to challenge the existing institutional setting lack the capacity to do so. Therefore, instead of actually changing the original rules, they work within the current institutional setting and they incorporate new rules into the pre-existent framework. Such new rules may take the form of amendments, revisions and the adoption of new treaties adding to the existing ones. In this case the supporters of the *status guo* are able to maintain the existing rules, however they are not able to prevent the introduction of amendments. These amendments and modifications, although being small changes, can accumulate and over the long-run lead to a big change (Mahoney and Thelen 2010: 17).

Drift is when the rules are not changed, however the impact of these rules change due to shifts in the environment. For example it can occur when the actors of the institution choose not to respond to a shift in the external conditions and, therefore, cause with their inaction a change with regards to the impact of the institution (Mahoney and Thelen 2010: 17).

Conversion is when the existing rules are neither being removed nor neglected, however they are interpreted in new ways (Mahoney and Thelen 2010: 16). Mahoney and Thelen argue that this gab between the existing rules and the way they are redeployed is produced by actors who aim at exploiting the existing ambiguities within an institution. These actors, or "institutional challengers", aim at changing the goals, functions and purposes of the institution towards more favorable ones (Ibid).

In order to conceptualize the dimensions of the political context and the institutional characteristics that play the most important role in explaining institutional change, Mahoney and Thelen (2010) focus on two main aspects: whether the political context offers strong or weak veto points, and whether the institution offers actors a low or high level of discretion

CEU eTD Collection

regarding the interpretation or enforcement of the rules. By combining these two aspects Mahoney and Thelen produce an analytic framework, so as to explain institutional change. The different combinations among strong and low veto possibilities and the level of discretion when interpreting and enforcing the rules are related to the different modes of institutional change presented above.

Layering is more likely to happen when the political context is characterized by strong veto possibilities and the targeted institution offers a low level of discretion in the interpretation and enforcement of rules. Whereas, if veto possibilities are high, and the level of discretion in the interpretation and enforcement of the rules is also high, then drift is more likely to take place, as actors will not introduce new rules, however they can neglect the old ones and change their impact. When the political context is characterized by weak veto possibilities and at the same time the institution allows a low level of discretion when interpreting and enforcing the rules, then displacement is more likely to occur. That is, new rules are more likely to be introduced in the place of old ones, as the defenders of the *status guo* will have less power in retaining the existing rules because of weak veto possibilities. Conversion, i.e. the change in the interpretation and enactment of the rules without removing or adding new ones, is more likely to happen when there are weak veto possibilities and a high level of discretion in the interpretation and enforcement of rules.

Besides the relation between the characteristics of the political context and the institution, Mahoney and Thelen (2010) move a step further and differentiate between actors of change and the modes of institutional change. They identify four types of "change agents" – *insurrectionaries, symbionts, subversives and opportunists*. This typology is constructed upon the agents' behavior, and specifically according to whether the agents seek to preserve the institution and follow the rules of the institution. Identifying the type of agents' behavior

CEU eTD Collection

is useful for explaining institutional change, as different types of ‘change agents’ are associated with a particular mode of institutional change (Mahoney and Thelen 2010: 23). However, this research will not deal with the type of change agents because identifying the type of change agents is something very malleable and can be the focus of another endeavor.

By conceptualizing the main characteristics of the political context and the main institutional characteristics associated with institutional change, Mahoney and Thelen (2010) construct a model for explaining institutional change. This model or theory of gradual institutional change aims at offering a tool for the substantive analysis of institutional change, applied in concrete cases and actual episodes of institutional change (Ibid: 32). The aim of this thesis is to test whether this theoretical framework can be applied in the case of changes in European economic governance, and in particular the latest Fiscal Compact. By doing so the goal is to examine whether this theory can help us explain the creation of the Fiscal Compact and make predictions as to the ways in which European economic governance might evolve in the future. In the following section, the European economic governance framework will be presented, taking into consideration the main characteristics of the political context and the institution and the type of the occurring institutional changes. This will help us identify in the third chapter what type of institutional change the Fiscal Compact represents and whether this theory can be applicable in this case.

CEU eTD Collection

CHAPTER II: European Economic Governance and the Theory of Gradual Institutional Change

This chapter starts from the historical evolution of European economic governance and focuses on the main policy lines followed within this context. Subsequently, the theory's main assumptions will be traced in the framework of European Economic Governance. This will assist in explaining later on the creation of the Fiscal Compact, and to identify what type of institutional change the Fiscal Compact represents according to the modes of institutional change proposed by Mahoney and Thelen (2010). The aim is not to explain the creation of the Economic and Monetary Union (EMU) or the creation of the Stability and Growth Pact (SGP)[4], neither to criticize the economic and monetary polies followed so far. The goal is to focus on the main policy lines, such as low inflation, and trace whether these policies are being sustained and gradually reinforced or whether they are replaced, thus testing the main assumptions of the theory of gradual institutional change.

2.1. Historical Overview of the Creation of EMU

The Economic and Monetary Union (EMU) started as an official endeavor of the European Community in the 1969 summit in The Hague (see Ungerer 1997: 97-117) when the heads of government made a commitment to create the EMU. However, it was only achieved in 1992 with the signing of the Maastricht Treaty. According to McNamara, this was not an "overnight success", but rather a process that has "deep roots in the history of European integration" (McNamara 2005: 143). Dyson (2010: 159) argues that the main reason for the European Economic Community (EEC) leaders to agree on a plan for the EMU was the

CEU eTD Collection

[4] For answers to these questions one can refer to the work of many profound scholars (see Dyson and Featherstone 1999, Heipertz and Verdun 2004)

decline of the Bretton Woods system. Ensuring smooth trade relations within the common market and diminishing the transaction cost of financing the common agricultural policy was their main concern. A switch from fixed to floating exchange rates, because of the fall of Bretton Woods, would have jeopardized that.

The plan, or the Werner [5] report, was presented in 1970 and it proposed the coordination of economic policies as well as a limit within which exchange rates could fluctuate. This resulted in the establishment of the "snake in the tunnel", an exchange-rate system aiming at narrowing exchange-rate fluctuations. However, this system collapsed in 1971, following the ending of the dollar convertibility. It was reestablished in 1972, but only to collapse once more because the strong economies were not ready to support the value of the currency of weaker economies (Bache, George and Bulmer 2011: 403). The creation of the EMU was then stalled until 1979 when the European Monetary System was set up. The reason for that was the unstable international monetary situation (fall of Bretton Woods), as well as the differences among the member states concerning the EMU (Verdun 2010: 328). There was a lack of consensus regarding economic policy priorities - France was in favor of prioritizing growth and employment, whereas Germany was in favor of low inflation policy.

Finally, in 1979, the EEC countries in a new attempt to coordinate their macroeconomic policies established the European Monetary System (EMS) and the exchange-rate mechanism (ERM), so as to minimize fluctuations in bilateral exchange rates. This system also adopted a notional currency, the 'ecu', which accounted for the average of the values of the currencies of the member states. This system performed better than the "snake", therefore promoting *exchange-rate stability* and *low inflation* (Dyson 2010: 161). At that point, the member states were more willing to accept Germany's position in favor of

[5] The name was taken from Pierre Warner, chairman of the working group and Luxembourg's prime minister.

CEU eTD Collection

economic priorities, such as low inflation. According to Bache, George and Bulmer (2011) this was because of the increase in inflation due to the rise in oil prices in 1973. Despite the general consensus towards promoting low inflation, however, the United Kingdom remained outside the ERM.

The concrete steps towards the EMU started with the Luxemburg European Council in 1985 and the agreement on the provisions of the Single European Act, and further developed in 1988 at the Hannover European Council, when it was decided to establish a committee under the chairmanship of Jacques Delors, President of the Commission. The committee's task was to prepare a report on strengthening monetary co-operation. The report was accepted in the 1989 European Council meeting in Madrid and after that an Intergovernmental Conference was set up, in order to decide upon the necessary institutional changes for the establishment of a monetary union. The report was built on the previous idea of narrowing the fluctuations in exchange rates parallel to economic policy co-ordination. It proposed a gradual, three-stage process towards monetary integration. The first stage, from July 1990 to December 1993, focused on establishing the free movement of capital among member states, a closer co-ordination of economic policies and a closer cooperation among central banks. The second stage, from January 1994 to December 1998, aimed at achieving convergence of the economic and monetary policies of the member states so as to ensure the stability of prices. Finally, the third stage, from January 1999 onwards, established the European Central Bank, the fixing of the exchange rates and the introduction of the single currency (Verdun 2010: 329).

During the first stage, an Intergovernmental Conference (IGC) was initiated in order to discuss the next stages of the EMU. The IGC work finished in Maastricht. Within the IGC it was generally agreed that a further economic convergence is needed for a sustainable

CEU eTD Collection

monetary union (Bache, George, Bulmer 2011: 405). More specifically, these criteria stipulated in the Maastricht Treaty were setting the level of a country's budget deficit up to 3 per cent of the gross domestic product (GDP) and the public debt up to 60 per cent of the GDP, a maximum level of inflation and a maximum level of interest rates, and a good performance of exchange rates, in order for a county to be able to join the EMU. Although the criteria were strict, there were 'escape clauses' in the wording of the treaty (Verdum 2010: 329): the treaty left room for maneuver, "if states were moving towards the right direction of all relevant indicators" (Bache, George and Bulmer 2011: 405). It is important to note that the Maastricht Treaty faced difficulties with its ratification. UK opted out from the EMU and Denmark rejected the Treaty in the Danish referendum of 1992, resulting in an opt-out clause for Denmark as well[6].

The creation of the EMU with the Maastricht Treaty was only the beginning of a long road of European economic and monetary development, leading to further agreements for economic and monetary integration, such as the Stability and Growth Pact and the "Six-Pack", further analyzed below. The aim is to focus on the main policies stipulated through the EMU and on whether and how those policies were sustained or evolved in the future through subsequent agreements.

CEU eTD Collection

2.2. From the EMU to the Stability and Growth Pact and the "Six-Pack"

In order for the EMU to be sustained, the European Council took a number of steps so as to reinforce economic policy coordination. Among those steps was the creation of the Eurogroup[7] in December 1997; an informal body consisted of the finance ministers of the

[6] The opt-out clause is attached in a protocol to the Treaty.
[7] For an answer to why the EMU needs informal governance, see Puetter 2006: chapter 2.

euro-area. This intergovernmental body plays a significant role in shaping European economic governance (Puetter 2006; 2004). The most important step, however, towards maintaining the EMU criteria was the establishment of the Security and Growth Pact in 1997, following the proposal of Theo Waigel, German finance minister.

The goal of the SGP was to ensure that the Maastricht convergence criteria, such as budget discipline and avoidance of excessive deficits, would be sustained by the member states. The SGP took the form of a Resolution of the Amsterdam European Council of 17 June 1997 and two Council Regulations of 7 July 1997. It has “a preventive and a dissuasive arm” (European Commission 2012). The preventive arm offers policy advice and the possibility of early warning[8] towards the member state that is about to have an excessive deficit. The dissuasive arm consists of the excessive deficit procedure (EDP), a procedure that starts when the deficit of a member state breaches the 3% of GDP ceiling stipulated by the Treaty. The procedure initiates with recommendations towards the member state in question and in the case of no compliance the Council has the possibility of imposing sanctions, such as fines. Besides ensuring the maintenance of the convergence criteria, the SGP was put in place so as to secure that no member state would free ride after joining the EMU, and it was designed primarily as a preventive mechanism (Verdun 2010: 331).

This preventive mechanism, however, proved insufficient when member states such as France and Germany experienced problems with meeting the rule and objectives of the SPG. In 2002 France, Germany and Portugal were given an early warning, part of the preventive arm, in order to reduce their budget deficits. However, only Portugal made the necessary corrections. France and Germany failed to comply and reduce their budget deficits. Therefore, they both had to go under the excessive deficit procedure (EDP). Nevertheless,

CEU eTD Collection

[8]The Council, following a proposal by the Commission, addresses early warning.

they managed to get support from other member states and to avoid possible financial sanctions. Subsequently, in the meeting of the Council of Economic and Financial Ministers (ECOFIN), in November 2003, they managed to circumvent the Commission's proposal to follow the EDP. This led to a weakening of the SGP, ironically caused by the two member states that were its initial bigger supporters.

This ECOFIN's decision caused disagreement among the member states, as countries such as Austria, the Netherlands and Spain felt that France and Germany used their power to avoid sanctions, whereas in a similar situation for a smaller state this would not have been possible. Moreover, the Commission asked the European Court of Justice (ECJ) whether the Council's decision was legal. The ECJ ruled in 2004 that the Council's decision was illegal, however the Council had the right not to follow the recommendations of the Commission[9]. As a result of this situation, the SGP was reformed in 2005. These reforms were "softening" the SGP (Dyson 2010). More specifically, the two Council regulations of 1997 were amended so as to include more flexible provisions regarding the circumstances under which a member state may have a temporary deficit higher than that stipulated in SGP, and the preventive arm was strengthened by adding to it more differentiated medium-term orientated provisions aiming at the fiscal sustainability of budgetary objectives (Verdun 2010: 332).

Following the global financial crisis of 2008 and the European sovereign debt crisis of 2011, the SGP was further reformed in 2011 to ensure the maintenance of its provisions under the new circumstances. This reform, known as Six-Pack, is a set of five regulations and one directive that entered into force in December 2011, therefore being part of EU secondary law. It applies to all EU member states, with specific rules for the euro-area member states, mainly with regards to sanctions (European Commission 2012). The aim of the Six-Pack is to

CEU eTD Collection

---

[9]For the exact ECJ ruling, see Case C-27/04 Commission v. Council.

strengthen the SGP, primarily in the fiscal field, by reducing public debt with fiscal surveillance and also by introducing macroeconomic surveillance with the new Macroeconomic Imbalance Procedure. Furthermore, it introduces the reverse qualified majority voting (RQMV), under which the Council adopts a proposal made by the Commission, unless a qualified majority of member states vote against it. This principle of reverse voting seeks to prevent situations such as the one in 2003, when the Commission's recommendations against France and Germany failed to reach the support of the ECOFIN (Puetter, forthcoming).

In addition to the Stability and Growth Pact, as well as its subsequent reforms of 2005 and 2011, there have been more initiatives in the field of European economic governance, mainly triggered by the sovereign debt crisis, in an effort to assist member states in huge debt. Among those initiatives is the Euro Plus Pact, which was adopted by the European Council in March 2011 and aims at fostering economic policy coordination between the euro-area member states, Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania. Moreover, other mechanisms, such as the European Financial Stability Facility (EFSF) and the European Financial Stability Mechanism (EFSM) were put in place as bailout mechanisms. These mechanisms, however, lack the legal basis in the EU treaties, and therefore are only temporary. Another temporary mechanism, the European Stability Mechanism (ESM) is in process[10]. However, this work deals primarily with the EMU and the SGP and its reforms, as these are part of EU law, and therefore signify the institutional evolution – seen as the adoption of formal rules and procedures – in European economic governance. Here, a question emerges: why to deal with the Fiscal Compact, if the focus is on those measures that are part of EU legislation? The answer is that even though the Fiscal Compact is an

[10]The ESM is aimed at being incorporated in EU law with an amendment to the Treaty on the Functioning of the European Union, which will give legal basis to a separate treaty, the Treaty Establishing the European Stability Mechanism.

CEU eTD Collection

intergovernmental treaty - thus binding only for those member states that ratify it - the aim is to place this treaty in the bigger framework of European economic governance and identify whether there is continuity and whether we can apply the theory of gradual institutional change to explain its creation. Moreover, the fact that it is not incorporated into EU law, but it stands as a separate intergovernmental treaty, is also important for the subsequent analysis. It can help us draw conclusions about the trends towards European monetary integration.

After portraying the main aspects of the European economic governance, from the EMU to the Six-Pack, the aim is to trace whether the theory of gradual institutional change can be applied within this framework.

2.3. Tracing the Theory of Gradual Institutional Change in the Field of European Economic Governance

As mentioned in chapter one, the gradual institutional change theory's main assumption is that institutions change with subtle and gradual ways over time (Mahoney and Thelen 2010: 1). These changes are small and incremental and sometimes very hard to trace. However, these "incremental shifts" have an accumulative effect and they often add up to "fundamental transformations" (Mahoney and Thelen 210: 2). Moreover, the theory places attention to the concept of path dependence (Mahoney 2000; Pierson 2004; Thelen 1999), as it suggests that these gradually unfolding changes may be the causes of other outcomes. In order to trace these assumptions within the general framework of the European economic governance, the focus will be placed on the characteristics of the political context (strong or weak veto possibilities) and the characteristics of the institutions (low or high level of discretion in the interpretation and implementation of the rules), as suggested by the theory.

CEU eTD Collection

EMU traces back to the history of European integration according to McNamara (1998). He stresses that monetary cooperation and price stability has long been a concern of European political leaders, as monetary integration would encourage trade and investment among the economies of the common European market. Moreover, McNamara (1998) argues that monetary integration with a single currency for all EU member states was considered by many European leaders as a way to ensure peace and stability in Europe. The attempts to achieve monetary stability by fixed exchange-rate cooperation, besides being a continued desire of the member states (McNamara 1998: 2), were not always successful, like the 'snake'. However, the European leaders stayed committed to their goal of establishing the EMU and this commitment is evident by their adoption of the EMU and their following decisions on provisions strengthening the EMU.

The political context of the EU, within which decisions are taken towards institutional changes, offers strong veto points. For decisions regarding the EMU and Treaties' reforms, consensus among member states is necessary. For example, the concrete steps for creating the EMU were taken by the European Council. Therefore, due to the decision making process that offers strong veto points, according to the model of gradual institutional change (Mahoney and Thelen 2010), only *layering* or *drift* can occur, depending on whether the level of interpretation of the rules is high or low respectively. *Layering* is the introduction of new rules along the previous ones, without the removal of the old, while *drift* does not imply introduction of new rules, but the changed enactment of the old ones.

Although there was a general consensus regarding monetary integration, at the beginning there was a disagreement about the cooperation's focus. France was in favor of policies fostering economic growth and employment, whereas Germany was in favor of a low inflation policy. However, exogenous conditions, such as the rise in oil prices of 1973 moved

CEU eTD Collection

member states towards Germany's position of fostering low inflation policy and price stability (Bache, George and Bulmer 2011). As a result, the creation of the EMS and ERM aimed to achieve low inflation and price stability by minimizing fluctuations in exchange rates. This policy was sustained throughout the whole design of the EMU. The goal of the Maastricht criteria was to achieve convergence of the economic and monetary policies so as to ensure price stability. Maastricht Treaty is a case of *layering*, as in addition to the old rules, new rules were introduced for the creation of the EMU. Although consensus was needed for the adoption of the Maastricht Treaty, countries such as the UK and Denmark could opt out. Moreover, the level of discretion regarding the enforcement of the new rules was high, as they constituted primary source of EU law.

Following the creation of the EMU, the Eurogroup was created after a decision by the European Council of December 1997 for better coordination of economic policies. This informal body consists of the financial ministers of the euro-area countries. Although informal at the beginning, after the Lisbon Treaty the Eurogroup was 'formalized' with the protocol No 14 to the Treaty, and it can now have a president for two and a half years. Once again this was a layering, as we have the introduction of a new rule – here the creation of Eurogroup recognized by the Lisbon Treaty – alongside the existing rules.

A more evident example of layering, however, is the creation of the Stability and Growth Pact, consisting of one resolution and two council regulations, which were adopted in 1997. Again there are strong veto possibilities, as consensus is needed for the adoption of resolutions and regulations in the European Council. More specifically, these new rules have been adopted in order to maintain the policy goals of EMU, such as low inflation and price stability. The SGP added a preventive clause – the early warning – to the Maastricht convergence criteria. Moreover, it added the excessive deficit procedure (EDP), according to

CEU eTD Collection

which sanctions could be imposed to member states that would not take the necessary measures to correct their excessive deficit. These provisions are in line with the Maastricht convergence criteria and they have an added value to these piecemeal changes that take place within the general framework of European economic governance.

Although the SGP is an example of layering, its reform of 2005 could be seen as a drift, because of the Institution's discretion in the implementation of the measures. In the case of the SGP, when France and Germany failed to correct their deficits after the early warnings, the Council decided not to follow the Commission's proposal for putting France and Germany under the excessive deficit procedure. Although the Council has the right to decide against the Commission's proposal (see also ECJ ruling, case C-27/04), the Council decision was illegal, as it was against the provisions that the same Council decided upon. Therefore, we can only see the Council's decision regarding France and Germany as a drift because the rules are the same, however these rules are implemented differently (in this case the rules were not implemented). Even though France and Germany managed to gain support in the Council, the Council's decision followed by the ECJ ruling caused the discontent of several member states, as well as the Commission. The 2005 reform was the aftermath of this situation. In order to avoid similar situations in the future, the SGP was reformed in a way to permit more flexibility when it comes to sanctions (for example the one year time frame, as well as the clause regarding exceptional cases). This reform can be seen as a drift, as we have the enactment of the previous rules but in slightly different ways. The political context still remains the same, however now there is more discretion in the interpretation of the provisions and their implementation.

The Six-Pack, however, is an example of layering, as it does not question the previous rules, neither does it enact the existing rules in different ways. It only adds new rules, in the

CEU eTD Collection

form of five regulations and one directive, parallel to the SGP, so as to strengthen it. Among the Six-Pack provisions is the introduction of the Macroeconomic Imbalance Procedure, as well as the reverse qualified majority voting (RQMV), so as to enable the Commission's recommendations to reach the Council's support more easily. Again in this case we have strong veto points, as consensus was needed for the adoption of these measures. Finally, the level of discretion regarding the implementation of the provisions is rather high, and the new rules are adopted in support of the previous ones.

From the delineation of the general framework of European economic governance, it is evident that the theory of gradual institutional change can be traced, as gradual changes are happening in a piecemeal way and have an accumulative effect at the end. In this case the member states went from cooperation regarding fixed exchange rates to such an economic integration where countries can face sanctions if their deficits are higher than the limit stipulated by the SGP. The characteristics of the political context, namely the strong veto points, allow only for layering or drift, according to the level of discretion in the interpretation and application of rules allowed by the institution. The institutional changes taking place, with the exception of the 2005 SGP reform, can be characterized as layering, as new rules are added parallel to and in support of the existing ones.

After having traced the theory of gradual institutional change in the general framework of European economic governance, the Fiscal Compact will be analyzed with regards to the SGP, so as to examine what its added value is towards the SGP. This will assist to identify what type of institutional change the Fiscal Compact represents, and therefore to enable us draw conclusions as to the Fiscal Compact itself, as well as the applicability of the theory of gradual institutional change in this context.

CEU eTD Collection

CHAPTER III: Explaining the Fiscal Compact through the Lens of the Theory of Gradual Institutional Change

This chapter analyzes the Fiscal Compact (FC) with regards to the Stability and Growth Pact (SGP) after the 2011 reform of the latter. The purpose is to examine the new provisions of the Fiscal Compact and whether these provisions are diverging or in line with the previous ones stated by the SGP. This will prove whether the assumptions of the theory of gradual institutional change can be applied in the case of the creation of the FC. If so, the occurring type of institutional change can therefore be identified, and thus offer an explanation of its creation. This explanation will subsequently help us draw conclusions and make predictions as to where the European integration is directed.

3.1. The Fiscal Compact and the Stability and Growth Pact

As stated in the introduction, the Fiscal Compact[11] was signed on 2 March, 2012, by 25 out of 27 European countries[12]. It is an intergovernmental treaty that introduces reforms to the euro-area governance. If ratified by twelve member states, it will enter into force and have binding effect for all euro-area member states and for the other member states after they adopt the euro. Like the original institutional design of the EMU, which was considered to be a compromise between Germany and France, "the institutional reforms to euro area governance implemented in the light of the crisis have proceeded along similar lines with Germany seeing the Fiscal Compact as a means of strengthening member states' commitment to fiscal discipline" (Puetter, forthcoming). In order to assess the Fiscal Compact in the light

[11] The official name of this treaty is Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG). The Fiscal Compact only refers to the Title III of the TSCG where the main provisions are stated. However, in this work the use Fiscal Compact refers to the whole Treaty.

[12]The two non-signatory countries are the United Kingdom and the Czech Republic.

CEU eTD Collection

of the theory of gradual institutional change, it is necessary to compare it with the previous institutional change - in this case the last reform of the Stability and Growth Pact - so as to examine what are the new provisions and whether they are parallel to or diverging from the previous ones.

The last reform of the SGP consists of five regulations and one directive, known as Six-Pack, and entered into force on December 2011. It applies to all EU member states with specific provisions for the member states that have adopted the euro. The Six-Pack was adopted in order to strengthen the SGP. According to the SGP the general government deficit must not exceed 3% of the GDP and the public debt must not exceed 60% of the GDP, as well as each member state's budgetary balance should be in accordance with the country-specific medium-term objectives (MTO). The Six-Pack aims at reinforcing these provisions by ensuring their strict application. It does so by defining in quantitative terms what 'significant deviation' from the MTO means in the context of the preventive arm under the SGP (European Commission 2012). It further reinforces the SGP by "operationalizing the debt criterion" so as to trigger the Excessive Deficit Procedure (EDP) for a debt ratio above 60% of the GDP and not just for a government deficit of 3%, which has been the case so far.

Another key reform introduced by the Six-Pack is the reverse qualified majority voting (RQMV) for financial sanctions. Under the EDP, the Council can impose financial sanctions following the Commission's proposal. Before the 2011 reform, the Council had to approve with a qualified majority the Commission's proposal for sanctions, therefore offering the large states the possibility to oppose such proposal (as it has happened in 2003 in the case of France and Germany). With the introduction of RQMV, the Commission's proposal for financial sanctions is considered adopted, "unless a qualified majority of member states vote against it" (European Commission 2012). Therefore, the likelihood of member states to avoid

CEU eTD Collection

sanctions is less, thus signifying a stricter enforcement of the fiscal rules. Furthermore, besides the stricter enforcement of fiscal rules, the Six-Pack introduces the Macroeconomic Imbalance Procedure (MIP), which fosters macroeconomic surveillance. According to MIP an early warning system is established based on macroeconomic indicators that would initiate studies to identify potential macroeconomic imbalances (McArdle 2012).

The Fiscal Compact follows the policy directions stipulated by the revised Stability and Growth Pact (Six-Pack). It binds member states to respect and ensure convergence to the country-specific medium-term objectives (MTO) "as defined in the revised Stability and Growth Pact" (TSCG, Article 3). Moreover, it stipulates that the progress with regards to the MTO "shall be evaluated … in line with the revised Stability and Growth Pact" (Ibid). It specifies that the correction mechanism should be triggered automatically in case of deviation from the MTO (TSCG, Article 3). At the same time, it permits temporary deviation from the MTO but only in exceptional circumstances. These "exceptional circumstances" have already been set out in the Six-Pack, however the FC reiterates them and specifies that temporary deviation should not "endanger the fiscal sustainability in the medium term" (Ibid).

In addition, the articles 4 and 5 of the FC, with regards to the excessive deficit procedure, reiterate what was already stated under the Stability and Growth Pact, the TFEU and the Protocol (No 12) annexed to the European Union Treaties. Although articles 4 to 6 of the FC are not adding something new, but only restate previous provisions, article 7 commits euro-area member states to support the Commission's proposals when a member state, whose currency is the euro, "is in breach of the deficit criterion in the framework of an excessive deficit procedure", unless a qualified majority of euro-area counties is against it (TSCG, Article 7). This implies that the RQMV, which was introduced by the Six-Pack, will apply to

CEU eTD Collection

all stages of the excessive deficit procedure, and not just during the sanctioning stage as provided by the Six-Pack.

Furthermore, the FC adds a new rule to the SGP, the balanced budget rule (TSCG, Article 3). An innovation of the FC is that this balanced rule and correction mechanism should "take effect in the national law", "through provisions of binding force and permanent character, preferably constitutional" (TSCG, Article 3). Moreover, the same article states the role of independent institutions at national level in monitoring the compliance with this rule.

Another innovation introduced by the FC under the article 8 is to enhance the role of the European Court of Justice in the euro-area governance. More specifically, it derives legal basis from the article 273 of TFEU and provides for a special agreement between the contracting parties. According to this agreement, one contracting party can take another contracting party to the ECJ if the later has failed to transpose the balance budget rule and the correction mechanism into national law. In this case the ECJ can impose financial sanctions to the member state in question.

Articles 9 to 11 of the TSCG[13] restate the need for economic policy coordination and convergence by encouraging the member states (MS) to work jointly, make effective use of the measures provided by TFEU and of the enhanced cooperation for the proper functioning of the euro-area. In addition, article 11 suggests benchmarking best practices and invites MS to reinforce surveillance and coordination of economic policies among themselves with *ex-ante* discussion of the economic policy reforms that the member states plan to undertake.

Regarding the governance in the euro-area, article 12 provides for Euro Summit meetings to take place at least twice a year. It also stresses the way in which the President of

CEU eTD Collection

[13]FC refers only to title III, articles 3 to 8. Therefore, for legal clarity the full name of the treaty is now being used.

the Euro Summit shall be appointed. It further states that that non-euro area MS shall be involved in the Euro Summits when institutional issues are elaborated (Puetter forthcoming, TSCG article 12). These clauses, together with the other provisions of article 12, constitute an indirect formalization of the Eurogroup, because its functions are being recognized and supported by the contracting parties. Last but not least, article 16 suggests that after five years from the entry into force of the TSCG the treaty should be assessed and steps should be taken in order to incorporate the text of the treaty into the legal framework of the European Union.

3.2. An Assessment of the Fiscal Compact through the Theory of Gradual Institutional Change

As stated before, the main assumption of the theory of gradual institutional change is that institutional changes are happening gradually and in an incremental way. These changes are sometimes so small that are hard to trace. Moreover, these "gradual changes can be of great significance in their own right; and gradually unfolding changes may be hugely consequential as causes of other outcomes" (Mahoney and Thelen 2010: 3).

In the second chapter the EMU history was elaborated so as to trace the type of institutional changes taking place within the general context of European economic governance. It was shown how, because of strong veto possibilities within the European Council, those changes constituted either *layering* or *drift*, according to the level of discretion towards the interpretation and implementation of the rules. Most of the developments in the euro-area governance, such as the SGP, constituted *layering* because they added new rules in support of the existing ones, with the exception of the 2005 reform of the SGP. After having delineated the institutional changes within the general framework of EMU, the focus is

CEU eTD Collection

placed on the type of change the FC represents and how it can be situated within the spectrum of gradual changes in the EMU.

From the examination of the main provisions stated by the Six-Pack and the Fiscal Compact, it was shown that several provisions of the Six-Pack are being replicate in the FC, such as the escape clause of extreme circumstances, the convergence to the budgetary objectives and the assessment of compliance. However, there are few new rules added supporting the substance of the revised SGP (Six-Pack): the automatic triggering of the correction mechanism in case of deviations from the MTO, the incorporation of the balanced budget rule and the MTOs in national law, and the possibility of financial sanctions posed by the ECJ in case a MS fails to implement the balanced budget rule in national law. Therefore, it is evident that the Fiscal Compact is a case of *layering*, as it reinforces the existing rules by restating them and by adding new ones alongside the previous ones that further strengthen the previous provisions.

The fact that the FC is an intergovernmental treaty – therefore part of primary law at intergovernmental and national level – and not part of secondary EU legislation (such as regulations and directives, like the SGP and its reforms) signifies the reluctance of the MS to convey more sovereignty in the field of euro-area governance to the supranational institutions. However, as Dehousse (2012) points out, this reluctance of the MS to allow supranational institutions to have a more controlling role in the field of euro-area governance was evident already from the Maastricht Treaty. He further notes that in the article 126(10) of the TFEU "the infringement procedure[14] before the ECJ is excluded in the excessive deficit procedure framework." The same trend is still evident in the adoption of the FC by the fact that is not part of secondary EU law. However, the creators of the FC show their aim of

[14]The Commission's power to bring a case before the ECJ against a MS that fails to comply with EU law.

CEU eTD Collection

enhancing the involvement of both the ECJ and the Commission in the euro-area governance. By deriving legal basis from article 273 of the TFEU, they give to the ECJ a control power, as it can pose sanctions to a MS for its failure to transpose the provisions of article 3 in national law, but only if one of the contracting parties takes the non-complying MS to the ECJ. Therefore there is still MSs' control over the process. Nevertheless, the creators of the FC strengthen the control powers of the Commission as MSs "commit to supporting the proposals … submitted by the Commission" (TSCG, Article 7). Finally they show an open intension for the TSCG to gradually become part of EU law in article 16, where "the aim of incorporating the substance of this Treaty into the legal framework of the EU" is clearly stated.

Another important point with regards to article 3 is that once the TSCG is ratified and the provisions of article 3 are being transposed into the constitutions of the member states, any future unilateral amendment of those provisions of the FC will be is automatically prevented. This is because any amendment of these clauses at a "pan-Union level" will then require all contracting parties to achieve majorities domestically so as to amend their constitutions, something very difficult in nature (Chalmers 2012). This fact can be explained as a way to commit member states to these strict rules, preventing them from amending them in the future.

The future of the European economic governance is for sure uncertain, especially in the light of the economic crisis. From the beginning of the EMU until nowadays there have been many changes in the field of European economic governance. These changes, although underpinned by a neoliberal consensus towards a closer economic coordination and the support of policy ideas such as low inflation and price stability (McNamara 1998), have been further triggered by critical moments, such as the fall of the Bretton Woods in 1971 or the

CEU eTD Collection

current economic crisis. Dehousse (2012) for example argues that the adoption of the Fiscal Compact is an attempt to “reduce the fiscal discretion of the states” and, therefore, “calm down market fears regarding the sustainability of the euro”. The theory of gradual institutional change does not disregard the triggering effects of exogenous variables, such as the economic crisis. However, it places changes into a context of gradual institutional evolution, where each change is built on the foundations of the previous policies and where every change has an accumulative effect.

According to the theory of gradual institutional change the FC constitutes a *layering,* which adds to the existing rules and supports their foundation. Several articles in the press (Vitorino 2012, Feldstein 2012) mention that the FC has limited added value and it is rather the reiteration of the previous provisions stated by the SGP and its last reform. These comments prove one of the theory’s main assumptions that changes are small and sometimes hard to trace. Nevertheless, the FC does add some new provisions, which can now seem as small changes, however, if seen within the bigger context of the EMU and through the theory of gradual institutional change, one can identify that these small changes have an accumulative effect leading to closer and stricter economic cooperation. Already the article 16 offers a hind by stipulating that after five years all the necessary steps should be taken in order to incorporate the substance of the TSCG into the legal framework of the EU. This clause, together with article 3 that aims at reducing MS’s fiscal discretion, article 7 that strengthens the control of the Commission and article 8 that offers ECJ the power to impose sanctions under certain conditions, show a tentative but clear trend towards more economic and monetary integration, with the possibility of introducing more supranational control in the future.

CEU eTD Collection

CONCLUSION

This thesis aimed at examining whether the assumptions of the theory of gradual institutional change could be traced in the context of European economic governance, and more specifically in the creation of the Fiscal Compact (FC), so as to provide an explanation of its creation. For this purpose the main aspects of European economic governance were delineated in order to trace the theory's main assumptions within the bigger context of European economic governance, up to the creation of the FC. This enabled me to identify what kind of institutional change the FC represents according to the types suggested by the theory, and therefore shed light on what the FC signifies and what further developments can be expected in the field of European economic governance.

It was proven that the main assumptions of the theory of gradual institutional change are applicable in the context of European economic governance in general, and in the case of the FC in particular. More specifically, it was shown that the case of the FC constitutes *layering*, as new rules are being introduced parallel to and in support of the already existing ones. The fact that the changes introduced by the FC with regards to the Stability and Growth Pact are small and even hard to trace proves the theory's main assumption that changes are slow and piecemeal, having an accumulative effect.

Due to time constraints, as well as limitations regarding the availability of literature, this topic should be subject to further research. This is because the Fiscal Compact is new, and only after its ratification and enforcement one can actually observe its functionality and applicability and the actual level of discretion with regards to its implementation. Further research could aim at incorporating the change agents – suggested by the theory of gradual institutional change – so as to correlate the main actors' strategies with regards to the occurring mode of institutional change, and whether the political context of the European

CEU eTD Collection

economic governance favors one type of change agent over another. Another suggestion would be to examine how gradual institutional changes happening in the field of European economic governance are being supported or entangled by gradual institutional changes occurring at the same time in the EU, such as the introduction of new decision-making rules in favor of less veto points, and whether this is leading to changes such as *conversion* or *displacement*.

CEU eTD Collection

BIBLIOGRAPHY

Annett A., Decressin J. and M. Deppler. 2005. “Reforming the Stability and Growth Pact”, *IMF Policy Discussion Paper*. PDP/05/02, IMF.

Bache I., George, S. and S. Bulmer. 2011. *Politics in the European Union.* New York: Oxford University Press.

Begg, I., Hodson, D., and I. Maher. 2003. “Economic Policy Coordination in the European Union.” *National Institute Economic Review* 183: 67-77

Brunila, A., Buti, M. and D Franco, eds. 2001. *The Stability and Growth Pact: The Architecture of Fiscal Policy in EMU.* New York: Palgrave Macmillan.

Bulmer, S. 1998. “New Institutionalism and the governance of the Single European Market.” *Journal of European Public Policy* 5(3): 365-86

Buti, M. and A. Sapiro. 2002. *EMU and Economic Policy in Europe: The challenges of the Early Years.* Cheltenham, UK: Edward Elgar Publishers.

Buti, M. and D. Franco. 2005. *Fiscal Policy in Economic and Monetary Union: Theory, Evidence and Institutions.* Cheltenham, UK: Edward Elgar Publishers.

Cabral, A.J. 2000. Main Aspects of the Working of the SGP. In *The Stability and Growth Pact: The Architecture of Fiscal Policy in EMU, e*ds. Brunila, A., Buti, M. and D. Franco. New York: Palgrave Macmillan.

Chalmers, D. 2012. “The European Court of Justice has taken on huge powers as ‘enforcer’ of last week’s Treaty on Stability, Coordination and Governance. Yet its record as a judicial institution has been little scrutinized.” http://blogs.lse.ac.uk/europpblog/2012/03/07/european-court-of-justice-enforcer/ [accessed 18 May 2012]

Chang, M. 2012. “Understanding the rules of European economic governance: Economics, politics and wishful thinking.” *Journal of European Integration* 34(3): 297-303

Chang, M. 2009. *Monetary Integration in the European Union.* Basingstoke: Palgrave Macmillan.

Collignon, S. 2003. “Is Europe going far enough? Reflections on the Stability and Growth Pact, the Lisbon strategy and the EU’s economic governance.” *European Political Economy Review* 1(2): 222-247

De Grauwe, P. 2005. *Economics of Monetary Union.* 6th edn.; New York: Oxford University Press.

Dehousse, R. 2012, “The ‘Fiscal Compact’: legal uncertainty and political ambiguity.” *Notre Europe Policy Brief*, (33) http://www.notre-europe.eu/en/axes/visions-of-europe/works/publication/the-fiscal-compact-legal-uncertainty-and-political-ambiguity/ [accessed 18 May 2012].

Deroose, S., Hodson, D. and J. Kuhlmann. 2008. “The Broad Economic Policy Guidelines: before and after the re-launch of the Lisbon Strategy.*”Journal of Common Market Studies* 46(4): 827-848

CEU eTD Collection

De Schoutheete, P. 2011. “Decision-making in the Union.” *Notre Europe Policy Brief*, (24). http://www.notre-europe.eu/uploads/tx_publication/Bref24-DeSchoutheete-EN.pdf [accessed 18 May 2012]

Dyson, K. and K. Featherstone. 1999. *The road to Maastricht.* Oxford: Oxford University Press.

Dyson, K. 1994. *Elusive Union: The process of Economic and Monetary Union in Europe.* London: Longman.

Eichengreen, B. 2012. “European Monetary Integration with Benefit of Hindsight.” *Journal of Common Market Studies* 50(S1): 123-136

Feldstein, M. 2012. “Europe’s Empty Fiscal Compact”, *Project-Syndicate,* http://www.project-syndicate.org/commentary/europe-s-empty-fiscal-compact [accessed 18 May 2012]

Hall, P. A. 1986. *Governing the Economy.* New York: Oxford University Press.

Hall, P.A. and R. C. Taylor. 1998. “The Potential of Historical Institutionalism: A Response to Hay and Wincott.” *Political Studies* 46: 958–62

Hall, P.A. and R. C. Taylor. 1996. “Political Science and the Three New Institutionalisms.” *Political Studies* 44(5): 936–57

Heipertz, M. and A. Verdun. 2010. *Ruling Europe: The politics of the Stability and Growth Pact.* Cambridge: Cambridge University Press.

Heipertz, M. and A. Verdun. 2005. “The Stability and Growth Pact – Theorizing a Case in European Integration.” *Journal of Common Market Studies* 43(5): 985-1008

Heipertz, M. and A. Verdun. 2004. “The dog that would never bite? What we can learn from the origins of the Stability and Growth Pact.” *Journal of European Public Policy* 11(5): 765-780

Hix, S. 2005. *The political system of the European Union*. Houndmills Basingstoke: Palgrave Macmillan.

Hodson, D. and U. Puetter. 2012. The EU and the Economic Crisis. In *European Union Politics,* eds. Gini, M. and N. Perez-Solorzano Borragan. 4th edn.; Oxford: Oxford University Press, forthcoming.

Hodson, D. 2011. *Governing the euro area in good times and bad.* Oxford: Oxford University Press.

Hodson, D. 2009. “EMU and political union: what, if anything, have we learned from the euro's first decade?” *Journal of European Public Policy* 16(4): 508-526

Hodson, D. 2009. “Reforming EU economic governance: A view from (and on) the principal-agent approach.” *Comparative European Politics* 7: 455-475

Hodson, D. 2007. “Economic Developments in the Euro Area.” *Journal of Common Market Studies* 45: 213-230

Hodson, D. and L. Quaglia. 2009. “European Perspectives on the Global Financial Crisis: Introduction.” *Journal of Common Market Studies* 47(5): 939-953

Hodson, D. and I. Maher. 2004. “Soft law and sanctions: economic policy co-ordination and reform of the Stability and Growth Pact.” *Journal of European Public Policy* 11(5): 798-813

CEU eTD Collection

Hodson, D. 2004. “ Macroeconomic co-ordination in the euro area: the scope and limits of the open method.” *Journal of European Public Policy* 11(2): 231-248

Hosli, M. O. 2005. *The Euro: A Concise Introduction to European Monetary Integration.* Boulder CO: Lynne Rienner.

Issing, O. 2004. “The Stability and Growth Pact: The appropriate fiscal framework for EMU.” *International Economics and Economic Policy* 1(1): 9-13

Jorgensen, K.E., Pollack, M. A. and B. Rosamond, eds. 2006. *Handbook of European Union Politics.* London: SAGE Publications.

Korkman, S. 2001. Fiscal policy coordination in EMU: Should it go beyond the SGP? In *The Stability and Growth Pact - The architecture of fiscal policy in EMU,* eds. Brunila, A., Buti, M. and D. Franco. New York: Palgrave Macmillan, pp. 287-312.

Lane, J. E. and S. Ersson. 2000. *The New Institutional Politics. Performance and Outcomes.* London: Routledge.

Mahoney, J. and K. Thelen. 2010. *Explaining Institutional Change. Ambiguity, Agency, and Power.* Cambridge, NY: Cambridge University Press.

March, J. G. and J. P. Olsen. 2006. Elaborating the New Institutionalism. In *The Oxford Handbook of Political Science,* eds. R. A. W Rhodes and S. A. Binder. Oxford: Oxford University Press.

March, J. G. and J. P. Olsen. 1998. “The Institutional Dynamics of International Political Orders.” *International Organization* 52(4): 943-70

March, J. G. and J. P. Olsen.1989. *Rediscovering Institutions: The Organizational Basis of Politics.* New York: Free Press.

March, J. G. and J. P. Olsen. 1984. “The new institutionalism: organizational factors in political life.” *American Political Science Review* 78: 734-49

Martin, A. and G. Ross. 2004. *Euros and the Europeans: Monetary Integration and the European Model of Society.* Cambridge: Cambridge University Press.

McArdle, P. 2012. “The Euro Crisis, The ‘Fiscal Compact’ and Fiscal Policy.” *Working Paper No. 6.* The Institute of International and European Affairs http://www.iiea.com/publications/the-euro-crisis-the-fiscal-compact-and-fiscal-policy [accessed 18 May 2012]

McNamara, K. 2005. Economic and Monetary Union. In *Policy-Making in the European Union,* eds. H. Wallace, W. Wallace and M. Pollack. 5th edn. Oxford: Oxford University Press, pp. 141-60.

McNamara, K. 1998. *The Currency of Ideas: Monetary Politics in the European Union.* Ithaca, NY: Cornel University Press.

Medrano, J. D. 2012. “The Limits of European Integration.” *Journal of European Integration* 34(2): 191-204

Moravcsik, A. 1998. *The choice for Europe: Social Purpose and State Power from Messina to Maastricht.* London: UCL Press.

North, D. C. 1990. *Institutions, Institutional Change and Economic Performance.* New York: Cambridge University Press.

CEU eTD Collection

North, D. C. 1986. “The New Institutional Economics.” *Journal of Institutional and Theoretical Economics* 142: 230–37

Offe, C. *Designing Institutions for East European Transitions*, http://www.colbud.hu/main_old/PubArchive/PL/PL09-Offe.pdf [accessed 18 May 2012]

Parsons, C. 2007. *How to Map Arguments in Political Science*. New York: Oxford University Press.

Peters, G. 2008. Institutional Theory: Problems and Prospects. In *Debating Institutionalism*, eds. J. Pierre, G. Peters, G. Stoker. Manchester: Manchester University Press.

Peters, G. 2005. *Institutional Theory in Political Science: The ‘New Institutionalism’*. UK: Ashford Colour Press.

Peters, G. 2000. “Institutional Theory: Problems and Prospects.” *Political Science Series*, Vol. 69. Institute for Advanced Studies, Vienna.

Pierson, P. 2004. *Politics in Time: History, Institutions and Social Analysis.* Princeton, NJ: Princeton University Press.

Pierson, P. and T. Skocpol. 2002. Historical Institutionalism in Contemporary Political Science. In *Political Science: State of the* Discipline, eds. I. Katznelson and H.V. Milner. New York: Norton, pp. 693–721.

Pierson, P. 2000. “Increasing Returns, Path Dependence, and the Study of Politics.” *American Political Science Review* 94(2): 251-267

Pierson, P. 1998. The path to European Integration: A Historical Institutionalism Analysis. In *European Integration and Supranational Governance*, eds. W. Sandholtz and A. Stone Sweet. Oxford: Oxford University Press.

Posner, E. 2007. Financial Transformation in the European Union. In *Making History: European Integration and Institutional Change at Fifty, State of the European Union*, Vol.8, eds. K. McNamara and S. Meunier. Oxford: Oxford University Press, pp. 175-193.

Puetter, U. 2012. “Europe's deliberative intergovernmentalism - the role of the Council and European Council in EU economic governance.” *Journal of European Public Policy* 19(2): 161-78

Puetter, U. 2006. *The Eurogroup: How a Secretive Circle of Finance Ministers Shape European Economic Governance*. Manchester: Manchester University Press.

Puetter, U. 2004. “Governing informally: The Role of the Eurogroup in EMU and the Stability and Growth Pact.” *Journal of European Public Policy* 11(5): 854-870

Rosamon, B. 2000. *Theories of European Integration*, European Union Series.

Rothstein, B. 1996. Political Institutions: An Overview. In *A New Handbook of Political Science*, eds. R. Goodin and H. D. Klingemann. Oxford: Oxford University Press.

Sandholtz, W. 1993. “Choosing Union: Monetary Politics and Maastricht.” *International Organization* 47: 1-39

Shepsle, K. A. 1989. “Studying Institutions. Some Lessons from the Rational Choice Approach.” *Journal of Theoretical Politics* 1(2): 131-147

CEU eTD Collection

Shuknecht, L., Moutot, P., Rother, P. and J. Stark. 2011. "The Stability and Growth Pact, Crisis and Reform." *Occasional Paper Series* No. 129, European Central Bank

Streeck, W. and K. Thelen. 2005. *Beyond Continuity: Institutional Change in Advance Political Economies*, Oxford: Oxford University Press.

Tallberg, J. 2010. "Explaining the institutional foundations of European Union negotiations." *Journal of European Public Policy* 17(5): 633-47

Thelen, K. 1999. "Historical Institutionalism in Comparative Politics." *Annual Review of Political Science* Vol. 2

Tsebelis, G. 1990. *Nested Games.* Berkeley, CA: University of California Press.

Tsoukalis, L. 1997. *The Politics and Economics of European Monetary Integration.* London: George Allen and Unwin Publishers.

Ungerer, H. 1997. *A Concise History of European Integration: From EPU to EMU.* USA: Greenwood Publishing Group.

Verdun, A. 2010. Economic and Monetary Union. In *European Union Politics*, eds. Cini, M., Pérez-Solórzano Borragán, 3rd edn.; Oxford: Oxford University Press.

Verdun, A. 2009. Economic Growth and Global Competitiveness: From Rome to Maastricht to Lisbon. In *The SAGE Handbook of European Studies*, ed. C. Rumford.

Verdun, A. 2007. "Economic Developments in the Euro Area." *Journal of Common Market Studies* 44: 199-212

Verdun, A. ed. 2002. *The Euro: European Integration Theory and Economic and Monetary Union.* Lanham, MD: Rowman and Littlefield.

Verdun, A. 1999. "The role of the Delors Committee in the creation of EMU: An epistemic community?" *Journal of European Public Policy* 6(2): 308-328

Vitorino, A. 2012. "The 'TSCG': much ado about nothing?" *Notre's Europe Viewpoint* http://www.notre-europe.eu/uploads/tx_publication/TSCG_ViewpointNE_Feb2012_01.pdf [accessed 23 May 2012].

Zimmermann, H. 2001. "The euro under scrutiny: History and theories of European monetary integration." *Contemporary European History* 10(2): 333-341

European Central Bank (2012) "A Fiscal Compact for a stronger Economic and Monetary Union." *ECB Monthly Bulletin*, May 2012 http://www.ecb.eu/pub/pdf/other/art1_mb201205en_pp79-94en.pdf [accessed 18 May 2012].

Gateway of the European Commission http://www.europa.eu [accessed 18 May 2012].

Treaty of Stability, Coordination and Governance in the Economic and Monetary Union http://european-council.europa.eu/media/639235/st00tscg26_en12.pdf [accessed 18 May 2012].

Treaty on the Functioning of the European Union http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:115:0047:0199:en:PDF [accessed 18 May 2012].

CEU eTD Collection

Resolution of the European Council on the Stability and Growth Pact, Amsterdam 17 June 1997
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997Y0802%2801%29:EN:HTML
[accessed 18 May 2012].

Judgment of the European Court of Justice 13 July 2004, Case C-27/04
http://curia.europa.eu/juris/liste.jsf?language=en&jur=C,T,F&num=C-27/04&td=ALL
[accessed 18 May 2012].

CEU eTD Collection