

Economic and Monetary Union: Insights into the Theoretical Conundrum of European Integration

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Abstract

As part of an ongoing research, this paper focus on European monetary integration depicting to what extent existing theories and theoretical approaches fit with the ontology and subsequent developments of Economic and Monetary Union (EMU). A special emphasis goes to the Stability and Growth Pact (SGP) as a crucial ingredient of European monetary integration, particularly for the political turmoil it produced in recent years.

On a previous conference (UACES Annual Conference 2007: *Exchanging Ideas on Europe: Common Values and External Policies*, Portsmouth, UK, 3-5 September 2007), EMU and the SGP were assessed through the lens of neofunctionalism, liberal intergovernmentalism, supranational governance, new institutionalism and the fusion thesis. This paper turns to the federal theory and the rational choice theory. Some argue that the power of ideas (the monetarist school) and national governments’ adjustment to a new international setting provide the broad explanation of the move towards EMU. Others claim that the project of European monetary integration was independent from such exogenous inputs, understanding the step towards EMU as part of the dynamism encapsulated by European integration. I test these contrasting perceptions against the explanatory power of federal theory and rational choice. The analysis of the SGP (in both the original version and after the November 2005 reform) follows the same methodology.

The rationale behind the paper is twofold. On the one hand, whether EMU and the SGP fit into one of the theories under examination, and whether the corresponding mapping is telling of theoretical prevalence or dissemination. On the other hand, whether the SGP (and subsequent reform) converges or diverges with EMU’s theoretical matrix.

INTRODUCTION

The design and launch of Economic and Monetary Union (EMU) considerably affected member states’ economic policy autonomy, for some even national sovereignty. What is certain is that EMU significantly altered the process of European integration. Section 1 presents the theoretical framework for understanding whether EMU evolution is

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instructive of paradigm shift. For that purpose, a brief review of federal theory and rational choice's theorisation of European integration is undertaken. Sections 2 and 3 review EMU through the federal theory and rational choice, respectively. The aim is to isolate specific events or ideas beneath EMU and to what extent they match rational choice and the federal theory. Sections 4 and 5 follow the same methodology to examine the Stability and Growth Pact (SGP). I am particularly interested in an interpretation of events that triggered reform and whether change goes against the theoretical tide of EMU or is just a confirmation of its theoretical paradigm.

1. A SURVEY OF FEDERALISM AND RATIONAL CHOICE AS THEORISATIONS OF EUROPEAN INTEGRATION

Engaging on a theoretical approach of EMU through the federal theory and the rational choice theory is a risky undertaking. On the one hand, both are meta-theories and they predated the theorisation of European integration (Von Krosigk 1970, Benson and Jordan 2008, and Pollack 2006). Both rational choice and the federal theory are second-order theorisations since they do not draw on the specific context of European integration. At best, they are an exogenous element that enters the field of European integration theories. On the other hand, federal theory and rational choice stand in distinctive plans as far as their methodologies are concerned. It might be puzzling how I propose to build a theoretical interpretation of European monetary integration taking federalism and rational choice as theoretical frameworks. Each theory has different conceptual tools: federalism looks at the *finalité* of the European Union (Burgess 2003: 65) while rational choice dives into the ontology of European integration (Pollack 2006: 32).

The question concerns the viability of bringing together two theoretical approaches lying in different levels of analysis. While rational choice looks through the rear-view mirror (Wendt 2001) and explains how it was possible to achieve the present status of European integration, federal theory takes one step further (looking through a time dimension) and pays attention to the outcome of European integration. Despite the apparent implausibility of comparing federalism and rational choice, I suggest they are not contradictory in terms. Although located at different levels, they may be complementary as theoretical explanations of EMU. Their potential for the theoretical assessment of European monetary integration lies on the possibility of being *overlapping theories* (Jachtenfuchs 2002) for much of EMU's design and operation.

Notwithstanding several sectors demonise the “federal” word, many accounts of European integration look at the EU as a polity with embedded federal principles of governance (Inman 2007). Scholars who put the EU on the federal track stand outside the truism of the EU as a *sui generis* polity, drawing on comparative studies (Neyer 2006), to argue that it is located somewhere between the state and the international dimension (Koslowski 1999). The reason behind this methodological position is that

(...) since the 1960s the EU has achieved a degree of maturation that makes it comparable to state-like political systems. In consequence, what we see in the EU is ‘politics like any other’ that can be and should be analysed by the tools and theories of comparative politics (Jachtenfuchs 2002: 651).

According to the literature on federalism, any effort to illustrate the characteristics of federalism is in vain, because federalism is a heterogeneous, open to variability concept as federal countries’ experiences reveal. In fact, ‘(...) attempts at defining either the word or the thing are likely to be futile’ (Sawer 1969: 2) Nonetheless, a survey on the literature provides a minimum denominator of federal systems’ features:

- i) The federal polity emerges from a constitutional settlement as the culmination of a bargaining process (von Krosigk 1970);
- ii) The outcome is a system of government where two or more levels of government interact and sovereignty provisions are mainly concentrated on the central government;
- iii) In conceptual terms, federalism is a “balance between organizational principles” (Egeberg 2001: 741) of centralisation and decentralisation. On a comparative dimension, this formula is better than claiming that federalism encompasses a decentralisation bias (Burgess 2003). Some federations are more decentralised than others, while in some cases recent evolution made them more centralised than in the past;
- iv) Constitutional competence delimitation ensures each government tier enacts and monitors policies granted by the constitutional settlement. Although the absence of state sovereignty makes the EU distinct from other federations, competence delimitation is typical of the historical development of federations elsewhere (Swenden 2004).

Assuming, as the federal theory does, that normative considerations are important to shape a federal polity, the understanding of federal values is crucial to find out whether they affect the development of European integration, and EMU in particular. Three

basic values guide the creation of a federation: economic efficiency, democratic participation, and the protection of personal rights and liberties (Inman 2007). The federal theory might be well equipped as long as European integration in general and EMU in particular fit with these values. To this extent, the usefulness of federal theory might go beyond the positivist prescription that envisages it as a toolkit for examining the vertical allocation of powers in the EU (Benson and Jordan 2008). Outside conventional patterns, a normative dimension invades the federal theory analysis of the EU. Thus, a third difference between federal theory and rational choice comes to the surface: while federalism shows no embarrassment in handling with normative prescriptions, rational choice is inherently averse to normative considerations.

At this stage I am interested in finding out the seeds of the federal analysis of European integration at large, without going into the examination of monetary integration. How embedded is federalism in the EU? According to mainstream federalist literature of European integration, today there is a federal Europe that

has at his core a set of basic principles or assumptions that indicate a voluntary union of states and citizens committed to the shared goals of welfare, security, and prosperity, and which is structured in a manner specifically designed to preserve nation states' identities, cultures, and interests, where these are consistent with the overall wellbeing of the Union (Burgess 2003: 66).

Rational choice theory is also exogenous to European integration. It is a “broad social approach to social theory, capable of generating an array of specific theories and testable hypotheses about a range of human behaviors” (Pollack 2006: 31). Rational choice focuses on ontological and epistemological questions. It is an interesting focal point for explaining how EMU emerged and subsequent developments. The crucial question is whether many events that paved the way to monetary union in Europe meet the theoretical underpinnings of rational choice.

At the heart of rational choice theory lie three conditions (Pollack 2006: 32): i) the basic unit of analysis is the individual; ii) individuals' behaviour is expected to be utility-maximising; iii) nonetheless, the prospects for maximising utility depend on exogenous factors that constraint actors' choices, i.e., rational decision is taken after measuring several alternatives in the face of exogenous constraints. In this respect, the interaction of individuals' interests influences outcomes. Rational choice takes for granted that a certain outcome is possible because several prominent actors' interests converge. This is, I suggest, the promising potential of rational choice to explain how EMU emerged and further crucial developments (the creation of the Stability and Growth Pact and the

reform the pact underwent following political turmoil about its enforceability). Outside the realm of EMU, some authors argue that rational choice is becoming increasingly important for the study of European integration, since

as the EU develops a stable and familiar institutional environment and pattern of interest articulation and interaction, rational choice explanations are increasingly important. (...) (Only by drawing from our wealth of existing knowledge about institutions, behaviour and democracy, from the study of politics and government in existing political systems, will we be able to understand how the EU works and how it could be made to work better (Hix 1998: 55).

Actor-centred rational choice is a valuable input for the study of European integration. It emphasises how the interests and strategies of relevant actors bolster the EU policy-process (Hix 1998). These actors maximise their interests irrespective of pressures exerted by social and political forces (Neyer 2006). Actor-centred rational choice downplays the role of supranational institutions as key and autonomous actors shaping European integration. Even though rational choice is ready to acknowledge supranational institutions have a say in the EU, actors' choices predetermine institutions. EU institutional configuration is an outcome of relevant actors' preferences. They estimated that such institutional setting was suited to bring mutual gains over time (Pollack 2008).

Some scholars suggested a derivation of rational choice encompassing the role of institutions – *rational choice institutionalism*. The picture is an interactive relationship between actors, institutions and policy outcomes (Koremenos, Lipson and Snidal 2003). At the end of the spectrum lie policy outcomes. Institutions have a direct impact on policy outcomes. Nevertheless, institutions are not entirely autonomous actors since their design closely follows actors' preferences (Hix 2007). The way institutions behave and their preferences face a straightjacket: institutions' design is the constraint upon their preferences and actions. No matter how autonomous institutions appear to be, that autonomy is illusory. After all institutions are the creation of their masters – actors who behaved rationally.

There is room for an application of rational choice institutionalism to European integration. The model acknowledges a three-level relationship (Leblond 2004). Member states' preferences and interests lie at the heart of crucial EU developments bargained at intergovernmental conferences. Developments, however, ask for implementation – the day-to-day politics of the EU. Member states delegate implementation on supranational institutions. Thus, institutions have the lion's share

when European integration politics translate into policies. Importantly, at the end of the delegation process frequently results are more ambitious than if they were established right at the intergovernmental conference (Pollack 2003: 101). Yet, ambitious results do not render institutions' emancipation because they are constrained by the mandate given by principals. It is member states who take the helm of European integration, for they

(...) understand what they are doing when they sign treaties. (...) (T)he institutional interactions (...) generally reflect the collective will of the member governments concerning their desired trajectory for the evolution of the EU (Tsebelis and Garrett 2003: 360).

Even in cases where a noticeable ambition marks policy outcomes, rational choice institutionalism explains that ambition does not come against member states' willingness. The centrality of institutions is itself an intended consequence of actors' strategies.

2. THE FEDERAL THEORY AND ECONOMIC AND MONETARY UNION

According to several scholars (Pinder 1998, Buitter 1999, Burgess 2000, and McKay 2001), federalism makes part of the genetics of European integration from the moment EMU was planned. EMU is not a typical monetary union for two reasons: i) it is composed of countries where nationhood is deep-rooted for centuries (Levitt and Lord 2000: 256); in other federations the central (federal) government is dominant in macroeconomic policy-making. Conversely, despite EU national governments lost monetary policy they still have a fundamental say in the design and implementation of economic policy. Thus, Eichengreen is right when he warns that the

US experience cannot be applied mechanically to Europe. The United States of America and a 'United States of Europe' would differ in both economic and political structure (Eichengreen 1997: 14).

EMU also represents a different case of integration within the EU system. It is different from all other areas of European integration due to the exclusion of the Council of Ministers from monetary policy definition and implementation (Featherstone 1999) – and, crucially on this respect, monetary policy is the key instrument of economic policy-making in the Euro-zone.

This section emphasises the institutional aspects of EMU that reinforce its distinctive federalist conception. Firstly, it stresses how the supranational central bank dominates the institutional architecture of EMU. Then it proceeds to the characterisation of the European Central Bank (ECB) as a genuinely federal institution.

2.1. An ECB-centric EMU

Two institutional aspects reveal the federalist nature of EMU: ECB's hegemony, and the emphasis on monetary policy and price stability. Accounts of the institutional characteristics of EMU underline how it is a system highly dominated by the ECB (Jones 2002, and Howarth and Loedl 2003). The illustration comes on Dyson's assertion that EMU is 'ECB-centric' (Dyson 2000a: 12). The central role of monetary policy and the mechanisms ensuring the ECB a dominant position in EU's inter-institutional relationships as well as with national governments explain the central bank's prominent role. Central bank's monopoly on monetary policy has a constitutional backup on strong guarantees of political, operational and financial independence. This seems consistent with one aspect of federalism: a constitutional settlement establishing the distribution of competences among the several units of government involved and ensuring that each government tier is independent (Von Krosigk 1970).

For some, EMU emulated the rationale of the time-inconsistency literature and the claim that price stability requires the delegation of monetary policy to an independent agency (Alesina and Tabellini 2004). This aspect finds resemblance with rational choice and not so much with the federal theory. As I stressed in the previous section, the ambiguity of taking stock of two theories standing at different levels explains the analytical confusion. Despite no correlation with the federal theory seems discernible, this rational choice strategy produced an outcome consistent with the federal theory.

Moreover, if a member state insists on excessive deficits this option is unproductive because ECB's strong powers offset the unwanted consequences of that fiscal policy stance. The effect is an increase in interest rates dictated by financial markets. If higher interest rates go against central bank's preferences, the ECB reacts through faster growth of the money supply. Rising inflation cancels out the strategy of the lenient member state (Beetsma and Uhlig 1999), because higher inflation creates extra difficulties for the country to service its debt.

From an institutional point of view, these facts help to understand how dominant the ECB is – according to some, the most powerful institution of the EU (Padoa-Schioppa 2000). Being genuinely supranational, as the Commission is, a comparison between their powers and effectiveness shows how ECB's role is superior to the Commission's (Dyson 2000a). In addition,

(...) explicit, treaty-based commitment has the advantage that the performance of the Bank can be measured unambiguously against the rod provided by the regular statistical measurements of inflation in the Eurozone. In this sense, at least, the ECB is an accountable institution, which is more than can be said about the European Commission (Majone 2006: 620).

2.2. Is the ECB an Archetype of a Federal Institution?

So far, the only conclusion is the central role of the ECB. This does not add too much to the federal theory approach of EMU. It is possible to establish a similarity between EMU and federalism, but that depends on a comparison with federal countries where a national (federal) central bank is above regional (state) central banks. Nonetheless, an accurate, federal theory analysis of EMU requires a far-reaching examination of ECB's institutional architecture in order to capture whether the central bank shows any resemblance with a federal-type institution.

For some, the ECB is a federal institution without advancing elaborated explanations (Sandholtz 1993). Others relied extensively on the comparison between the institutional settlement of EMU and central banking structure in federal countries, notably the hierarchical relationship between different tiers of central banks (Gerdesmeier, Mongelli and Roffia 2007). The hierarchical relationship sends some signals, but they are not enough to envisage the ECB as a federal body.

The explanation of the federal dimension of the ECB lies in its operational details. The European System of Central Banks (ESCB) comprises the ECB at the top of the pyramid and national central banks (NCBs) at the bottom. Beyond the hierarchical characterisation of the ESCB, what matters is the relationship between the ECB and NCBs. The key aspects enabling the federal classification of the ECB are the institutional characterisation of the ECB and the implementation of decisions emanating from the central bank.

Firstly, ECB's institutional set up is made of two bodies: the Governing Council and the Executive Board. The latter is where European Council-appointed six members monitor the evolution of the European economy and, in doing so, they act independently (from other EU institutions and national governments). All Euro-zone member states' central bankers plus the six supranational central bankers meet at the Governing Council. This is the main decision-making body of the ECB for all monetary policy major decisions. NCBs implement monetary policy decisions at the national level (Quaglia 2007).

NCBs are the executive agents of the ECB, which is further evidence of a hierarchical relationship. More importantly yet is the decentralisation nature of the ESCB (Howarth and Loedl 2003): policy design is centralised but only NCBs participate at the implementation stage. For the purposes of federal theory's examination of EMU, this *decentralisation feature* is crucial on two accounts: on the one hand, despite monetary policy is overall centralised, this decentralist element softens centralisation; on the other hand, it resonates with decentralised federalism.

Secondly, each national central banker does not represent his/her country's interests in the ECB Governing Council. Nonetheless, since they are not personally in representation of a supranational institution this softens the overall centralised decision-making process of the ECB. True, they are *formally* members of a supranational institution. More important than this formalism is to ask why NCBs governors have a seat on the ECB: because they are governors of national central banks. Material linkage supersedes the formalist measure. By implication, fifteen out of twenty-one members have a seat on the ECB Governing Council because of their national affiliation.

Both implementation stage and membership of the ECB Governing Council signal the soft centralisation nature of the ECB (and the ESCB). This finding is consistent with a model of federalism dominated by decentralisation (Riker 1964). On this respect, the ECB shows a remarkable similarity with a federalist-structured institution. Even on a comparative dimension, the ECB seems more federal than other federal central banks like the U.S. Federal Reserve System or the Bundesbank (Sbragia 1992: 275-6). Several reasons support this conclusion:

- i) Equal voting powers among national central bankers;
- ii) The nature of Governing Council decision-making process, where decisions are passed by simple majority (despite it has been noticed that decisions are taken by consensus) (Amttenbrink 2002);
- iii) ECB's far-reaching powers and a political independence status that is more extensive than in the U.S. Federal Reserve and the *Bundesbank* feed the conclusion that the ECB is more federal (de Haan and Eijffinger 2000). The federal characteristic emerges from a decentralisation outcome, because technocratic decisions about monetary policy fall outside politics: *the central bank is scrutinised by markets and the public at large* (Issing 1999, and Majone

2006). Before EMU, monetary policy relied on a complex and rather obscure collusion between national executives and central banks (Gowan 1997).

3. RATIONAL CHOICE THEORY AND ECONOMIC AND MONETARY UNION

Monetarism was the ideational force behind EMU. It is therefore important to acknowledge the reasons that lead the architects of monetary integration to choose a monetarist-led model. For that purpose, four aspects are analysed throughout this section: the fear of inflation and a culture of stability; how economic interdependence worldwide diminished national governments' ability to run Keynesian economic policy; how member states promoted monetary union to launch painful domestic reforms; and the effect of EMU in terms of decentralisation.

The ideational underpinnings of EMU ran together with member states' shift to a different economic policy-making paradigm. Member states already accommodated to neo-liberalism before EMU, going alongside a structural tendency among industrialised countries (Gillingham 2003). Keynesian economic policy was no longer among member states' interests (McNamara 1999). The landmark was Mitterrand's decision to change French economic policy paradigm in the early 80s: the French president welcomed monetarist ideas. This triggered ideational change in Western Europe (McNamara 2001). Subsequently all centre-left parties in charge of national governments accommodated to neo-liberal ideals (Verdun 2000). Macroeconomic ideological convergence predates EMU, as long as

(...) the Maastricht provisions on EMU represent the culmination of an 'historic economic policy convergence' in the Western Europe of the 1980s, as governments of the left as well the right sought to emulate the economic success of the Bundesbank, embracing the monetarist project as the most promising answer to the economic policy failures of the late 1970s' (Pollack 2000: 276).

Other aspects explain the neo-liberal agenda that inspired EMU. The climate of market liberalisation in Europe was particularly important, notably after the Single European Market (SEM) planned for January 1st. 1993. The SEM created a new impetus for monetary integration (Sandholtz 1993, and Verdun 2002). Moreover, intense economic integration changed the relationship between states and capital, increasing markets' power and decreasing national governments' autonomy to run economic policy (Hooghe 1998). Neo-liberal agenda was already in motion when EMU negotiations

started. The outcome was a monetary union influenced by the monetarist school, the extension of the neo-liberal agenda already in motion.

According to rational choice accounts, the far-reaching neoliberal consensus that gave rise to EMU (Mistri 2007, and Schneider and Häge 2008) feeds alternative outcomes. Some argue that EMU was designed to “bind-in Leviathan” in order to protect savings and prevent the accumulation of huge public debt (Dyson 1999). In addition, EMU was an opportunity to rebalance member states’ power: at the end of the bargaining process, EMU was in line with certain member states’ preferences, thus reinforcing these countries’ status and power within the EU. They acted as “cognitive leaders, providing policy models that others [would] emulate” (Dyson 2000b: 663). Germany and to a lesser extent France were at the forefront at the input stage of EMU. During the operation of EMU, the attention shifted to superior economic performance (growth and job creation) and, hence, Denmark and the Netherlands were the paradigms to be emulated (Heipertz and Verdun 2004).

Alternatively, the neoliberal consensus shifted politicians’ attention to new priorities such as “sustained electoral pressure” (Donnelly 2005: 950) with the purpose of “establishing stabilising institutions or growth promoting institutions” (Donnelly 2005: 964). Partisan and/or sectoral pressures played a central role in member states’ decision of encouraging monetary integration in Europe (Bernhard, Broz and Roberts Clark 2002). Empirical evidence supports this ideological consensus: the public pays greater attention to low inflation when prices are rising quickly, notwithstanding significant cross-country variation when inflation-aversion is estimated (Scheve 2004). Finally, EMU also bolstered politicians and officials’ conversion to convinced, instead of only necessary, Europeans (Dyson 1999).

EMU signalled member states’ awareness of intense economic interdependence worldwide. National authorities realised their ability to provide efficient economic policy solutions was affected (Collignon 2003). They were willing to transfer powers to the supranational level, as this strategy was suited to accommodate the forceful effects of globalisation (McKay 1999, and Dyson 2002). The independent variable was increasing capital mobility at the international level. This variable significantly empowered financial markets. As national governments were eager to attract floating capitals, they became prisoners of financial markets. Capital mobility undermined

national politicians' control of some of the most important macroeconomic variables (Underhill 2002).

This helps to understand how (and why) member states accommodated to the monetarist school. Member states did not spontaneously adhere to monetarism. Instead, strong pressures exerted by globalisation impinged upon them (Rhodes 2002). Hence, '(...) *the governments of Europe followed a pragmatic, not ideologically purist, type of monetarism*' (McNamara 1999: 466). Maybe for this reason McNamara (2002) rejects that globalisation hampered member states' autonomy. Correspondingly, EMU is an attempt to control international financial markets' activity (Moran 2002). EMU simply attenuated the intense pressures from globalisation and portrayed member states' strategy designed to keep their power unchanged. Nonetheless, *EMU adjusted to a neo-liberal model*. EMU was not the scapegoat for member states' neo-liberal shift (Crouch 2002). Member states' choice towards monetary integration faced an external constraint, in the sense that

(...) European governments favoured EMU because it would provide the highest possible level of credibility; monetary union would once and for all 'tie their hands'. (...) In fact, monetary union would provide price stability for governments that would be unable, for domestic political reasons, to achieve it on their own (Sandholtz 1993: 35).

Member states sought to tie their hands in order to enforce painful reforms at home for three reasons (Jones 2002): i) before EMU national politicians were free to manipulate macroeconomic data to meet the pressures from powerful lobbies. This is no longer possible with EMU; ii) EMU's political economy is anchored on price stability, thus granting strong independence to the ECB. The only way of delivering income redistribution is through (national) fiscal policy (not anymore through exchange rate and monetary policies). Hence, fiscal policy must be intrinsically efficient and transparent. Otherwise the purposes of income redistribution are unclear and troublesome; iii) in the pre-EMU scenario national governments easily resorted to inflation because it was unproblematic to hide the costs from voters. With EMU, this behaviour is no longer feasible.

So far, rational choice accounts relied on international explanations of EMU. In contrast, other scholars anchor a rational choice approach to domestic explanations. Now the range of explanations shifts to the ontology of EMU, not so much to its legitimacy. On the one hand, a convergence of domestic interests towards low inflation in the late 1980s triggered the transition towards EMU (Sandholtz 1993). A wide

community of professional economists were the face of coordinated domestic coalitions (McNamara 2001). Thus price stability emerged as the sacred goal of EMU, since ‘(...) *it was the first and (...) perhaps the second and the third commandments as well*’ (Sandholtz 1993: 5). Correspondingly, the burden of adjustment towards the low inflation target of EMU has fallen on high-inflation member states. Perhaps surprisingly, they accepted to bear the burden of adjustment. For them it was at the same time a threat (of exclusion from EMU) and an opportunity (of becoming a member of EMU) (Mistri 2007). Still on a domestic background, yet without naming countries, an alternative approach envisages the costs and benefits of EMU in terms of trade and investment as the motivation for EMU (Frieden 2002). Member states realised they could extract considerable microeconomic effects from monetary integration.

On the other hand, realism influences other rational choice analyses of EMU. The creation of monetary union owes to domestic events in EU’s influential member states, notably Germany and France. For some, EMU happened because in Germany the foreign policy elite lost power to a coalition where financial interests prevailed (Kaltenthaler 2002). An alternative explanation looks at broad German interests as an illustration of calculations based on domestic economic interests. What might have fed German enthusiasm was the prospect of a new regime of currency stability that prevents the Deutschemark from appreciation in the future (Hosli 2000).

4. THE FEDERAL THEORY AND THE STABILITY AND GROWTH PACT

McKay’s words are instructing as a starting point for exploring the SGP within the federal theory:

(...) EMU member states will find themselves in more fiscally constrained than the American states, for the proposed Stability Pact requiring fiscal rectitude will be imposed centrally. Fiscal discipline in the American states, including constitutional prohibitions on deficit financing, are imposed locally, not by the federal government (McKay 1999: 134). (...) Unlike the states in many federations (...) central authorities have placed a fiscal straightjacket on member states. Individual countries suffering from localized recessions will be deprived both of traditional monetary and exchange rate stabilization devices, but they will also be constrained fiscally (McKay 1999: 150).

Since the federal theory follows a comparative approach, federal theorists seek for federations as the focal point for examining to what extent the EU (or certain elements of it) matches federal features. From the federal theory perspective, such comparative exercise is a necessary ingredient for methodological purposes. Thus, I will ignore criticisms against the strict comparison between the EU and the United States (Moravcsik 2001, and Schmidt 2001), not least because many critics stand on the

opposite methodological underpinning that emphasises the *sui generis* nature of European integration.

Unlike in the United States, fiscal discipline in the EU depends on a central (supranational) decision-making process. From this viewpoint, there is no parallel between the SGP and existing fiscal rules in federal states (Szasz 1999). A preliminary conclusion is that the SGP is not federal. Nevertheless, a careful inspection of how the SGP operates might provide a different insight. McKay (1999) rejects the federal dimension of the SGP based on the absence of central fiscal constraints on national governments. However, the decision-making process is decentralised because in the end national representatives play a prominent role within the Ecofin. If the Council is a supranational institution encompassing intergovernmental vested interests (Egeberg 2001), it is more important to ascertain its goals (intergovernmental, thus functionally decentralised) than its formal clothing (supranational, akin to functional centralisation).

The fact that fiscal discipline is enacted at the supranational level (be it the Excessive Deficit Procedure as a constitutional rule or the SGP as an ordinary rule) is not representative of centralised fiscal discipline. What matters is the means chosen to lay down the foundations of both constitutional and ordinary rules of fiscal discipline: *the initiative came from national governments and member states gave their consent*. Beyond this input dimension one cannot ignore that, on the output side, national governments have the final say in the SGP implementation. A cornerstone of functional decentralisation is at stake, disregarding the ‘non-federal’ qualification of the SGP.

Two other possibilities remain open: the SGP as a federal instrument or, even more ambitious, a ‘more-than-federal’ instrument. The awareness of decentralisation characteristics of the SGP makes it very similar with other federations where states’ fiscal discipline also faces binding rules. Viewed from this angle, the SGP is federal. However, the judgment must examine the extent to which pecuniary sanctions fit with other federations’ fiscal rules. Here lies the dissimilarity between European integration and federations elsewhere. The limits on deficits and public debts are stringent than in other federal states, because *no comparable mechanism of pecuniary sanctions exists elsewhere* (De Haan, Berger and Jansen 2003: 13).

As a pattern of fiscal policy discipline, the SGP goes beyond other federal countries’ established patterns. By implication, the claim is that *the SGP is a ‘more-than-federal’ device*. This qualification is rather similar to the one suggested by Balassone and Franco

(2001a) – of a ‘radical federation’. They emphasise that ‘*(t)he solutions adopted in several countries with federal structures are more flexible than the rules defined (...) in the Stability and Growth Pact*’ (Balassone and Franco 2001b: 602).

5. RATIONAL CHOICE THEORY AND THE STABILITY AND GROWTH PACT

From a rational choice perspective, the pact is a consequence of EMU macroeconomic orthodoxy and accommodates member states’ interests in a supranational setting with the potential for deep fiscal externalities. Section 5 explores in detail both arguments.

Germany prompted the discussion of fiscal rules at the supranational level. The result was the proposal laid down by the then German Minister of Finance, Theo Waigel, to extend sound fiscal policy beyond the inception of stage three of EMU. The SGP is a case of strict *negative integration* because the purpose was to establish the conditions under which unsound fiscal policies are not accepted. There is no additional effort to term the ‘appropriate substance’ required for member states’ public finances (Dyson 2000a: 45). The need to avoid fiscal profligacy after the beginning of EMU’s stage three was the prevailing reason supporting fiscal discipline. Cutting national fiscal authorities’ obedience to fiscal rules could bring a dangerous outcome (loose fiscal policy), since

(c)ountries going through the convergence game may act opportunistically, i.e., they may do this today so as to gain access later. Once they are in the Union, they will reveal their true preferences (De Grauwe 1997: 146),

Positive externalities conveyed by sound fiscal policy both for EMU’s operation and member states (as fiscal authorities) were the first rationale of the SGP. Focusing on how the SGP helps EMU’s operation, the belief is that fiscal rules mitigate the imbalance between supranational monetary policy and national fiscal policies (if they point to different directions) (Artis and Winkler 1998). Credibility risks were real, particularly if the ECB was not able to resist political pressures to bailout profligate member states or to loosen monetary policy. Thus, the SGP reinforces the role of the ECB and emphasises the dominance of monetary policy. The central bank is able to deliver monetary policy offsetting whenever member states’ fiscal indiscipline threatens the SGP (Brunila, Buti and Franco 2001).

This rationale highlights how actors shaped fiscal rules in a manner that seems not too convincingly favourable to national governments’ interests. The set of ideational beliefs

emphasising how monetary policy should be insulated from fiscal policy profligacy shows, if anything, a decline in member states' leeway. At this point, one question comes to the surface: *how is this consistent with rational choice if national governments gave their consent to fiscal rules that cut their room of manoeuvre?*

To begin with, it is hard to believe national governments ignored the consequences of the SGP. Furthermore, EMU altered the conditions under which national governments estimated their interests. Instead of looking to national interests in isolation, governments realised that EMU changed the context of interests-estimation. Constraints of entering in the coordinated game of monetary integration, together with the awareness that EMU's credibility required interaction between the single monetary policy and national fiscal policies, pressed national governments to accept the SGP. Therefore, the features of rational choice seem fulfilled: i) member states acknowledged that the SGP matches their own interests. ii) Since they gave their consent to EMU, and the connection between EMU and SGP was then understood the necessary step to anchor EMU's credibility, this is consistent with actors' utility maximisation. Moreover, iii) this decision is taken in the face of external constraints that force actors to choose among the alternative which is likely to maximise their utility. To that extent, I must turn to the implications of the SGP on member states as fiscal authorities.

Assuming that worldwide economic interdependence undermines national fiscal authorities' autonomy (due to negative fiscal externalities), the SGP was a helpful device to improve national performance. With EMU, member states lost monetary and exchange rate policies as instruments for macroeconomic adjustment. They only keep fiscal policy. As a result, national governments face mounting obstacles to neutralise country-specific shocks. Hence, they should improve fiscal policy efficiency. The rationale behind the SGP is that '*(...) strong fiscal discipline in good times goes hand-in-hand with fiscal stabilization in bad times*' (Artis and Buti 2000: 568).

Recent experience (the crisis that ended up with the reform of the pact) may reflect the need for enhanced fiscal discipline at the national level. Unwillingness to avoid expansionary fiscal policies during booms might explain fiscal profligacy in some member states (Galí and Perotti 2003). An alternative explanation points to overoptimistic growth forecasts ending up in excessive deficits. It was not political unwillingness to abide by the SGP. Instead, insufficient skills resulted in overoptimistic growth forecasts that, in turn, propelled unwanted expansionary fiscal policy (Jonung

and Larch 2006). The problem is that absent fiscal prudence during upswing exacerbates trouble once recession hits the ground. Then it becomes troublesome to respect the SGP.

National governments' decision seems to match rational choice. Now calculations are restricted to each member state's constituency, for politicians in office realised improved fiscal policy efficiency provided by fiscal rules was an incentive. Despite SGP's livery is a straightjacket that curtails national governments' autonomy, it is wrong to envisage fiscal rules as the gun member states shot towards their own feet. National politicians' enhanced their position vis-à-vis the electorate. If the outcome of the SGP was to be achieved (fiscal discipline) that could be an important trump card in future elections. Thus, the SGP is not a trap for national governments.

Events that triggered the SGP crisis are the plausibility test of rational choice theory. In a previous paper (Vila Maior 2007), I suggested that the reform of the SGP meant a discontinuity with the prevailing theoretical approach. While neo-functionalism and new institutionalism were the dominant theoretical approaches in the original version of the pact, a liberal intergovernmentalist shift was noticeable after the reform. The crisis of the SGP and the subsequent reform revealed that national governments' interests prevailed over the explanatory variables of neo-functionalism (the spillover effect) and new institutionalism (supranational institutions' independence and path-dependency as the engine of European integration).

Turning to rational choice theory, the chain of events that culminated in the reform of the SGP is instructive of *how* national governments' interests prevailed but also, and more importantly, *why* they prevailed. Throughout the SGP crisis, two large member states' interests – not by coincidence they were not able to respect the deficit ceilings – converged to a flexible interpretation of fiscal rules. France and Germany (together with Portugal and Italy) escaped pecuniary sanctions for repeated excessive deficits, thus circumventing the SGP. While it is easy to capture French and German officials' rationale (to avoid the implementation of pecuniary sanctions), it is difficult to understand why a majority of member states accepted not to fine profligate member states in the Council of Ministers. Considering that the rules of the pact are biased – the problem of *partisan implementation* of the SGP (De Haan, Berger and Jansen 2003) – rational choice theory is the appropriate background for assessing *why* a coalition of member states refused to implement pecuniary sanctions.

A cooperative behaviour based on inter-state solidarity prevailed. After all, who knows whether one of the ‘well-behaved countries’ might be in the position of fiscal profligacy in the future? Fear of the uncertain future and the heavy burden of power politics (unwillingness to challenge two of the largest EU member states) (Chang 2006) are the explanations for the rational calculation that triggered the reform of the pact.

CONCLUSION

Despite the problems of federal theory and rational choice on the theoretical analysis of EMU, I stressed that both theories operate at different explanatory levels of EMU and encapsulate different methodological underpinnings. In addition, as meta-theories of European integration some positive and negative aspects come to the surface. On the one hand, both theories are valuable inputs for they are not confined to European integration. Therefore, they provide a far-reaching theoretical background for the EU in general and EMU in particular, bringing insights from political science and social sciences. On the other hand, this is exactly the ground for both theories’ shortcomings. This is the case especially for “purists” of European integration theories, notably those who argue that the EU is unique and thus needs a theoretical examination focused on European integration *per se* (Burgess 2000).

Without nurturing here this interesting debate, I just want to stress that federal theory and rational choice are complementary theories for different aspects of EMU: the outcome of EMU (federal theory) and its ontology and legitimacy (rational choice). In a sense, they are *overlapping theories*. Figure 1 provides a picture of how a combination of federal and rational choice theories covers a broad explanation of both EMU and SGP ontology and outcomes.

[Figure 1 here]

Besides, as meta-theories rational choice and the federal theory are open to other specific theories of European integration when together they supply an explanation for a particular development in the EU. Put it differently, the federal theory and rational choice theory are the theoretical background for specific explanations provided by European integration theories or approaches.

Taken separately, federal theory and rational choice present some flaws. The federal theory is criticised for its inappropriateness to the EU. Firstly, territorial elements take

the dominance over non-territorial elements, and this makes the EU unsuitable to federalism (Egeberg 2001). Secondly, many scholars argue that fiscal federalism is unfeasible in the EU. As a result, member states' lack of commitment towards common problems (the absence of a supranational *ethos*) prevents the recognition of a federal structure in the EU (Vrousalis 2006). Finally, the institutional infrastructure of a federation is absent in the EU (Crowley and Rowley 1998).

Scholars within constructivism oppose rational choice. To them, more relevant than ascertaining actors' interests and preferences beneath European integration developments is social constructions that sparkle and influence actors' preferences and interests (Christiansen, Jorgensen and Wiener 1999). The purpose of this paper is not to get involved in the theoretical discussion between rational choice and constructivism (Jachtenfuchs 2002). I just wanted to warn that rational choice is far from being unambiguously accepted.

Rational choice and the federal theory face further weaknesses. Although they are the theoretical background of context-specific European integration theories, in some cases the distinction between meta-theories and European integration theories is fuzzy. On the one hand, the difference between federal theory and the multilevel governance approach is largely blurred. On the other hand, a rational choice approach of EMU significantly subsumes on liberal intergovernmentalist accounts (or is it the other way round?). To this extent, it seems that rational choice obfuscates liberal intergovernmentalism (or vice versa).

One should not ignore both theories' shortcomings. Nonetheless, I turn again to one of the most relevant insights from federal theory and rational choice when taken together to the theoretical examination of EMU: their potential to overlap. Then I recapture one development within rational choice theory – *rational choice institutionalism* – and ask whether the combination of federal theory and rational choice paves the way to an alternative theoretical account of European monetary union: *rational choice federalism*.

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