THE DYNAMICS OF INSTITUTIONAL CHANGE

AND THE CASE OF THE EU BUDGETARY NEGOTIATIONS

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This dissertation analyzes how institutions change, particularly how institutions go in and out of equilibrium; it proposes a dynamic account of institutional change by examining the endogenous and exogenous factors that change the preferences of players and the distributional implications of (renegotiated) institutional outcomes. The EU budgetary negotiations provide a compelling case for institutional change in the EU.

Motto:

"Disequilibrium, or the potential that the status quo be upset, is the characteristic feature of politics…What prevents purely random embodiments of tastes is the fact that decisions are customarily made within the framework of known rules, which are what we commonly call institutions." (Riker 1980, 443)

TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

1.0 INTRODUCTION - A RATIONAL CHOICE HISTORICAL INSTITUTIONAL APPROACH OF THE DYNAMICS OF INSTITUTIONAL CHANGE

Change is the driver of progress; the history of mankind is evidence of the fact that change means evolution. However, time and time again established patterns have proven resistant to change. Hence the perennial question: why and how does change come about?

Since political science scholars have been long studying the evolution of political entities and the role of the institutions of government, the preoccupation with why and how stable structures develop and change has grown naturally. Reinvigorated by the new institutionalism, the study of the emergence, growth and breakdown of institutions has been a constant preoccupation in the last three decades. In spite of this sustained interest, most institutionalist literature has not reached a full understanding of the complex mechanisms that trigger and sustain change.

The creation and expansion of the European Union (EU) is a landmark in modern political development. The density of institutions in the EU and especially the rate at which new institutions are created make the EU the most pertinent field for studying institutional change. The legitimacy of such a project is justified by the fact that scholars studying the EU have come to agree that, in spite of the EU's unique features, there are general underlying political processes that explain European integration. In addition, the uncertainty of the EU institutional equilibrium is one of the central puzzles in terms of institutional change. While EU institutions are the

1

product of political bargaining, depending on the theoretical approach, they could be viewed either as a stable equilibrium resulting from recent treaty negotiations or as a disequilibrium caused by recent exogenous factors – i.e. enlargement or economic crises – accompanied by failure to reform the EU institutions consequently.

This dissertation attempts to solve the puzzle of EU institutional equilibrium. The model proposed gains explanatory power by adding a game theoretical component that can deductively investigate the outcomes – the equilibria – of political bargaining at EU level. Given that general underlying political processes are at work in the EU, the answer to the puzzle of institutional change applies not only to the EU but also to political outcomes in general, thus satisfying the quest for generalizations in political science.

In the second chapter, I first review the institutionalist literature in order to identify the main frameworks and theoretical perspectives that deal with institutional change. Then I draw on what I believe is an incomplete conceptual framework that reduces the explanatory power of the theories on institutional change. I propose a rational choice historical institutional approach that revisits some mechanisms of change proposed by the literature, builds a formal theoretical model and tests the model empirically using analytical narratives. In chapter 3, the theoretical model is applied to the EU budget and enriched by the particular specifications of this case.

This dissertation proposes a dynamic approach to institutional change; the underlying theory on why and how institutions change is that both exogenous and endogenous factors contribute to changes in both preferences and the distributional implications of (older) institutional equilibria; these changes, that happen gradually, lead to an inconsistency between preferences and benefits obtained from past agreements. The players whose benefits are no longer advantageous will push for a renegotiation of the institutional arrangement that is no

longer in equilibrium. Thus the mechanism through which institutional change comes about is renegotiation of institutional arrangements that are no longer in equilibrium; renegotiation is realized through issue-linkages that the most powerful players use to obtain an outcome as close as possible to their preferences. Of the independent variables, the exogenous factors are of economic nature – a difference in the degrees of economic development – and also political – an increase in the number of players (enlargement in the EU context). Of the endogenous processes identified in the literature, my theory builds on the processes of learning – awareness of a change in preferences and benefits – and reinforcement of institutions that are part of an older institutional equilibrium but have the potential to restore/increase distributional benefits for the disadvantaged players.

Of the various institutionalist approaches, rational choice historical institutionalism represents the best analytical framework for a dynamic approach to preferences and institutional change. In this dissertation, preferences are not taken as fixed and exogenous, like in standard game theoretic models and, unlike in historical institutional approaches, institutions are equilibria that change every time their distributional benefits are renegotiated. This dissertation thus compensates for the weaknesses of both rational choice and historical institutionalism, which suffer from too much or too little change, respectively; it addresses the main weakness of game theoretic models by introducing a dynamic perspective on bargaining games.

Unlike in historical institutional accounts, both incremental and radical changes are possible. On the one hand, dramatic changes happen as a result of renegotiation of the institutional agreements, therefore they occur from one equilibrium outcome to another. If the institutional agreement does not contain a renegotiation clause, foreseen by the designers, renegotiation will occur when the disadvantaged players will push for it in order to restore their

benefits. On the other hand, incremental change happens in between the big bargaining moments, and affects both preferences and the distributional benefits deriving from the institutional agreement.

The main emphasis in this dissertation is on institutions-as-equilibria that are negotiated by political actors. Change occurs when institutions go out of equilibrium (incremental change) and when a new equilibrium is found (radical change). Institutions-as-constraints feature in my approach but are not central to the argument; they define the rules of the game – i.e. the bargaining rules – that govern the interactions between the goal-oriented players.

Like in any rational choice approach, actors are assumed to be rational, acting based on their preferences over outcomes; they choose strategies that best satisfy their interests and their overall goal is to obtain an agreement as close as possible to their own preferences. The actors are considered unitary because they aggregate the preferences of their members and act as one single entity. From this point of view, the individuals that represent states or organizations are the agents that carry the interests of the respective unitary actors. Given that the 'two-level games' literature argues that politicians behave strategically on the international scene because of domestic constraints, I take domestic constraints into account but I do not model them explicitly because they are conceived as being incorporated into actors' preferences: the interest in an international agreement is defined by each country's desire to maximize benefits in the respective field.

Two distinct dynamic processes interact with agency and structure in this dissertation. On the one hand, preferences are modeled dynamically in order to identify endogenous and exogenous factors and changes in distributional benefits. On the other hand, the processes of (re)negotiation are modeled using the tools of game theory. The preferences of players reflect

what actors want – which is their most preferred outcome. The goal of every player is to obtain an outcome as close as possible to her ideal position: "member governments grappled with their desire to reach agreement, on the one hand, and with their determination that the terms of the agreement be as favorable as possible to their own viewpoint, on the other hand." (Laffan and Lindner 2005, 200)

This dissertation challenges standard rational choice models that assume preferences as being fixed and exogenous. Instead, preferences are followed historically and thus allowed to change as a result of endogenous and exogenous factors. Further departing from standard models, two input intervening variables are used to represent players' preferences: first, there is the ideal position of a player (classic view of preferences) and second, the salience of the issue being negotiated is also part of the concept of preferences.

Even though position and salience are part of the general notion of preferences, they are conceptually and empirically distinct. The ideal position on an issue represents a player's most preferred outcome on that issue, whereas salience is defined as the importance a player attaches to an issue negotiated. Given that position and salience are characteristics of the unitary actor (i.e. country), they feature in member states' national interests: salience shows how high a given issue is ranked among a country's national interests whereas position shows the precise outcome on the issue that a country would like to obtain. While it is intuitively plausible for actors with extreme positions on issues to also attach high salience to those, it is possible for an actor to take a moderate position on an issue to which it attaches high salience.

Institutions-as-equilibria represent compromises between actors with diverging preferences. Since conflict between players is defined as competition for resources[1], the increase

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[1] This definition is according to Deutsch, cited by Lindner (2006).

in the heterogeneity of players increases distributive conflict, as bargaining approaches have shown. The existence of diverging interests makes coalitions difficult, especially when the voting rule is unanimity: "shifting interests across issues mean that states have permanent interests but no permanent friends." (Achen 2006) However, the search for consensus – an agreement acceptable to all – underlined by functional approaches is prominent because the reversion point – no collective good and thus lower utility – is not desirable to rational players.

The propositions on institutional change advanced above are tested empirically by analyzing the EU budgetary politics. The case of the EU budget is challenging from the point of view of institutional change because budgets are known to be stable institutions, at best incremental. However, the data shows that dramatic changes happen when the Financial Frameworks (FF), the budgetary agreements that fix the ceilings of the EU budgets are negotiated every five to seven years. On the contrary, incremental change occurs in the EU annual budget and through the mechanisms that affect the preferences of the member states and the 'division of the pie'.

The analysis of the last two negotiations on the FF and the negotiations for the 2008 EU budget show that indeed endogenous and exogenous factors lead to an incremental change in both the preferences of member states and the distribution of benefits from the FF. The exogenous political factor of enlargement, accompanied by the lower degree of economic development of the newer member states led to a change in the preferences of the net contributors to the budget, enabled by a deterioration of the benefits derived from the FF and a reinforcement of the 'balance' issue that becomes more salient to net contributors. The endogenous mechanism of learning worked gradually such that member states became aware of a change in preferences and distributional benefits. At the moment of renegotiation of the FF,

6

member states used issue-linkage to restore / increase their advantages; the endogenous mechanism of reinforcement pointed to the rebate as an institutional equilibrium solution; this equilibrium solution represents a departure from the previous FF equilibrium and, compared to the changes in the annual budget, constitutes a substantial change. The most powerful member states – the net contributors – managed to obtain an outcome as close as possible to their preferences; this dominance of the net contributors is also revealed in the annual budgetary negotiations, where institutions change incrementally, within the margin stipulated by the FF. Last but not least, institutions are shown to have a dual face: while the FF outcomes represent institutions-as-equilibria, they act as institutions-as-constraints for the annual budget.

This dissertation contributes in several ways to enriching our knowledge on political processes and outcomes. By explaining both radical and incremental change, it contributes to the incipient theoretical and empirical literature that attempts to explain institutional change. The game theoretical elements of the dissertation show that the dynamic component that has been long missing in bargaining games can be added by simply allowing preferences and payoffs to vary. This dissertation also speaks to the historical institutionalist literature in which time matters but it enriches it by analyzing both exogenous and endogenous mechanisms of change. In the realm of European Union studies, it advances our understanding of EU budgetary procedures but also of mechanisms that affect member states' interests and benefits deriving from European integration. Last but not least, from an international relations perspective, it adds to the bargaining models that have tried to explain how preferences and institutional constraints are translated into equilibrium outcomes.

In Chapter 2, I present the theoretical framework and expand on the problems posed by institutional change; I also sketch the theoretical model and discuss the methodological

approach. Chapter 3 outlines the EU budgetary procedure and justifies its choice as a case study for institutional change. The dynamic preferences as well as the analytical narratives that empirically support the theoretical models are presented in Chapters 4 (the FF negotiations) and 5 (the annual budgetary negotiations). The last chapter discusses the findings and their implications for a theory of institutional change.

2.0   THEORETICAL FRAMEWORK AND METHODOLOGICAL APPROACH FOR
A THEORY OF INSTITUTIONAL CHANGE

2.1   THEORETICAL FRAMEWORK FOR THE STUDY OF INSTITUTIONS

The modern polity studied in social sciences is a structure of institutions that describe the context in which governance and politics occur. (March and Olsen 1989; March and Olsen 2006, 5) Conceiving political systems as polities organized by rules, the new[2] institutionalism is – "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) While there is no full-blown theory of political institutions, the institutionalist framework has pervaded political science in the last three decades such that "we are all institutionalists now." (Pierson and Skocpol 2002, 706)

In this framework, institutions are understood as humanly devised sets of rules that constrain and regulate human interaction, hence 'the dual face of institutions'. (North 1990, 2005) Rules facilitate exchanges among individuals and create opportunities for collective action; they can be either endogenous or exogenous to actors' choice. (Snidal 1996) Institutions constitute therefore the rules of the game and operate at the macro level, whereas organizations,

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[2] The adjective 'new' distinguishes the institutionalism that started to flourish in the 1980s as a reaction to the behavioral revolution in social sciences from the older, pre-World War II form of institutionalism that studied the formal institutions of government.

found at the meso level[3], are defined as groups of individuals acting for a collective purpose in the game of political competition. (Hall and Taylor 1996; Stacey and Rittberger 2003, 860) In political spaces, organizations[4] perform governance functions – the "authority to make, interpret and enforce the rules." (Stone Sweet et al. 2001, 6) Stone Sweet and colleagues distinguish between rules and procedures. While rules determine the appropriate behavior in particular settings, procedures prescribe the way in which actors and organizations fabricate rules; rules can vary according to the type of behavior they stipulate, the degree of codification and the extent to which they are compulsory (Stone Sweet et al. 2001, 6-7)

The agents that populate the institutional environment have a common understanding of the rules: "for a set of rules to be an institution, knowledge of these rules must be shared by the members of the relevant community or society." (Knight 1992, 3) Moreover, Sweet and colleagues argue that actors are individuals whose behavior is governed by three different types of logic: first, according to the logic of consequences, rational actors want to maximize their own well-being; second, the logic of appropriateness (March and Olsen 1989) defines the range of suitable behavior and its rules are transmitted through socialization; third, policy entrepreneurs/skilled social actors mobilize cooperation among others by propagating cultural frames, understood as representations of collective problems with the accompanying solutions. (Stone Sweet et al. 2001, 8)

The different varieties of institutionalism that have emerged all have in common the fact that the analytical quest starts with institutions rather than actors and structure is paramount

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[3] The micro level is occupied by actors, defined in a further section as goal-oriented individuals.
[4] Organizations are in 'judicial mode' when they settle pre-existing disputes by creating new rules; in 'legislative mode', organizations structure the future behavior of individuals in order to reduce conflict. (Stone Sweet et al 2001, 8)

because it determines behavioral patterns and political outcomes. (Peters 2005, 156) In fact, the main institutionalist assumption posits that institutions create order and predictability and thus impact political actions; these effects are generated by comprehensible and routine processes that lead to both institutional continuity and change. While variation in institutions can explain the variation in the observed political processes and outcomes, institutions may be also considered as intervening variables between political players and outcomes, hence their crucial constraining role.

In spite of their common institutionalist framework, the different approaches to institutions have some fundamental differences in the way institutions are defined but also in the conception of preferences and change. (Peters 2005, 159-162) Given that preferences and change are critical in my argument and in order to identify the most appropriate approach, I will briefly review below the main varieties of institutionalism – sociological institutionalism, historical institutionalism and rational choice institutionalism – as well as some hybrid forms of institutionalism – actor-centered institutionalism and rational choice historical institutionalism – that seem to correct some of the weaknesses of the main approaches.

In sociological institutionalism, actors lie in a dense institutional environment in which institutions provide opportunities for action and reflect shared understanding of norms: institutions impact the behavior of individuals through shared beliefs and cognitions that individuals internalize and enact. (March and Olsen 1989, 1998, 2006) In this approach, political life is organized by these shared values into a community of common culture; political actors carry roles and identities and, being constrained by institutions, act within a 'logic of appropriateness' that ensures the preservation of the constitutive principles and standards, hence the stability of norms: "the basic logic of action is rule following-prescriptions based on a logic

11

of appropriateness… rules are followed because they are seen as natural, rightful, expected and legitimate." (March and Olsen 2006, 7) In this approach, preferences are endogenous: while individuals possess basic values, their involvement with institutions leads to their preferences being shaped by the institutions. (Peters 2005, 161)

Historical institutionalism seeks to explain the creation of institutions in past contexts and explores the interactions between the institutions' creators and the contextual structure; in particular, the unit of investigation is the institutional choice made at a particular point in time and its long-term implications. Even though it lacks a coherent body of commonly shared assumptions, the main tenet of historical institutionalism is that institutions are constructed by humans, therefore it is better to study them in sequence rather than in a snapshot. (Sanders 2006, 40)

Ideas are central in historical institutionalism because they hold institutions together and mobilize collective action by social groups that create institutions. Sanders argues that historical institutionalist approaches have an endogenous view of actors' preferences as ideas generate and are a disguise for preferences and their evolution over time. (Sanders 2006, 42) As actors are not fully aware of the consequences of their participation in institutions, present behavior is constrained by the lock-in effect of past choices, thus creating 'path dependencies'. (Thelen 2004) Pierson (2004) argues that most social processes are path dependent: some fundamental causal factors do not re-occur but their effects are long-lasting; positive feedback makes forgone alternatives less and less attractive. (Pierson 2004, 15) In Pierson's view, sequencing, defined as the temporal order of events is important for institutional outcomes, which are explained by institutional development rather than by institutional selection; one of the ways to analyze

institutional development is to study the interactions between institutions[5]. (Pierson 2004, 15-16). Since the preferences of the designers cannot determine long-term institutional functioning because actors may have a short time horizon, institutions have unintended effects and become by-products of social processes rather than embodying actors' goals.

Rational choice institutionalism views political life as the exchange bet self-interested actors that want to maximize their utility and accordingly act in predictable ways; institutions are understood as structures that constrain individuals and provide incentives and opportunities for collective action; the actors can also change the rules and recalculate their strategies. (Shepsle 2006; Tsebelis 1990) Both agency and structure interact to produce outcomes; preferences and the rules of the game determine the strategic choices of actors, which lead to political outcomes: "specific outcomes are the result of both prevailing institutions and the preferences of the actors involved." (Tsebelis 2002, 8) While players have preferences over outcomes, rational choice institutionalism differs from historical institutionalism by treating preferences as exogenous to the political game.

As in historical institutionalist approaches, in the rational choice framework political outcomes are the result of the interactions of goal-oriented actors, hence Sanders' argument that rational choice institutionalism and historical institutionalism are complementary approaches: they differ in the use of empirical descriptions and inductive reasoning (historical institutionalism) and analytical descriptions and deductive reasoning (rational choice

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[5] Pierson describes two possible ways to study the interactions between institutions. Institutional coupling is appropriate if there are complementarities between institutions (they are mutually reinforcing) and the presence of each institution has a positive effect on the durability of the other institutions; reform in one institution increases the probability of change in the complementary institutions. If there are ambiguities between the allocation of authority among institutions, loose coupling should be used to examine the interactions between institutions, as for example in executive-judicial relations; in loose coupling the ambiguities of authority create opportunities of reform for those actors unhappy with the status quo. (Pierson 2004, 162-164)

institutionalism). (Sanders 2006, 43) Shepsle also argues that theories that rely on bounded rationality, behavioral economics and transaction costs economics blur the line between rational choice and historical institutionalism. (Shepsle 2006, 26-28) Further, Stone Sweet and colleagues contend that both rational choice institutionalism and sociological institutionalism view individual behavior dependent on the expectations regarding the behavior of other actors: "institutions make purposive actions possible by providing individuals with a framework of shared expectations." (Stone Sweet et al 2001, 6-7)

Within the rational choice approach, institutions can be interpreted in two different ways, as argued by Shepsle (1998, 2006). First, institutions-as-constraints define a game form in game-theoretic parlance (the game form and players' preferences make up a game) and constitute a script of actors, strategies, sequences and information at the moment of choice. (Shepsle 2006, 24) Institutions-as-constraints are exogenous to the game and thus do not allow the possibility of a change in the game, therefore this approach should be used only for stable institutions. (Calvert 1995, 58-59) Second, institutions-as-equilibria are defined as observed "behavior patterns of individuals and their expectations about the behavior of others…consistent with utility maximization by each individual." (Calvert 1995, 58-59) In this approach institutions are endogenous, "equilibrium ways of doing things," Calvert (1995, 74) "equilibrium of behavior in an underlying game;" (Schotter 1981) they are focal points that induce cooperation. (Schelling 1960) The common property that institutions share is that, given that all others are doing so, it is rational for almost every individual to observe the behavioral prescriptions of the institutions. Calvert (1995, 60) When the institutions-as-equilibria are created through a specific process of negotiation and agreement, they are not particularly robust, as small perturbations in the environment will determine players to find incentives to deviate from the institutional

prescriptions. (Shepsle 2006, 26; Shepsle 2006 b, 1034) This is to say that institutional change can be explained only by an exogenous parameter shift, i.e. in payoffs, number of players etc. (Calvert 1995, 75)

In addition to the institutional varieties discussed above, two hybrid approaches borrow elements from more than one framework. First, actor-centered institutionalism is interested in policy-as-outcome: policy is defined as"intentional action by actors who are most interested in achieving specific outcomes." (Scharpf 1997, 36) Actor-centered institutionalism explains policy outcomes by focusing on the interaction between individual/collective actors that are shaped by the institutional settings within which they take place. The main tenet builds on rational choice institutional assumptions: the institutional setting, comprising anarchic fields, networks, associations and organization affects preferences and interactions between "individual and corporate actors endowed with certain capabilities and specific cognitive and normative orientations;" (Scharpf 1997, 37) In Scharpf's view, the static unit of analysis is the modes of interaction that drive policy processes that lead to policy outcomes and actor constellations (i.e.type of games being played); interaction can thus be unilateral action, negotiated agreement, majority vote or hierarchical direction. (Scharpf 1997, 44-46) Actor-centered institutionalism departs from rational choice by conceiving a range of socially constructed and institutionally shaped preferences: institutional self-interest, normative orientations and identity-related preferences; collective actors are thus institutionally constituted and institutionalized expectations that create common knowledge go beyond the assumption of self-interested actors. (Scharpf 1997, 36)

The second hybrid framework is rational choice historical institutionalism that focuses on the choices made by rational actors over time (Lindner 2006, 5). This approach shares with

rational choice the assumptions that decisions are the result of the interactions between unitary and goal-oriented players that are constrained by institutions but differs from rational choice by assuming bounded rationality. This framework borrows from historical institutionalism the view that actors' choices and their subsequent behavior are path dependent, hence the accrual of increasing returns; repeated interaction and multiple plays of the game might increase the stickiness of institutions. Consequently, the main claim of rational choice historical institutionalism is that "institutions are not especially thin" (Stacey and Rittberger 2003, 873) and institutional equilibria are "somewhat persistent." (Stacey and Rittberger 2003, 874)

The advantage of rational choice historical institutionalism is that it attempts to overcome the shortcomings of both rational choice and historical institutionalism. While the rational choice approach uses history as illustrative material for general theories, historical institutionalism answers empirical puzzles derived from observed events at the expense of theory-building. Most historical institutionalist approaches look at relatively stable institutions over time, whereas rational choice institutionalism views temporal dimensions with the analytical tools of strategic calculations but usually leaves out issues of ordering and sequence. (Thelen 1999) As pointed out below in the theoretical section, rational choice historical institutionalism in the best analytical framework for my dynamic approach to preferences and institutional change: in my approach, preferences are not taken as fixed and exogenous, like in standard game theoretic models and, unlike in historical institutional approaches, institutions are equilibria that change every time their distributional benefits are renegotiated.

2.2 THE PUZZLE OF INSTITUTIONAL CHANGE

…It is important to understand that if preferences are created externally, and are also largely unchangeable, then the only way to generate change is to alter the structure of incentives and rules that exist within an institution. On the other hand, if preferences are conceptualized as mutable, then transformations can be an ongoing process of remaking individual preferences through the operations of the institutions themselves. (Peters 2005, 161)

Institutions have proven to be considerably robust, even when facing radical social, economic, technical and cultural change, and routine processes of learning and adaptation have been shown to work reasonably well, (March and Olsen 2006, 10) therefore the institutionalist framework is most successful at explaining stability rather than institutional change. (Stacey and Rittberger 2003, 859) Streeck and Thelen (2005) complain about the "impoverished state of theorizing on issues of institutional change" and "the absence of analytic tools to characterize and explain modes of gradual change." (Streeck and Thelen 2005, 1) March and Olsen argue that a lot has been written in the last few years on processes that transform individuals into rule followers, utility maximizers or cooperating actors in networks, but the questions related to the dynamics of change have remained unanswered; the processes that translate structures and rules into political outcomes, the conditions that favor change and the underlying causal factors still puzzle social scientists (March and Olsen 2006, 10) Institutionalist scholars are yet to clarify how political processes and institutions are stabilized and destabilized and which factors sustain or interrupt these processes. (Stacey and Rittberger 2003, 859-860)

Most institutional accounts attempt to explain why institutional change occurs – because of actors' calculations or exogenously induced variation in the conditions on which the institutions rest, be they efficiency-based, power-based or cultural: change is viewed as being

instantaneous and efficient. According to March and Olsen, the processes of change considered in the literature are better understood theoretically than empirically; these processes of change can be grouped in the following four models: single-actor design, conflict design – multiple actors with conflicting goals create designs that reflect the outcomes of political trading and power – learning through feedback or borrowing and the selection of rules that compete for survival and reproduction. (March and Olsen 2006, 11)

In most institutional accounts change is incremental, if at all, rather than radical because the tendency of social structure is considered to be towards reproduction and not towards transformation. Sociological institutionalism views change as happening at the margin, prescribed by prevailing institutional scripts; institutional change represents the co-constitution of individuals as social agents and institutions as social structure. Historical institutionalism is better at explaining institutional persistence in spite of changes in preferences, competition and highly volatile technological, social, economic an political environment; institutions are sticky because of increasing returns that lock in institutional arrangements, uncertainty of risk-averse actors about future payoffs in a new institution, the number of institutional veto points, and divergent preference constellations; these factors make change incremental rather than abrupt through mechanisms like layering or conversion. (Stone Sweet et al 2001, 5-8) In the rationalist approach, given that preferences are exogenous, at any given moment in time, actors adopt strategies that best maximize their utility and thus lead to an equilibrium outcome. In spite of the inherent stability of the notion of 'equilibrium', most rational choice approaches to institutions appear to be "infinitely mutable, simply through the selection of rules or structures." (Peters 2005, 162)

While a rational choice historical institutional approach can compensate for the weaknesses of both rational choice and historical institutionalism – too much or too little change, respectively – the mechanisms of change still need to be identified. Below I review the incipient mechanisms of change that the institutionalist literature has attempted to develop theoretically and to a lesser extent empirically; most factors that trigger change are exogenous and, except for critical junctures, change is conceived as mostly incremental. My theory builds on economic and political exogenous factors, as well as the endogenous mechanisms of learning and reinforcement that work gradually to produce the outcome of renegotiations, characterized by layering new institutions on top of old ones; power also plays a role in shaping institutions-as-equilibria.

Stone Sweet and colleagues (2001) identify four approaches to institutional change. First, change comes as a response to exogenous shocks[6] and to the way in which they are perceived. In times of crises, the search for new models and policy innovation leads to competition between actors (Sandholtz 1992), competition for survival between organizations, (North 2005) and the alteration of organizational routine. Second, institutional innovation can be endogenous to politics. Actors search for new rules when increased interactions expose the limits of the existing rules and take the opportunity to enhance their social, economic and political positions; in this approach actors compete on power, resources and meaning of rules. (Stone Sweet et al 2001, 10) Third, institutions can be altered at the organization level when change in one organization becomes mandatory for the others or when one organization innovates by copying the model of a more successful organization. (Stone Sweet et al 2001, 10-11) Fourth, institutional change can be

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[6] For instance a change in prices might lead to a change in people's tastes. (North 1990)

19

the effect of political entrepreneurs[7] who generate new frames when an organization breaks down and then propagate these frames by convincing the others and thus inducing cooperation. (Stone Sweet et al 2001, 11)

In the same vein, March and Olsen identify four sources of change that are incremental but produce transformative results. First, there can be internal pressure for change due to the gap between institutional goals and institutional practices. Second, change can be rooted in the implementation of rules due to the need to generate a coherent interpretation. Third, routine switches between standard operation procedures can occur as people gain or lose faith in institutional arrangements. Fourth, a reallocation of resources can lead to the exploitation if the existing rules or the exploration of new rules. (March and Olsen 2006, 12-13)

Arguing that path dependence limits change and rational choice explains only discontinuous institutional change, Streeck and Thelen contend that change is not only abrupt and exogenously generated because there are processes of "incremental change with transformative results." (Streeck and Thelen 2005, 8-9) Consequently, the authors propose five modes of gradual transformative change, of which two are discussed by Pierson (2004) and Thelen (2003): layering is defined as the coexistence of old and new elements of institutions, which is realized through amendments and revisions; conversion occurs when new actors, previously marginalized, come to power and seek to reorient the institution towards new goals and functions. Displacement is a mechanism characterized by the fact that a traditional rule is pushed aside by a new one and new models emerge and call the existing ones into question. While drift defines an erosion of institutions that are not maintained and adjusted to changes in

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[7] The term *political entrepreneur* was coined by Wagner (1966) who argued that such a type of individual makes a high contribution to collective action by offering incentives because he/she cares about the group's objectives but also because he/she can extract personal benefits.

the external environment, exhaustion gives the   ultimate institutional breakdown through depletion, overextension or decreasing returns. (Streeck and Thelen 2005, 19-20)

Arguing that on-path changes happen through adaptation, Lindner identifies some mechanisms of reproduction that cause major institutional (off-path) changes in case of break down; the choice of these mechanisms is determined by the willingness of actors to bear the costs and distribution of power. Lindner emphasizes the importance of informal institutions, as some reproduction mechanisms are more likely to collapse through informal off-path changes. Power underlines the first mechanism of reproduction: in line with Knight (1992, 1995) change is brought about by an increase in the bargaining power of the coalition interested in change; the sources of the increase in power can be exogenous, due to a change in coalition membership/size or linkages with other fields or endogenous, when actors learn to interact skillfully or gain a strong reputation. While interdependence within an institutional matrix creates different change coalitions, large switching costs enforce stability; change occurs when there is a lot of certainty over the distributive impact of the new outcomes and institutional choices or when the opportunity costs of maintaining the old institutions increase. Radical change happens when the scope and nature of change cannot be accommodated through small on-path changes. (Lindner 2006, 166-172).

Change can also be viewed from two different perspectives, depending if the approach to change is dynamic or static. In Heritier's opinion, a process perspective on institutional change analyzes the factors driving institutional change and the underlying causal processes. These processes may differ: bargaining can be of explicit nature or over the institutional change; the causal factors can be either exogenous – a change in the environment that changes actors' preferences – or endogenous – the institutional characteristics at t_1 alter the institutional

properties at t_2 without outside influence. (Heritier 2007, 8) By contrast, the structural perspective offers a static vision on change that happens across different levels/arena, depending on the types of actors that design and/or implement the rules; an important source of change is the discrepancy between the designers of the institutions and its distributive implications. (Heritier 2007, 9)

The rational choice functional framework builds on Keohane's (1984) well-known argument that institutions overcome the collective action problem by facilitating cooperation and thus providing mutual gains – they supply information and rules that reduce transaction costs, enhance decentralized enforcement and increase interaction. This framework describes incremental change in a stable environment, occurring through actors' repeated interaction and updating/learning. For North (1990), the learning process is the most important source of change because information regarding the environment is continuously improved and thus leads to small institutional modifications. In repeated interactions, actors continue "to change their planned responses to the actions of others until no improvement can be obtained in their expected outcomes from independent action." (Crawford and Ostrom 1995) In this approach, the source of change is intentionality: having undergone a change in capabilities, actors reconsider the existing institutional equilibrium and propose a more advantageous alternative. The cause of capability change is not explained by the model but exogenously defined as a revised parameter." (Heritier 2007, 14) Starting from actors' intentions, Heritier argues that, on one hand, "if, due to an external event, the benefits of rule A have decreased, the rule will be changed, if the gains of the proposed altered rule B including the transaction costs will be higher." (Heritier 2007, 18) On the other hand, while built-in flexibility and opt-out clauses do not change the rules, "with a renegotiation clause, by contrast, an external shock will lead to a

change of the institutional rule." (Heritier 2007, 18) The disadvantage of the functional approach is that it views actors as cooperating – a collective body – therefore the intention to change the institutions has to be collective, otherwise bargaining will occur and then the rational choice distributional approach becomes more appropriate.

While exogenous causal factors drive change, endogenous functionalist explanations of change are much rarer. One such variant is the principal-agent theory in which institutional change happens when the principal faces significant agency losses and thus corrects the contract initially agreed by both principal and agent. (Heritier 2007, 23-25) Greif and Laitin (2004) also endogenize the explanations of institutional change within the functionalist approach. The authors propose a dynamic model based on quasi-parameters (i.e. actors' capabilities and information) and distinguish between the mechanism of institutional reinforcement, which does not lead to change – more individuals in more different situations adhere to the institutions – and the mechanism of undermining, which creates endogenous change – fewer individuals in fewer situations adhere to the institutions. While reinforcement occurs through habitual action and ideology, laws and regulation, increasing returns of existing capabilities and learning, undermining happens through mechanisms like social utopias, counter-hegemonies and the decrease of gains from cooperation. Specifically, undermining creates an inconsistency between institutions and the associated rule, which reaches a critical level when past patterns of behavior are no longer reinforcing. (Greif and Laitin 2004, 633-35)

In contrast with the collective/cooperative assumption of the rational functional approach, the distributional/bargaining version of rational choice institutionalism contends that institutions are outcomes of power-oriented bargaining with distributional implications: institutions "reflect compromises between actors." (Stone Sweet et al 2001, 13) Existing institutional rules favor

some actors and disadvantage others, which will influence negotiations over institutional change; (North 1996) actors bargain over various institutional alternatives and seek to lock in equilibrium payoffs – their distributional advantages – through institutions. Political conflict and strategic bargaining are the defining features of this approach, especially when there is a 'shadow of the future' involved: the longer an agreement is in force, the harder actors will bargain over the distribution of benefits, hence a difficult cooperation. (Fearon 1998)

Due to the distributional character of bargaining, resource ownership becomes an ex-ante measure of power (Knight 1992) and actors with more bargaining power manage to impose their equilibrium (Heritier 2007, 40-41). Since institutions rest on power in this approach, power explains both institutional stability and change: actors that possess the most bargaining power (i.e. the power to initiate or prevent change) dictate the interpretation and adaptation of rules (Lindner 2006, 164). Alterations happen when there is a change in the distributional implications due to exogenous changes in power or resource ownership (Knight 1992; 1995), change in actors/coalitions – the dominant coalition that resists change breaks (Tsebelis 1990), or when unilateral action is less costly than cooperation. (Stacey and Rittberger 2003, 866) Heritier posits a power-induced institutional change hypothesis with distributive implications: a change in the preferences of a powerful actor or a change in the power balance leads to the renegotiation of the existing institutions. (Heritier 2007, 43) However, the translation of the preferences/power change into outcomes is mediated by the rules of the negotiations (i.e. voting by unanimity or majority), which may enhance/reduce the advantages of the most powerful and thus their ability to influence institutional change. Beside negotiation rules, issue-linkage is another tool for enacting change and thus empowering the actor who uses it: actors dissatisfied with the status quo may broaden the scope of the institutional issues discussed to create issue-linkages, as more

issues on the agenda increase the possibility of issue-linkages and thus enable distributive outcomes. (Davis 2004, 153-157; Heritier 2007, 43)

The power-constrained approach to institutions that brought power on the agenda of rational choice (Moe 2005) is rooted in realist theories of international relations. Krasner (1991) argues that, even though all benefit, power determines the choice from multiple equilibria: powerful nations have disproportionate influence on which point on the Pareto frontier is chosen. Gruber (2000) defines the 'go it alone power' as "a form of agenda control in which one actor denies the status quo to others in order to steer them into accepting alternatives more to his liking." (Moe 2005, 227) In this approach, change is determined by power and distributional benefits, as "there is no contradiction between mutual gain and the exercise of power, both are often going on at once." (Moe 2005, 227)

The distinction between functional and distributional rational choice approaches (Stacey and Rittberger 2003; Heritier 2007) echoes the distinction made by Scharpf (1997) between two dimensions of the common good – welfare production and distribution/distributive justice and also between two modes of negotiation that influence outcomes. (Scharpf 1997, 15) First, similar to the functional framework, the integrative bargaining mode is characterized by problem-solving in the common interest – the identification of possible solutions that 'enlarge the pie'. (Raiffa 1982) Second, like distributional approaches, the defensive bargaining mode focuses on the distributive implications of the (enlarged) pie and is status quo oriented, such that: "if issues are redistributive in nature and the proposed changes clearly reveal who is to gain and who is to lose, defensive bargaining will prevail…and the outcome will reflect the asymmetry of power of the involved actors." (Heritier 2007, 45)

Explanations of endogenous change in the distributive approach start from the assumption that actors are both designing and implementing formal institutional rules, which has effects across levels. First, formal institutional rules are viewed as incomplete/ambiguous contracts whose daily application gives rise to informal rules; these informal rules are the result of bargaining and reflect the power of actors. (Farrell and Heritier 2004) Second, in Jupille's procedural politics, when faced with the choice between different lower-order procedural rules, actors choose the rule that maximizes their influence; as procedural politics disputes over lower level rules increase, change at macro level becomes more likely, as these disputes raise the opportunity costs of leaving rules unchanged. (Heritier 2007, 50) Third, an actor that has its hands tied in one arena of negotiations has a better bargaining position in another arena of negotiations. (Putnam 1988; Moravcsik 1998; Heritier 2007, 51)

The above-described approaches barely grapple with the dynamics of significant institutional change. The models of punctuated equilibrium underestimate the dynamic sources of change and conceive of radical change as occurring only in case of massive failure of an institution due to an external shock. In fact, institutions are not that sticky because they escape path dependencies by changing in response to exogenous environmental factors; (Crouch and Farrell 2004) even when accounted for endogenously by conflict and competition among institutions, as Thelen (2003) prescribes, institutional frictions do not necessarily lead to critical junctures and institutional change, as conditions under which this could occur are not known. (Heritier 2007, 58) The models that propose incremental change manage to offer a picture of transformation that occurs over time but do not distinguish conceptually between less significant and more important change – conditions that favor gradual change and conditions that lead to minor alterations. The approaches that ignore the power of the constituencies that have created

26

the institutions cannot adequately explain the distributional interests and why changes in benefits lead to renegotiation. While the rational choice framework distinguishes between rule changes that are beneficial for all actors (the functionalist approach) and those that are clearly redistributive (the bargaining/distributional approach), its shortcoming consists in the fact that it describes change as happening in a static game where actors compete over their preferred institutional rule. Even in cases when repeated play is modeled, preferences and rules are not allowed to vary, hence the difficulty of capturing either endogenous change or the long-term effect of exogenous factors.

In order to fill in the gap on institutional change in the institutionalist framework, it is necessary to combine elements from the different approaches: "to explain processes of institutional change, it may, however, be essential to combine at least two of these [institutional] approaches." (Stacey and Rittberger 2003, 868) Rational choice historical institutionalism is more encompassing in terms of mechanisms of change and compensates for the fact that rational choice is deficient in explaining persistence from one snapshot to another and historical institutionalism does not describe change adequately. While changes due to exogenous factors are more easily understood in the literature, as reviewed above, endogenous mechanisms of change are much rarer and at best understood theoretically but not observed empirically. From the mechanisms reviewed above, the endogenous mechanisms of learning and reinforcement work gradually, together with exogenous factors, to create a model of institutional equilibrium and change in a rational choice historical institutionalist framework.

2.3   INSTITUTIONAL CHANGE IN THE EU

The EU invites the studying of institutions because it is one of the few areas where institutions represent recent creations and developments by strategic actors with a view to obtain mutual gains from cooperation. Even more specifically, the multiplicity of areas in which institutional change happens in the EU makes it the ideal site for studying institutional change: "change in the EU's institutional milieu has the potential to reallocate power among the EU's primary organizational actors, rendering each more or less able to achieve its own policy preferences." (Stacey and Rittberger 2003, 861) Heritier identifies institutional change in the EU as a situation in which member states reconsider the existing institutional rules and propose altered rules that are more advantageous; the reason for this could be a change in the capabilities of states, such as changes in population or wealth, which leads member states to ask for more votes in the European decision-making process. (Heritier 2007, 14)

The new wave of theories on the EU see the Union as a polity whose exact form may be unique, but whose underlying political processes replicate patterns that are present in all levels of governance: "The EU may be unique when viewed as a particular set of institutions, but most social scientists agree that these institutions ought to be the outcome of more conventional political and social processes." (Stone Sweet et al 2001) Compared to other institutionalist approaches that have been applied to the study of the EU – rational choice, (Scharpf 1997; Tsebelis 1990, 2003; Pollack 2003) constructivism, (McNamara 1998; Parsons 2003; Schimmelfennig 2003; Checkel 2003) comparative federalism (Kelemen 2004; Nicolaidis 2001) – rational choice historical institutionalism has just made its way into the discipline. (Stacey and Rittberger 2003; Lindner 2006)

Rational choice historical institutionalism is indeed a framework well equipped to analyze the processes through which member states change their preferences over time and solve their differences. Moreover, rational choice historical institutionalism appears as most suitable for analyzing the specificity of EU institutional change when compared with existing theories of European integration – informed by theories of international relations and regional integration. Of the other approaches, neo-functionalism (Haas 1964; Lindberg 1963) emphasizes the role of supranational institutions and spillover effects in European integration but does not consider EU institutional bargaining; intergovernmentalism (Moravcsik 1998) looks at member states' interests that shape European integration but disregards the effects of institutions. Some authors favor historical institutionalism as a "uniquely appropriate" approach because of the emphasis on "asking big, real world questions, on highlighting temporal sequences and historical trajectories, and on situating political events in their broader social and institutional contexts." (Meunier and McNamara 2007, 2) However, like any predominantly structural theory, historical institutionalism lacks an account of agency, therefore predicting change becomes rather difficult. (Meunier and McNamara 2007, 7)

In the EU, differences between member states' preferences provide an opportunity for institutional activity and member states bargain over rules in multiple areas: "preferences of national actors, projected onto the EU level, open up avenues for understanding the sources of change in the path of integration." (Meunier and McNamara 2007, 7) Garrett and Tsebelis (1996) rightly argue that, besides states' preferences, the actual institutional decision rules should be taken into account. In particular, the rule of unanimity, widely used at the beginning of European integration has a strong effect on institutional outcomes: under unanimity voting, an increase in the number of players with divergent preferences increases transaction costs because "bargaining

becomes more lengthy and complicated…and implementation becomes more costly." (Heritier 2007, 17) Since, under unanimity, enlargement increases the time of negotiations, (Ostrom 1990) a common institutional change in the EU is the switch to qualified majority voting. (Heritier 2007, 17) Besides voting rules, distributive bargaining realized through side-payments (Scharpf 1997, 129) is another dominant feature of the EU that invites a rational choice historical institutional approach:

> This is how the European Union has time and again been able to overcome deadlocks through package deals involving unrelated issues that were worked out in the 'summits' of the European Council. (Scharpf 1997, 129)

Incremental or radical, change in the EU cannot be understood in isolation from the broader political and social processes in which it is embedded. Looking at some macro processes, Meunier and McNamara argue that European integration did not create path dependencies over time. On the contrary, institutions are viewed as bargaining outcomes at different moments in time: "the EU institutions clearly are the product of hard-won political bargains embedded within specific institutional settings." (Meunier and McNamara 2007, 7) This notion of institutions-as-equilibria lies at the core of the puzzle of institutional change in the EU: depending on the theoretical approach, the current EU institutional structure could be viewed as a stable equilibrium resulting from a recent negotiation but also as a disequilibrium caused by the recent enlargement and failure to reform the institutions appropriately. Meunier and McNamara identify this uncertainty of the equilibrium as one of the contemporary EU challenges in terms of institutional change. (Meunier and McNamara 2007, 7-8) In my view, this puzzle of EU equilibrium can be solved, and with increased explanatory power, by adding a game theoretical

component that can deductively investigate the outcomes – the equilibria – of political bargaining at EU level.

2.4   A THEORETICAL MODEL OF CHANGE

I propose a rational choice historical institutional approach to preferences and processes that translate these preferences into political outcomes; I view change in a dynamic way and consider both exogenous and endogenous factors of change and functional and distributional elements. In my theory, institutions are equilibria – the outcome of political bargaining. (Stone Sweet et al. 2001; Calvert 1995; North 2005) In light of Riker's objection (Shepsle 2006 b, 1042) to institutions-as-constraints (i.e. fixed and exogenous), I view institutions as endogenous: institutions change from within and therefore cannot be taken as given, they are both the cause and the result of institutional change. This endogeneity creates strategic opportunities: "One can expect that losers on a series of decisions under a particular set of rules will attempt (often successfully) to change institutions and hence the kind of decisions produced under them." (Riker 1980, 445) Actors follow the rules they have created because it is in their interest to do so in order to maintain their gains from cooperation; given the institutional constraints and the expectations on the strategies of the other players, each actor chooses the strategy that maximizes her utility.

It is worth noting that rational choice models, which use the concept of utility, do not stress enough the commonality between this concept and those proposed by theories of socialization. As psychology has shown, the utility of a rational actor encompasses well not only material benefits but also the ideas and values that enhance the well-being of an individual (like

31

influence, prestige and satisfaction from following a given canon) in ways that are more difficult to compute. An increase in utility is more appropriately viewed as a proxy for any factor that brings positive results: it can be an increase in material benefits but also the satisfaction from being recognized as a leader or the peace of mind from following/disobeying a custom (as opposed to the misery of breaking with/obeying a tradition, respectively).

In my approach, institutional change is best analyzed from a process perspective, (Heritier 2007) follows the conflict design identified by March and Olsen (2006) and is endogenous to politics. (Stone Sweet et al. 2001) The result of institutional change is defined as 'layering' (Pierson 2004; Streeck and Thelen 2005) or 'institutional refinement' (Greif and Laitin 2004, 640) because old and new coexist in the newly negotiated institutional outcome. As a consequence of both endogenous processes like adaptation, learning, (North 1990; March and Olsen 2006; Lindner 2006) reinforcement and undermining (Greif and Laitin 2004) and economic, political and social exogenous factors that alter the parameters of the game, (Calvert 1995; Shepsle 2006) – i.e. reallocation of resources, change in the number of players – actors search for new rules and bargain over their distributional benefits. In the absence of such endogenous and exogenous processes, institutions are equilibria and therefore self-enforcing, each player's behavior is a best response, hence the absence of change in most rational choice accounts. (Greif and Laitin 2004) Standard comparative statics analysis seems to be insufficient to account for institutional change, which is dynamic and not a one-time change (Shepsle 2006 b, 1032)

The most dramatic mechanism of change is renegotiation of the institutional outcome. Given that the outcome represents an equilibrium, players have no incentive to deviate ceteris paribus. However, once there is a change in the parameters of the game, be it endogenous or

exogenous, the players whose distributional benefits are no longer advantageous will initiate renegotiation, as "institutional agents … may not only change their own responses in light of the changed circumstances but change 'the rules of the game' as well." (Shepsle 2006 b, 1037) This argument is in line with Heritier's (2007) claim that an external shock or a change in the preferences of the powerful actors lead to a renegotiation of the institutional arrangement.

The outcome of institutional renegotiation is characterized by layering. Streeck and Thelen follow Schickler (2001) and define layering as the process by which "new elements attached to existing institutions gradually change their status and structure." (Streeck and Thelen 2005, 31) In the authors' view, layering involves amendments and revisions but the actual mechanism for change is differential growth because the new added institutions grow faster than the old, established ones. The authors consider as a classic example the layering of a voluntary private pension scheme onto the public system in the welfare state, with the new arrangements continuing to gain ground and political support. (Streeck and Thelen 2005, 23) The result of layering is not as radical as dramatic change: "Since the new layers created in this way do not as such and directly undermine existing institutions, they typically do not provoke countermobilization by defenders of the status quo." (Streeck and Thelen 2005, 23) However, the incremental changes introduced by layering can set in motions dynamics that lead to deep transformation and reform, as the new fringe will end up "eating into the old core… and… siphoning off support for old layer." (Streeck and Thelen 2005, 31)

The concept of layering can be better understood when compared to geological sedimentation. Tolbert and Zucker (1994) define sedimentation within the framework of institutionalization: "sedimentation fundamentally rests on the historical continuity of structure…across generations of organizational members; sedimentation is characterized by both

spread of structures and perpetuation of structures over a lengthy period of time." (Tolbert and Zucker 1994, 185) Consequently, there are factors in the process of sedimentation that affect both the extent of diffusion and the durability of a given structure; the most prominent factor discussed by the literature is represented by agents disadvantaged by the structure that will mobilize against it. (Tolbert and Zucker 1994, 186) In my theory, the outcome of institutional renegotiation is made up of institutional layers or sediments that bear the print of the disadvantaged players; old layers coexist with new ones.

The distribution of benefits and the power of players are the defining factors that shape the renegotiation mechanism. The distributional implications of the outcome are what players bargain for: once the received benefits are altered, each actor will try to get rid of rules that are no longer advantageous and create new ones that bring more benefits. On the contrary, what lock in institutions are not increasing returns but distributive benefits and the uncertainty over future benefits. The asymmetries of power reflected by the outcome (Scharpf 1997) prove that mutual gains and power go together. (Moe 2005) The outcome of bargaining is determined by the more powerful players (the ones with more resources) who will pull the others towards their preferred outcomes by dictating which rules are chosen. (Knight 1992, 1995; Gruber 2000; Lindner 2006) The mechanism through which powerful players drive the outcome of negotiations is issue-linkage, which enables distributive outcomes. (Heritier 2007)

"Institutions can change due to endogenous processes, exogenous shocks and combinations of both." (Greif and Laitin 2004) On the one hand, the exogenous factors that affect the resources of players and the distribution of benefits deriving from the institutional arrangement are changes in the social, economic or political environment: "over time the institutional environment changes, thus also generating changes in preferences." (Shepsle 2006

34

b, 1037) Examples of exogenous factors are different levels of economic growth or a change in the number of actors negotiating the institutional arrangement. These changes happen gradually, such that there is an inconsistency between preferences and the distributional implications of institutions as equilibria.

On the other hand, endogenous mechanisms gradually affect both preferences and distributional benefits from the institutional arrangement, but in their turn players' preferences are affected by the distributional implications of the institutional outcome, hence preferences and institutions shape each other endogenously. The endogenous mechanism of learning is critical in raising actors' awareness on the change in distributional benefits: actors learn that the previous outcome is no longer advantageous because "information is continuously renewed into strategic interactions." (Heritier 2007) This learning leads to the above-mentioned inconsistency between preferences and the distributional benefits of an institutional arrangement negotiated in the past.

Greif and Laitin (2004) emphasize the endogenous mechanism of reinforcement; the authors argue that this mechanism stabilizes institutions and therefore does not lead to change, as opposed to the mechanism of undermining that leads to a point where institutions are no longer self-enforcing. On the contrary, I argue that, given the distributive implications of the institutional outcome, the mechanism of reinforcement, defined as a state where more players in more situations adhere to the institutions and increase benefits, (Greif and Laitin 2004) actually leads to institutional change with distributional implications. In fact, from the previous institutional arrangement, the institutions that will be reinforced by the disadvantaged players are precisely those that can restore/ increase distributional benefits. These reinforced institutions can very well coexist with institutions that do not change, hence the concept of 'layering'.

Stacey and Rittberger (2003) argue that in rational choice historical institutionalist approaches institutions are not very thin but somewhat persistent. In my approach, the thinness of institutions depends on how often players interact and the institutional outcome is renegotiated. If players foresee exogenous shocks, a renegotiation clause may be stipulated in the original agreement, such that change will happen at a pre-defined point in time. (Koremenos 2005; Heritier 2007) While incremental change happens in between the moments of renegotiation, at the moment of renegotiation change is dramatic because preferences and benefits have become highly inconsistent due to accumulated gradual change. In this renegotiation, like in any bargaining, powerful players prevail by using issue-linkages.

As argued above, renegotiation is the critical mechanism through which change comes about. During negotiations, players use issue linkage in order to increase their benefits derived from the institutional outcome. In order to correctly identify the distributional benefits and the bargaining success of powerful players, the most appropriate way to describe renegotiation is through a formal model that maps players' preferences into the institutional outcome. A bargaining game has the critical advantage that it links institutions-as-constrains – the rules of the game – with institutions-as-equilibria – the outcome of the game.

2.5 METHODOLOGICAL APPROACH

2.5.1 A Formal Model of Institutions-as-Equilibria

"Interaction-oriented policy research is the specific contribution of political science and political sociology and at its core is game-theoretic thinking." (Scharpf 1997, 14)

Political science has reached an era in which game theorists have become very interested in the empirical implications of theoretical models and their application to interactions that happen in the real world. (Scharpf 1997, 4) Within rational choice institutionalism, the use of formal models is a methodological tool that allows the identification of the mechanisms through which institutions come into being and shape the choice of strategies that lead to political outcomes. The main strength of formal theories is that they give a general prediction and thus the empirical task of the researcher is to check if and how observed behavior deviates from it. In contrast to verbally formulated theories, which are not equipped with a mechanism that could check logical consistency, formal models have the advantage of detecting logical inconsistencies in theory formulation.

In the game-theoretic conceptualization of strategic interaction, rational actors are central, hence the appropriateness of formal models for the study of political outcomes that emphasize agency: "(…)the game-theoretic conceptualization of interactions seems uniquely appropriate for modeling constellations that we typically find in empirical studies of policy processes." (Scharpf 1997, 5) In most models, the analysis is simplified by treating players as unitary: actors with relatively cohesive orientations are treated as 'composite': "public policy is not produced by a unitary actor but by strategic interaction between many policy actors, each with its own interest and capabilities to affect the outcome." (Scharpf 1997,11)

In spite of the appropriateness of formal models for actor-centered theories, empirically oriented political scientists have been reluctant to use game-theoretic models for two reasons:

First, game theory is a branch of applied mathematics, and much of the literature, written by mathematicians for other mathematicians, not only *seems* forbiddingly technical but *is* in fact practically inaccessible to the uninitiated. Moreover, empiricists who have nevertheless ventured

to look behind the veil of technical difficulties are generally repelled by the extreme unrealism of

the assumptions that they have encountered.   (Scharpf 1997, 6)

Formal models are stylized versions of reality and contain specifications that are essential

to the search for generalizations in political science. However, more than descriptive theories,

formal theories need to be explicit about their assumptions and the propositions derived by

deductive reasoning. The explanatory hypothesis in game theoretic models is that interdependent

strategic interaction between goal-oriented actors operating under institutional constraints

produces equilibrium outcomes. Due to this hypothesis, formal models have the advantage that

they emphasize the importance of the rules of the game, the bargaining resources of players and

their influence on the other players and on the equilibrium behavior. One of the defining features

of the actors is their preferences; in most theoretical models, preferences are exogenous, they are

not allowed to vary with the interactions of players.

In game-theoretic algorithms, comparative statics is used to analyze how equilibrium

behavior varies with variation in the parameters of the game (i.e. resources, payoffs, number of

players). Comparative statics analysis generates relationships between variables by manipulating

the conditions that define the equilibrium: changes in exogenous variables generate changes in

the endogenous variables that form the equilibrium or the set of equilibria in case of multiple

ones.

In formal models, political outcomes represent equilibria, therefore no player has

incentives to deviate from the equilibrium behavior. While Nash equilibria include threats that

are not credible due to the constraint that in a node that is not reached a player's choice should

maximize her utility, subgame perfect equilibria, a subset of Nash equilibria, include only

credible threats by imposing the off-equilibrium additional restriction that players' actions

should be best responses to other players' actions in the subgame. These credible threats help

institutionalize patterns of behavior because they prevent players to behave inappropriately, as they know the other players will respond by punishing their deviation. (Bates et al. 1998, 10)

Related to the concept of equilibrium, institutions are conceived as sets of rules that induce choices that are regularized because they are made in equilibrium and organize future strategic interactions. When no actor has incentives to change his behavior, should exogenous factors remain the same, actors' behavior stays unaltered and thus becomes institutionalized and individuals become locked in patterns of strategic interdependence. (Bates et al. 1998, 8-9) Institutions-as-equilibria are thus defined as stable, self-reproducing social structures achieved in the process of institutionalization. (Calvert 1995). However, when exogenous factors change, the equilibrium is altered and institutions change as well. This represents the beginning of game-theoretic preoccupation with the dynamics of institutional change. In this vein, a fundamental task of the researcher is to contradict Stone Sweet's argument that game theoretic models do break down when preferences are endogenous or when actors begin to make sense of how rule evolution can alter interactions and outcomes. (Stone Sweet et al. 2001, 5)

Formal theories have a particular, albeit incipient place in studies of the EU. While descriptive theories (Nugent 1989; Wallace et al 2005; Peterson and Bomberg 1999; Dinan 2005 etc.) have enriched the study of EU decision-making, they have also shown to formal modelers which specific features to include in their algorithms and how to match abstraction with empirical findings. (Thomson and Hosli 2006, 10) Rittberger (2007) draws attention to the fact that formal models on the EU make over-simplifying assumptions and counter-intuitive predictions, as for instance the impossibility to explain the Council's 'culture of consensus', defined as a common understanding of the European good resulting from frequent negotiations between the same partners. Thomson et al. (2006) outstandingly put together the existing formal

models applied to the EU and develop some empirical tests for these models. One difficulty with EU game-theoretic models is that information on European actors' preferences is generally not public, therefore scholars have relied on historical accounts, documents assessment and structured interviews with experts. Related to the latter, Konig and Proksch (2006) warn of missing values in data derived from expert estimates of actors' positions, Bueno de Mesquita (2004) cautions that estimates of initial positions by experts could be tainted by knowledge of the final outcome, and Schneider et al. (2006) draw attention on using continuous scaling for discrete issues.

Spatial models, a particular class of game theoretic models are reasonably successful at predicting behavior based on the rules of a particular social space and the actors' relative positions in such an arena, from which interests can be inferred; the distance between initial positions and final outcomes is a measure of bargaining success or power. Thomson et al. (2006) review two categories of spatial models – bargaining and procedural – and find that bargaining models perform better than procedural ones, possibly because actors are willing to compromise for the sake of reaching a common position, as bargaining models show, whereas procedural models consist of single-shot events in which actors maximize their own self-interest.

Procedural models focus on formal institutions (e.g. voting rules, the co-decision or cooperation procedures) and rely on non-cooperative game theory and spatial voting theories; actors affect outcomes either individually (e.g. as agenda-setters) or in groups (e.g. as collective veto-players). These models specify both the sequence of play and the moves available to each player; it does not matter if states are big or small, if they have similar preferences they might form a coalition. Steunenberg and Selck (2006) model consultation and co-decision but warn about the room of interpretation in applying the treaty rules in practice. Crombez (1997) provides

a procedural model for the EU co-decision procedure (but no empirical testing) and interprets the results in terms of the power of the institutional actors.

Bargaining models rely on cooperative game theory (e.g. the Nash bargaining solution) and look at informal institutions such as pre-voting bargaining in committees, logrolling, power strategies and exchanges in search of a compromise. The importance attached to the 'consensus' culture is based on the empirical finding that voting is rather rare in the Council. The exact sequence by which decision outcomes are reached is not specified; the bargaining process is treated as a black box inputting actors' power, preferences, and the salience attached to different issues. Scholars that use voting power indices based on the frequency of a member state being pivotal (i.e. Banzhaf 1965; Penrose 1946; Shapley and Shubik[8] 1954) argue that formal rules lead do a dominant position by the big member states. The difference in these measures lies in the underlying distribution of the voting poll, i.e. the number of voters in favor of a decision. Widgren and Pajala (2006) claim that empirical evidence from elections rejects the Banzhaf model, particularly in the consensus-seeking EU Council where voters cannot be assumed to be independent/oblivious of the others; they also discard the opinion that voting weights should be proportional to the square root of population, as this solution is not so fair and democratic as some thought. On the contrary, the authors find that the Shapley-Shubik model is preferable for calculating power and the coalitional probabilities. (Widgren and Pajala 2006, 240-250)

A well known bargaining model is Bueno de Mesquita's (1994) expected utility / challenge model that assumes that players put effort into strengthening the coalition around their

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[8] The Banzhaf model assumes that all members of a voting body act entirely independently of one another, and randomly (as the number of voters increases the probability continually increases that just around half of the members are in favour of any decision, and half against, so it becomes increasingly difficult to cross a threshold usually around a quota of 70 % of total votes. The Shapley-Shubik model assumes that there is an equal chance of j member states (j varying from 0 to $n= 25$ in EU25) being in favor of any particular issue, and that every coalitional combination made up of j countries is also equally likely within that. Efficiency is then the sum of the probabilities, thus determined, of winning coalitions.

favored policy positions and challenge others based on expected utility; the decision outcome is the weighted median voter position. In Stockman and Van Oosten's (1994) exchange model, actors exchange positions on issues and thus influence the outcome. Van den Bos' (1991) compromise model predicts outcomes at the mean of actors' policy positions on all issues in the same proposal, weighted by their capabilities and the salience attached to issues. (Rittberger 2007, 1154) In Achen's (2006) institutional realist[9] model, all actors must work to reach an agreement or else end up with the undesired status-quo; Achen argues that the Nash bargaining solution implies that the compromise model's formula of predicting EU decisions is a very good approximation. (Thomson and Hosli 2006, 21) Snyder, Ting and Ansolabehere (2005, 991) propose and apply a competitive bargaining model to the EU, predicting nearly proportional expected payoffs to voting weights, while the addition of new members decreases the original members' expected payoffs. Ansolabehere, Snyder and Ting (2003, 472) consider the EU as a case where both proposal power and voting power are maldistributed and offer useful insights on weighted voting and resource distribution. It is worth mentioning that some bargaining models use the notion of bargaining space – the winset / minimal winning coalition[10]. Putnam argues that, when negotiators have a larger win-set, they can more easily conclude an agreement, as they have more room for maneuver; however, their bargaining positions are weaker (Putnam 1988, 450).

Some mixed models comprise two stages: an informal bargaining stage before adoption of legislative proposals and a formal procedural stage derived from Treaty stipulations. Kőnig

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[9] Institutional realism is based on the idea that the relative power of governmental institutions determines political outcomes. (Thomson and Hosli 2006, 21)

[10] Putnam (1988) defines the winset as the set of possible agreements between actors that can obtain domestic support (ratification). Crombez (1997) describes the set of outcomes as the possible minimal wining coalition for the adoption of legislation.

and Proksch (2006) procedural exchange model integrates an issue-linkage stage between the Commission (as agenda-setter) and the member states, informal bargaining in the Council based on exchanges and the final voting round that involves the EP. Widgren and Pajala (2006) similarly assume cooperative bargaining on a single dimension in the first phase and a second phase of the formal voting. (Rittberger 2007, 1153-1154; Thomson and Hosli 2006, 5-9).

Some bargaining models offer insights into the behavior and impact of veto players. Tsebelis and Money (1997) consider the EU a bicameral legislature with the Council as the upper chamber and the EP as the lower chamber: the lower chamber gains veto power over the agenda-setter when the navette[11] procedure is employed, since the more impatient chamber - the upper chamber - is more willing to make a concession. Tsebelis (2002) argues that more veto players lead to policy stability because it is not possible to agree on change, while Tsebelis and Chang (2004) note that, since the preferences of the EP and the Council are divergent in terms of increasing the budget, the EU budgetary system leaves little room for exceptional changes (Tsebelis and Chang 2004, 449).

An appropriate model describing the dynamics of the institutions-as-equilibria is a rational choice bargaining model that allows players to shift their positions through exchanges on different issues with the view of reaching agreement in the final (voting) stage: while players' initial positions tend to be more extreme, once they realize what is feasible, their positions converge towards agreement. Empirical evidence, including my own, has shown the importance of informal discussions prior to formal voting plenaries, especially when the decision rule is unanimity. Bueno de Mesquita (1994, 74) argues that under unanimity it is very costly to be the

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[11] The navette or shuttle system is a way to resolve disagreements between the two chambers of a legislature. The house that first passes a bill sends the legislation to the second house; if the second house ratifies the legislation, the process ends; if not, the second house amends the legislation and sends it back. (Tsebelis and Money 1997, 63).

veto player, as the survival of the entire agreement is at stake, whereas being in the opposition is relatively cheap under QMV. Bargaining models have the advantage that they emphasize the importance of informal rules but yet acknowledge the importance of formal institutions, which set the rules of the game.

The position exchange model proposed by Stokman and Van Oosten (1994) is a bargaining model that distinguishes between two stages of the decision-making process: during the first stage, players try to influence each other in order to obtain an outcome as close as possible to their own policy positions; then, the decision or voting phase produces the outcome. In the influence phase, pairs of actors make exchanges on pairs of issues: a player agrees to shift her position on an issue of less importance to her in exchange of the other player making a concession on an issue of higher importance to the former player. (Stokman and Van Oosten 1994, 109) This influence stage is in agreement with the conditions for issue-linkage described by Tollison and Willett (1979) and Morgan (1994): exchanges happen when relative saliences differs. Each actor investigates the potential exchanges with all the other actors on all possible pairs of issues and then tries to realize her best potential exchange. All exchanges are binding and those with the highest utility gains are realized first. (Stokman and Van Oosten 1994, 110).

This bargaining model relies on several assumptions. First, like in any rational choice model, actors are assumed to be expected utility maximizers: they choose the strategy (i.e. the exchange) that produces the highest utility on a given issue. Second, the utility functions of the actors are single-peaked and each issue is unidimensional, even though the model implies multidimensional linkages across issues. This implies that players' preferences over outcomes can be represented on a line segment, like in any spatial model; the preferences with their associated utility diminish steadily the farther the Euclidian distance between the outcome and

the player's ideal policy position. Actors differ in their preferences over outcomes and in the salience they attach to different issues under negotiation. The expected utility for each player i is a utility loss linear function of the salience s_{ia} attached to the issue a by player i and the distance between the decision outcome on the issue X_a and the player's ideal policy position on issue a P_{ia}, such that:

$$EU_{ia} = - s_{ia} |X_a - P_{ia}|$$

The total expected utility for an actor i over all m issues is assumed to be the sum of her utilities over all issues:

$$EU_i = \sum_{a=1}^{m} - s_{ia} |X_a - P_{ia}| \quad \text{(Stokman and Van Oosten 1994, 108-109)}$$

The third assumption is that preferences and voting positions, as well as the saliences on all issues are assumed to be common knowledge. This assumption is supported by the literature (Achen 2006; Thomson and Stokman 2006; Arregui, Stokman and Thomson 2006) who argue that the 'consensual' atmosphere in collective good bargaining leads to interests being revealed beforehand, especially in the case of extreme positions; in some cases, states make a point from announcing their positions. I argue that, in bargaining that involves repeated interaction between the same players, the endogenous mechanism of learning leads to a situation in which actors know the preferences of the other players.

Fourth, actors cannot behave strategically, which means that mutually beneficial exchanges are possible only for actors on opposite sides of the expected outcome of both issues, as actors being on the same side can increase their utility just by choosing more extreme positions without having to give in on another issue. This implies that on issues a and b, actors' voting positions lie in the interval $[P_{iu}, P_{ju}]$ and:

$$(P_{iu} - X_u)(P_{ju} - X_u) < 0 \text{ for u} = a,b$$

Fifth, because actors aim to obtain symmetric benefits through the exchanges, there is a symmetric equilibrium post-exchange[12]: the exchange rate is equal utility gain for both actors involved in an exchange. In order to obtain the maximum gain, one actor needs to completely shift to the position of the other, whereas the latter shifts only partially to the position of the former; the complete shift can be realized in subsequent bilateral exchanges.

The equilibrium concept for this game involves two aspects. First, the equilibrium is based on the Nash bargaining solution[13]. Achen (2006, 92-120) demonstrates that Van den Bos' (1991) 'compromise formula' for computing decision outcomes closely approximates the Nash bargaining solution when disagreement is the least desirable alternative. Thomson and Hosli (2006, 21) state that: "this modest and straightforward compromise formula embodies the best case study wisdom of the last century." Second, Stokman and Van Oosten (1994, 111) draw the attention to the fact that the equilibrium of this game is based on intuitive reasoning and not derived from micro-processes, as an actor compares her expected utility on an outcome without exchanges with the expected outcome of the other voting for her policy position on both issues: "From a number of desirable axioms, an equal percentage of utility gain – instead of equal utility gain – is derived as the equilibrium after exchange. This solution is proven to be Pareto optimal for both actors, and it does not involve intersubjective comparison of utilities." (Stokman and Van Oosten 1994, 111)

The model proposed by Stokman and Van Oosten (1994) predicts decision outcomes according to a 'base model' that takes into account the voting power of actors and their policy positions. Van den Bos (1991) considers that larger member states have a larger weight in

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[12] The alternative would be the Raiffa-Kalai-Smorodinsky bargaining solution. (Stokman and Van Oosten 1994, 111)

[13] The alternative that maximizes the product of actors' utilities when the reversion point is zero. Achen (2006, 99)

decision making and thus proposes a 'compromise model' in which the Presidency makes a policy proposal on an issue a that represents a mean average of the policy positions p_{ia} of all n member states weighted according to their capabilities/resources v_{ia} and the saliences s_{ia} they attach to issues. Stokman and Van Oosten's position exchange model adds an intermediate exchange phase to Van den Bos' compromise model and thus extends the compromise model from one to m issues. Accordingly, in the first stage of the position exchange model the expected outcomes on every issue are determined according to the compromise model; after exchanges have taken place and players have moved to revised positions, in the last stage the compromise model is used again to generate the final outcome:

$$X_a = \sum_{i=1}^{n} p_{ia} v_{ia} s_{ia} \Big/ \sum_{i=1}^{n} v_{ia} s_{ia} \qquad \text{(Stokman and Van Oosten 1994, 114)}$$

Stokman and Van Oosten (1994, 115) stress the fact that both the position exchange model and the compromise model could be applied to decision involving numerical positions, like amounts of money to be spent, but cannot be used for binary outcomes (e.g. support for a proposal). Like in a rational choice functional approach, the compromise model emphasizes cooperation and the importance of information-based networks where common interests are more important than divergent interests, hence the high pressure to reach an agreement acceptable to all. On the contrary, the position exchange model is typical for a rational choice distributive approach that allows issue-linkages and the influence of powerful players.

2.5.2 Analytical Narratives

The most suitable methodology for a dynamic formal model on institutional change developed in the rational choice historical institutional framework is the 'analytical narrative': "An analytical

narrative is a case study but there is an underlying model that motivates the analysis and frames the empirical materials." (Shepsle 2006, 34-35) Bates et al. have developed "the analytical narrative as a case-oriented methodology for studying institutional development in historical context."(Bates et al. 1998) This case-study is different than in mainstream historical institutionalism because it is a narrative but logically rigorous account based on analytical models – spatial representations/ game forms – as frameworks that embed the case. One may argue that analytical narratives have the unique virtue of linking rational choice game theory to data by adding stories, accounts and contexts; this feature strengthens the validity of any rational choice historical approach.

Analytical narratives add "parsimony, refinement and elegance" and contribute to the "historical turn in the social sciences." (Bates et al. 1998, 10) While games are useful for the explanations of political outcomes, one needs to build a story that accounts for the outcomes of interest:

> By reading documents, laboring through archives, interviewing and surveying the secondary literature, we seek to understand the actors' preferences, their perceptions, their evaluation of alternatives, the information they possess, the expectations they form, the strategies they adopt, and the constraints that limit their actions. (Bates et al. 1998, 11)

As they explore mechanisms that have generated the outcomes of interest, analytical narratives follow George and Bennett's (2005) 'process-tracing'. The two methodologies have in common the fact that they convert historical accounts into analytical ones in a theoretically relevant language and prescribe an iterative process in which the analyst modifies his/her interpretation in light of the data. However, analytical narratives differ from process-tracing by putting greater emphasis on theory and by allowing not only tracing but also ways of testing the goodness of fit of the theory. (Bates et al. 1998, 16-17)

48

Analytical narratives trace the historical processes that unfolded the events, identify actors, the choices they made, the strategies adopted and not adopted, but focus on the logic of these processes. In doing so, analytical narratives emphasize the capacity of people to manipulate and strategize in order to achieve political outcomes, hence Bates' claim that "the theory is actor-centric." (Bates et al. 1998, 14)

On the selection of case studies, Bates et al. recommend 'soaking and poking' (Fenno 1990) but depart from the standard prescriptions of case selection:

> When students learn research methods, they typically start by learning *principles of case selection*. Like them, we resist this point of departure. As have many of our students, we too have been impelled to 'do social science' by our fascination with particular cases: World War I, the French Revolution, or the US Civil War. In effect, our cases selected us, rather than the other way round. So compelling do we find our cases that we wish to immerse ourselves in them, but also construct logically persuasive and empirically valid accounts that explain how and why the events occurred. (Bates et al. 1998, 13)

As George and Bennett (2005) suggest, case studies should combine deductive theory with empirics. Like all narratives, analytical narratives provide deep insights into the case and the interpretation of data, but are more vulnerable because they are constrained by very rigorous deductive reasoning and very close attention to empirical detail. In fact, the attention to detail is critical: in order to know which analytical narrative provides the best explanation, which equilibrium was chosen out of many and if assumptions correspond to what is known, "the theorist must ground his or her explanation in empirical materials, seeking the forces that shaped the selection of a particular equilibrium" (Bates et al. 1998, 15) Rather than testing hypotheses, Bates et al. prescribe that one should derive implications from theory and, when the case materials do not confirm the theory, it should be reformulated. (Bates et al. 1998, 16)

In order to explain why and how change happens in institutions-as-equilibria, I analyze the evolution of preferences and outcomes in a bargaining game over institutions. Exogenous and endogenous factors affect the preferences of actors and the outcome; the drivers of change are the most powerful players.

3.0   THE EU BUDGET AS A CASE STUDY FOR INSTITUTIONAL CHANGE

3.1   THE CHOICE OF THE EU BUDGET AS A CASE STUDY

In the literature on EU decision-making, the processes and outcomes of EU budgetary negotiations have puzzled social scientists because of several reasons. First, the history of the EU budget showed that change was possible in spite of the high potential to stagnate and even break down the Union. Second, like any negotiations on the allocation and distribution of scarce resources, extremely intense political bargaining characterized EU budgetary negotiations but still agreement was reached and certain outcomes prevailed. Third, the European Union was not a state but still it attempted to have an autonomous source of financing that resembled a national budget. Fourth, the interplay between intergovernmental and supranational institutions seemed to be inhibiting change in budgetary matters, especially because contentious national politics were brought into the EU arena.

This puzzle of institutional change is translated into EU budgetary matters as the challenge of explaining the absence of budgetary 'deadlock'. On one hand, deadlock means status quo bias, which is characterized by the impossibility of changing the budget due to either the lock-in effect of some institutions introduced in the past or the existence of two opposing coalitions – payers and receivers – that block change. On the other hand, deadlock means the

51

impossibility to agree on a budget, in other words a gridlock in negotiations that prevents the emergence of an outcome.

Studying the absence of deadlock in EU budgetary negotiations is critical for the understanding of institutional change. First, a study of the EU budgetary deadlock contributes to the institutionalist literature that explains change and thus answers the question: how can we change institutions that are locked-in? Second, answering the question on the existence of deadlock in EU finances explains the interaction between EU member states (and institutions) in an area conducive to conflict - bargaining over money – and where agreement is difficult because of the increased heterogeneity of players. In this respect, analyzing deadlock contributes to the rational choice literature on negotiations because it shows how agreement is obtained and who influences the outcome. Third, such an enterprise increases transparency on EU decision-making by explaining the interaction between member states and institutions within the EU institutional framework: while it is difficult to obtain an exact account of what happened, some theoretical lenses could help us understand the dynamics of negotiations. Fourth, while the budget has little macroeconomic significance for the Union as a whole, it is very important for the member states that benefit from EU funds. (Laffan and Lindner 2005, 193) The EU budget with its independent resources has also been a very important tool in the economic integration of the Union. Last but not least, studying the possibility of change in EU budgetary matters could help contribute to the 2008/2009 budgetary review.

Subsequently, the question that arises is: How do we recognize deadlock when we see it? In order to answer this question one needs to look for evidence of the two meanings of the term 'deadlock', no budgetary change and no agreement on the budget, respectively. On one hand, we are in deadlock when no change of the rules governing the EU budget is possible: because of the

lock-in effect of previous institutions, no innovation is possible therefore we do not see any new rules on the budget. An example of this is the 2003-2004 proposal of a new institution by the Commission – a generalized correction mechanism – which was not agreed upon, thus providing evidence for the argument that no new institutions are possible on the budget. On the other hand, when there is deadlock, we see veto players bringing EU budgetary negotiations into a halt – there is no agreement and negotiations are postponed – budgets are rejected by the budgetary authority and court cases on the budget are brought in front of the European Court of Justice. We see numerous examples of these in the early 1980s.

The emerging literature on the EU budget has tried to explain and bring evidence of the existence of deadlock in EU finances, but no agreement was reached on the conceptual meaning of deadlock. Lindner (2006) presents statistics showing the existence of conflict in the annual budgetary procedure for thirteen years during the period between 1978 and 1997. Using a historical-institutionalist approach of institutional change, Laffan (1997), Laffan and Lindner (2005) and Lindner (2006) argue that the reduction in conflict on the EU annual budgets is a result of the lock-in effect of the introduction of the Financial Framework (FF) in 1988, which created a specific institutional framework for budgetary negotiations, such that instead of fighting every year for EU funds, the big bargains occured every five to seven years. Shackleton states that the 1988 decision "marked the end of a long period of bitter argument about the financing of the EC and generated a widespread feeling that the Community had been dramatically reinvigorated." (Shackleton 1990, 1)

In this literature, the existence of a status quo bias is explained by actor-centered institutionalism: member states have specific preferences which interact and produce an outcome that cements the lock-in effect by institutions; change on the budget was possible in the past but

the lock-in effect of these past institutions hinders current change and thus leads to a status quo bias. The first institutional lock-in happened with agriculture in the early 1960s. On one hand, France was interested in a common agricultural policy and left the Council meetings in 1965 because France wanted a guarantee that the common agricultural policy would have independent financing and the related decisions would not be taken by qualified majority voting (QMV); once these matters were secured, the French agreed to open accession negotiations with the UK. On the other hand, Germany – the main payer for agriculture – decided that the cost of agreement would be better than no agreement[14].

The second institutional lock-in started in 1970-1975 with the own resources decision and the budget treaty and culminated with the introduction of the UK rebate in 1984. At the time of accession, the UK was troubled by the financial burden caused by its reduced agricultural field and the continuous increase in the agricultural expenses of the Union. Since joining the Union was more important for the UK, once member of the Union, the UK gradually pushed the budgetary agenda to equity matters until it finally obtained the UK rebate in 1984 – a correction mechanism on the revenue side in order to ensure unanimity[15].

The third institutional lock-in is represented by the introduction of the FF in 1988. This significant change of the budget meant an extensive increase in structural funds which originated in the desire of member states to achieve a single market. With this change, the dynamic of net payers shifted in the period 1988-1994. While Germany and the UK (before its correction) were already paying for the Union, the Netherlands also became a net payer, a position it did not anticipate. The countries that joined in 1995 – Austria, Sweden and Finland – soon joined the

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14 Based on discussion in the Workshop *The political economy of EU public finances: designing governance for change* organized by the Bureau of European Policy Advisers, European Commission. Brussels, February 5, 2009.

[15] Idem.

club of the financers of the Union because they obtained only temporary budgetary corrections immediately after accession. These developments led to the current status quo bias – the formation in the early 1990s of two coalitions of net beneficiaries and net payers[16].

Another explanation of budgetary deadlock is given by Blankart and Koester (2009) who argue that the historical development of decision-making on the EU budget has resulted in a re-distributive deadlock: "[…] two different historically formed coalitions now have an incentive to veto changes on the financing and the expenditure side, which leads to budget deadlock and prohibits a change […]." (Blankart and Koester 2009, 3) Trying to explain why some member states are consistently net payers while others are net receivers, the authors show that the threat of exit played an important role in the development of the budgetary deadlock. In the authors' view, deadlock is defined in the following way. Net receivers object to any reallocation of resources away from their individual interests, whereas net payers, anticipating net receivers' power to attract additional resources, veto any increase in their financial burden. However, net payers cannot enforce a decrease of their burden, as this would be objected by net receivers. This leads to a status quo that is a stable equilibrium.

Blankart and Koester (2009) argue that, with the introduction of the Common Market, the formal rules of the Treaty were applied but, since the rules separated expenditure from revenues, they generated opposing coalitions with veto power on either side of the budget: the expenditure side became dominated by net receivers, whereas the revenue side was controlled by net payers. The result was a budget deadlock dominated by redistribution with a fixed allocation of benefits and burdens per Member State; as the concessions granted to Spain, Portugal and Greece upon

16 Based on discussion in the Workshop *The political economy of EU public finances: designing governance for change* organized by the Bureau of European Policy Advisers, European Commission. Brussels, February 5, 2009.

their accession show. The authors bring evidence of the prevalence of the status quo bias by comparing the average annual net payment positions per head in the period 1995 to 1999 with 2000 to 2003 and finding a striking stability. Ireland, Greece, Portugal, Belgium, Luxembourg and Spain receive large net payments per head, while Denmark and Finland receive moderate net payments, whereas the net payers are Germany, Sweden, the Netherlands, Austria and the UK; France and Italy are break-even states. Only Denmark, was a net receiver in 1995-1999 and became a break-even state in 2000. (Blankart and Koester 2009, 14-15)

Blankart and Koester (2009) refute the argument that the 1988 introduction of the FF combined agreement both on the size of the budget and the basic structure of spending and therefore was a decisive innovation to overcome the budget deadlock. On the contrary, the authors emphasize the puzzle and argue that, instead of breaking up the budget deadlock, the FF increased the already very large status quo bias. In support of their argument, the authors bring several facts: the principle of annuality of the EU budget remains, the FF has to be passed by unanimity and does not specify the distribution of expenditure to the member states in full detail, the FF does not change the general incentive of the net payers to block increases of budget ceilings, and the FF does not fully restrict the bargaining on the allocation of expenditures to member states in the annual budget procedure. The authors find that deadlock is persistent in spite of the 2004 enlargement and the changes proposed by the Lisbon Treaty, therefore the mainly redistributive nature of the EU budget is likely to continue. (Blankart and Koester 2009, 16)

Kauppi and Widgren (2009) define the status quo bias in the EU budget on the basis of a game theoretic power distribution that specifies the relative voting power of each member state in the Council of Ministers, assuming that each state's share in the budget derives from its votes.

When comparing actual budget shares with this power distribution, the authors find that France, Germany, Spain and Greece have excess power, as they systematically receive more funds than their power distribution implies; by contrast, Austria, Finland, Sweden, the Netherlands, Denmark, UK, Belgium and Luxembourg systematically obtain smaller shares from the EU budget than their power distribution implies, therefore their excess power is negative; the shares received by Italy, Portugal and Ireland approximate their power distribution. In particular, France has excess power in CAP but negative excess power in structural funds, Spain, Germany and Greece have excess power in both structural funds and CAP, Portugal has excess power in structural funds but a negative one in CAP. In the authors' view, a high status quo bias is given by high excess power: countries with high excess power want an increase in funds, but countries with negative excess power will block any increase. This explains the stability – no change – of the budget over time. (Kauppi and Widgren 2009, 3)

Ackrill and Kay (2006) define deadlock in a slightly different way. Since changes in the budget are a zero-sum game, member states' interest is to safeguard their shares of the EU budget: every member state wants to maximize its budget share, but short of that preserving a member state's share is the second best outcome. This implies that the status quo is always maintained and no changes are possible, hence the EU budgetary negotiations have recently shifted to a debate on maintaining or even reducing the size of the budget: the 1999 inter-institutional agreement has made unexpected spending increases very difficult and the Lisbon Treaty tightens the budget rules even further. However, the authors argue that there is pressure leading to institutional change, and this pressure is endogenous to the EU budget. (Ackrill and Kay 2006, 128-130) Since reform of the policy framework is costly, the authors conceive change as additional institutions being layered on top of existing ones. (Ackrill and Kay 2006, 113-114)

The other meaning of deadlock, as mentioned above, is the impossibility to obtain agreement on the budget. This was a hotly debated issue before last enlargement and has re-emerged with the global financial crisis. Before 2004, some policy-makers in Brussels and the EU-15 and some social scientists argued that, as more countries join the EU, the decision-making mechanisms become more complex, hence the increased likelihood to end in deadlock, especially in a field where money is involved: "The conventional view is that the increase in the number of member states and the greater diversity of their views will not only create pressure for financial transfers, it will also trigger breakdown or gridlock in the EU's decision-making process." (Moravcsik and Vachudova 2003, 54)

In the 1980s and in the first half of the 1990s, there were numerous cases of no agreement (i.e. deadlock) on the EC/EU[17] budgets, as they were rejected or contested quite often. Lindner (2006) presents statistics showing the existence of deadlock – rejections of the budget or court cases involving budgetary decisions– in the annual budgetary procedure for thirteen years during the period between 1978 and 1997.

Thomson and Hosli (2006) emphasize the danger of deadlock by giving examples of the challenges European decision-makers face in reaching political agreements. The authors argue that the deadlock from the June 2005 negotiations on the 2007-2013 FF was a result of the French and Dutch referenda that rejected the Constitutional Treaty: forced by the referendum, the Dutch Prime Minister asked for a sizeable reduction in the Dutch net payments to the budget, the UK refused to discuss its correction mechanism and "agreement failed due to negative votes of the UK, the Netherlands, Spain, Sweden and Finland." (Thomson and Hosli 2006, 1-2)

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[17] European Communities before 1994.

With the more recent financial crisis, an argument that has been gaining ground is that, under financial strain from bailing out their banks and industries and given the difficulties to coordinate action at EU level, some member states will no longer be able to comply with EU rules and therefore will paralyze EU decision-making in areas involving money, hence the emergence of deadlock.

There is also a normative component of the deadlock issue but there is no agreement on if it is good or bad to keep the status quo; the opportunity costs of keeping the status quo have not been properly identified. Coalition theory argues that the larger the coalition needed to change the status quo, the more public goods are provided, whereas the smaller the size of the winning coalition, the higher the likelihood of bribery and clientele spending. When unanimity is the rule, it is clear that the EU has a high threshold for changing the status quo, like the US, therefore the EU should produce more public goods and less pork barrel, according to the theory. However, this contradicts the distributive nature of the EU budget, locked-in by the opposing coalition of net contributors and net beneficiaries, hence the additional puzzle – if deadlock exists, is it good?

Given the rules that govern the EU budgetary processes over time and the influence of actors on outcomes, rational choice historical institutionalism is the appropriate theoretical approach for the study of EU budgetary negotiations.

3.2   DESCRIPTION OF THE EU BUDGETARY PROCEDURE

The process of making budgets in the EU involves negotiations on both the FF and the annual budget that engage the two arms of the budgetary authority – the Council and the European Parliament (EP) – and the Commission as agenda-setter and mediator. Although the Council

(representing the member states), the EP, and the Commission prefer different levels of increases in budgetary resources, the outcomes of the budgetary negotiations show that agreement can be reached under different institutional voting rules – qualified majority (QMV) and unanimity.

While there is a close relationship between the FF and the annual budget, there are important differences between the two procedures. The annual budgetary procedure is based on Articles 268 - 280 of the Treaty Establishing the European Community[18] and Article 177 of the Treaty Establishing the European Atomic Energy Community. The EU budget has common features with a national budget: unity[19], annuality[20], specification[21], but it has two distinct characteristics: universality[22] and equilibrium[23]. The own resources system[24] is the revenue side of the EU budget that relies on the contributions of member states, capped at 1.24% of the EU GNI (Gross National Income)[25]. Before June 15 every year, the Commission presents the preliminary draft budget to the Council. Before July 31, the Council conducts its first reading and votes by qualified majority[26] on the draft budget, which is then sent to the EP. In October, the EP holds its first reading and proposes modifications on compulsory expenditures[27] by a majority of votes cast and amendments on non-compulsory expenditure[28] by a majority of members; then, the draft budget is 'shuttled' to the Council. During the third week in November,

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[18] Nice consolidated version 2002
[19] There is only one budgetary document in which revenues and expenditures are listed.
[20] The budget refers to only one financial year.
[21] All expenditures and revenues have to be mentioned in an article of the budget, otherwise the funds cannot be collected or spent.
[22] There are no special revenues out of which particular items of expenditures are financed.
[23] No deficit or surplus is allowed; if a deficit occurs, it is entered as expenditure in the coming financial year; if a surplus occurs, it is carried over as revenue to the next financial year.
[24] The EU own resources are made up of the following: traditional own resources (custom duties, agricultural and sugar levies), VAT resource (a uniform percentage of each member state's capped VAT base) and GNI resources (a uniform percentage of each member state's GNP).
[25] Equivalent to 1.27% of GNP according to the old European System of Accounts (prior to 1995)
[26] The qualified majority is explained in Section 4.
[27] Compulsory expenditure results directly from the treaties or other Cummonity acts; it mainly covers agricultural policy.
[28] Non-compulsory expenditure mainly covers regional policy.

the Council holds the second reading and votes by qualified majority on the EP amendments and modifications. If there are still disagreements between the Council and the EP, a conciliation meeting is held between the two budgetary players, with the Commission acting as mediator. The amended draft budget is sent back to the EP for the second reading in December. By a majority of members, the EP accepts or rejects the Council's proposals on non-compulsory expenditure, and then either adopts the budget with a majority of members or rejects the entire budget.

The FF is intended to pinpoint the budgetary priorities for a given period (usually five to seven years) and set ceilings for expenditures, so that forthcoming unexpected increases are kept under control. It is worth noting that the FF is not a multi-annual budget, but a forecast of maximum expenditures that introduces a budgetary constraint and thus helps to maintain budgetary discipline that is respected by all budgetary players. As the FF does not allow large budgetary changes from one year to another, the EU budget becomes incremental, like any other budget. The FF is the reference point, it stipulates the upper limits on every spending category and redistributes the actual amounts to be spent each year on every policy and program. What is distributed in the annual budget is the margin between the actual expenditures and the FF ceilings. The FF stipulates a 'revision clause' that allows a modification of up to 5% of the FF ceilings. The annual budgetary negotiations usually reflect the FF pattern: the most important debates are on agriculture and structural funds, whereas on internal policies member states generally leave a margin for the EP priorities, after satisfying external policies requirements and some 'pet' policies, like R&D. Compared to the FF negotiations, the annual budgetary procedure is less visible but still not just a simple formality, as the FF has not taken away the entire substance of the annual negotiations. However, without the ceilings imposed by the FF, it would

be easier for the budgetary players to refuse a compromise and thus end in deadlock in the annual budgetary procedure. This explains the common view that the FF has introduced budgetary discipline into the EU.

As mentioned above, the EU budgetary architecture comprises two levels of negotiations on the allocation and distribution of resources. While the FF is mainly negotiated by member states, the annual procedure involves bargaining between the Council and the EP, with the Commission serving as agenda-setter and mediator. Due to the difference in rules and player-structure, the EP often uses the annual procedure to increase its budgetary power. Different institutional rules operate for the two different budgetary negotiations involving member states: the FF is subject to unanimity voting, which gives every state the possibility to veto an agreement; on the contrary, member states vote by QMV on the annual budget and thus have the possibility to form coalitions for or against an agreement. Moreover, the 1988 budgetary reform that introduced the FF gave the Commission and the EP the possibility to demand concessions on the FF through signing an inter-institutional agreement with the Council. The inter-institutional agreement (IIA) is the mechanism that actually ensures budgetary discipline by forcing every player to comply with the rules. If a member state wants to obtain an increase in the budget of a particular policy, in principle it must first negotiate it in the FF to ensure the available resources; otherwise, a revision of the FF (up to 5%) might be insufficient or impossible to satisfy such a demand.

The complex EU budgetary construction has received special attention from the scholars of European integration that favor a historical institutionalist approach. Lindner (2006) argues that institutional change in 1988 – i.e. the introduction of the multi-annual perspective – led to a decrease in the conflict between the budgetary authorities. In Lindner's view, the problematic

design of the 1970 budget treaty – the exclusion of the distributive and institutional interests of the new members and the EP, and the wide scope of interpretation – explains budgetary conflict in the 1980s (Lindner 2006, 2). Laffan and Lindner (2005) argue that lower conflict on the EU annual budget is the result of the lock-in effect of the multi-annual budgetary bargains. The authors acknowledge the intergovernmental nature of the budgetary game and theorize that the power of the EP has increased considerably in budgetary matters, while the influence of the Commission has decreased over time: "since it was granted budgetary powers in 1975, the EP has regarded EU finances as one of its key channels of influence vis-à-vis the Council." (Laffan and Lindner 2005, 210-211).

Even though Lindner focuses on the reduction of conflict in the budgetary procedure and explains the constraining effect of the FF, the author acknowledges, but does not develop, the link between enlargement and budgetary issues: an increase in the heterogeneity of member states intensifies conflict over redistribution and enlargement reduces this conflict only when it is linked to budgetary decisions (Lindner 2006, 30). Further, Lindner argues that "integration decisions and the treaty renegotiations had a limited impact on annual budgetary decision-making, but a considerable effect on multi-annual negotiations." (Lindner 2006, 85) In terms of resources distribution, Lindner claims that allocation decisions are made by the FF, whereas the "annual fine-tuning" is left to budgetary experts. The author notes that the debates between the Council and the EP were over "(…) small amounts or declarations, which had limited distributive importance, but were of symbolic value," (Lindner 2006, 110) but does not further discuss the implications of these.

Laffan (1997) provides a comprehensive analysis of the evolution of EU public finances and the political processes that led to the institutional rules that form the EU budget. As the

economic and market integration of the Union progressed, common policies emerged, hence the multiplication of financial instruments made available at EU level. Financial autonomy from the member states was truly gained only with the creation of the system of own resources, as the Commission used the EU finances to gain the upper hand on member states. For many years, fierce conflict characterized budgetary debates, on one hand between the Council and the EP and on the other hand between member states on contributions to the budget and net balances. Last but not least, enlargement has had a strong impact on EU finances. (Laffan 1997, 1-14)

Laffan (2000) highlights the role of the (German) presidency in large package deal negotiations like the Agenda 2000. As the presidency is the architect of a compromise, the cost of obtaining agreement is paid by the presidency abandoning its national interest: in the case of Agenda 2000, Germany dropped the request of cutting its net contribution in exchange for agreement in Berlin under the German presidency. (Laffan 2000, 1-3)

Ackrill and Kay (2006) approach the development of the EU budget from the same historical institutionalist perspective. The authors' fine-grained approach hopes to correct the weak points of historical institutionalism and path dependence, namely the impossibility to explain change. The authors view institutions as single/complex set of rules governing the interactions of political actors and conceive of a matrix of layered institutions as making up a policy framework. As change means policy reform, it can occur at the level of either the individual institution or the policy framework. There are two types of layers: the spatial layer is made up of the individual decision (i.e. the individual budgetary institutions) the collective choice of policy decision (i.e. the policy framework of the EU budget) and the macro/constitutional level (EU decision-making on budgetary matters); the temporal layering

deals with the past and the matching between institutions and the designers' intentions. (Ackrill and Kay 2006, 113-114)

In the opinion of Ackrill and Kay, the initial set of budgetary institutions was unable to fulfill their treaty objectives. Since reforming the policy framework was costly due to the unanimity rule, additional institutions were layered on top of the existing ones to preserve the key institutions – the balanced budget rule (introduced by the 1957 Treaty of Rome) and the compulsory / non- compulsory distinction (introduced by the 1970 Luxembourg Treaty). When analyzing budgetary institutions, Ackrill and Kay divide them into procedural constraints (i.e. compulsory / non-compulsory) – affecting the rules for reaching a collective decision – and domain constraints (i.e. the balanced budget rule, the maximum annual increase rate) – defining possible outcomes under the given procedures. (Ackrill and Kay 2006, 113-114) The authors argue that the pressures leading to institutional change were endogenous to the EU budget. In particular, the CAP price support increased spending over the own-resources limit, such that in 1984 and 1985 the EU budget required additional payments from the member states. (Ackrill and Kay 2006, 129-130) As a consequence, the 1984 Fontainbleau Council had to agree on a budgetary constraint that introduced dairy production quotas and the UK rebate and increased VAT call-up rate to 1.4% to accommodate Portugal and Spain from 1986. In December 1984, a further constraint stopped CAP expenditure from growing more than the own resources. (Ackrill and Kay 2006, 120).

Since changes in the budget are a zero-sum game, Ackrill and Kay (2006) state that member states had the interest to preserve their shares of the EU budget: every member state would want to maximize its budget share, so that preserving its share would be the second best outcome, hence the importance of the net balance. However, this implies that the status quo is

always maintained and no change is ever possible; the authors claim to explain change, but their argument runs into the same problem as historical institutionalism – the impossibility to predict change.

In response to Lindner's argument, Ackrill and Kay (2006, 130) argue that the 1988 reform made the balanced budget rule more transparent, added 'budgetary discipline' by controlling the rise in own resources and introduced the inter-institutional agreement to avoid the regular clashes between the EP and the Council, but did not alter the compulsory definition and the open-ended nature of CAP support; the 'supposed' 1988 stabilization stipulated that, if production exceeded a certain level, support prices would be cut the following year and CAP spending ceiling would be 74% of the EU GDP growth rate (Ackrill and Kay 2006, 124-125) "The limits on EU spending set out in the FF are endogenous to the EU budgetary process…FF thereby strengthened both procedural and domain constraints, developing significantly the institutional setting of the EU budget process." (Ackrill and Kay 2006, 125) Since the reform lacked an effective enforcement mechanism, "by 1992 the balanced budget rule was again threatened by ever-rising CAP spending." (Ackrill and Kay 2006, 130) The authors claim that the reform needed was the 1992 decoupling of production from levels of support, continued in 2003 by granting direct support to farmers. The 2003 CAP reform further strengthened the balanced budget rule by introducing a financial discipline requirement stipulating cuts in direct payments if spending raises over 300 million Euro above the FF ceilings. The authors refute some of Lindner's arguments: the 1988 reform was crucial, as Lindner states, but needed the endogenous pressure of the 1992 MacSharry reform to ensure a balanced budget, reduce support prices by 30%, introduce direct payments to farmers and decoupling from production. The

authors note that another possible alternative – a new definition for compulsory expenditure – had 'enormous bargaining costs'. (Ackrill and Kay 2006, 127)

Last but not least, Ackrill and Kay (2006, 128) note that recently the EU budget debate has shifted from negotiating more money for specific policies to maintaining or even reducing the size of the budget. The 1999 inter-institutional agreement has made unexpected spending increases very difficult: if the increase is less than 0.03% of EU-GNP, the Council must agree by QMV and the EP by a majority of members and 3/5 of votes cast; if the increase exceeds 0.03%, both EP and the Council must agree, but the Council must vote by unanimity. The Lisbon Treaty tightens the budget rules even further: the decisions on own resources require unanimity in the Council; the Council may act by QMV on FF by a unanimous decision of the European Council, and the distinction between compulsory and non-compulsory expenditure is eliminated.

Member states' concerns with their EU budget balances have become critical for the budgetary negotiations. Bache (1999) argues that, when the second FF was negotiated in 1992, there were no concerns with net positions. The author hypothesizes that Germany did not want to have its efforts for unification be compensated by a smaller contribution to European integration. The author claims that the question of EU budget balance was brought about by German Länders, taken up by the federal government and then by the Netherlands, Austria and Sweden. Bache (1999, 20-23)

Besides member states, the other EU institutions have a stake in the EU budgetary negotiations. Van den Berge (1999) argues that inter-institutional conflict between the Council, the Commission and the EP is based on 3 main differences in preferences: expenditure classification, legal basis for expenditure and the use of reserves. In terms of expenditure classification, the obligatory budgetary commitments were linked in 1982 to the internal and

external obligations deriving from the treaties and the inter-institutional agreement of 1988 classified structural policies and internal policies as non-obligatory. The 1995 budgetary conflict centered on this classification of expenditure. In the first reading, the EP adopted amendments on the EAGGF-Guarantee and Fisheries Agreement; when the Council voted against them, the EP rejected the entire budget and stopped the procedure, arguing against that all commitments that do not relate to agreements and protocols in force are non-obligatory. The Court of Justice annulled the EP President's decision, but without expressing an opinion on the distinction obligatory/non-obligatory. Article 16 of the inter-institutional agreement proposed a solution to the conflict: if the Council and the EP do not agree, the Commission proposes to classify as non-obligatory Headings 2 and 3 (structural actions and internal policies) and agricultural expenditures that are not market organizations, and as obligatory Headings 4 (fisheries agreements and contributions to BERD) and 5 (pensions etc). (Van den Berge 1999, 20-21) The EP uses the legal basis to express its priorities and thus enhance its powers over the budget. The Court of Justice has established that there must be a legal basis for budgetary expenditures (i.e. regulation, directive, decision) and no commitment stipulated in the budget can be made without it. The inter-institutional agreement allows one exception – pilot projects and preparatory actions for some limited amounts. (Van den Berge 1999, 21-22) Finally, the EP regularly puts commitments in reserve. Art. 19 (para. 4) of the Financial Regulation stipulates that 'reserves for unforeseen' are commitments that can be used only by transfers ('virements'). In practice, the EP uses reserves when the commitments seem too high and the EP has doubts or wants to keep a means to exert some pressure on the Council; if some conditions need to be fulfilled, the EP lifts the reserves only if the conditions are met. The Commission is of the opinion that the EP abuses

the use of reserves, arguing that, according to Art. 274, the Commission is in charge of executing the budget and the EP should not mix into the budgetary execution. (Van den Berge 1999, 23-24)

Blankart and Koester (2009) explain why some countries became net payers/receivers and argue that the historical development of decision-making on the EU budget has resulted in deadlock, which makes change unlikely. The authors attempt to answer the questions: Why is there so much redistribution and why are some Member states consistent net payers and others consistent net receivers? The authors use the theory of incomplete contracts and show that the threat of exit led to the formation of two coalitions, net payers and net beneficiaries who block any change in the budget.

When applying the theory of incomplete constitutional contracts to the EU budget process, the authors distinguish four different stages. The first is the contractual stage: the Treaty of Rome of 1957 was typically an incomplete contract, therefore post-contractual decisions on redistribution had to be expected. In post-contractual stages I (1958 - 1970) and II (1971 - 1986), redistribution happened according to the rules of the Treaty, but also through threat. Member states that had alternative policy options and were able to harm the other member states by terminating their membership used their threatening power to enforce their distributive goals in the budget. As empirical evidence for the exit threats, the authors cite the 1966 'empty chair crisis' and the concessions made then to France and the 1984 Fontainebleau agreement on the UK rebate. (Blankart and Koester 2009, 7-12)

In post-contractual stage III (1987-2003), threats became increasingly less credible because cooperation had progressed in the Common Market, therefore the loss from terminating membership would have been large. The formal rules of the Treaty were applied to the status quo that resulted from the previous post-contractual stages but, as the rules separated expenditure

69

from revenues, they generated opposing coalitions with veto power on either side of the budget: the expenditure side became dominated by net receivers, whereas the revenue side was controlled by net payers. The authors find the same persistence of deadlock in post-contractual stage IV (2004-2009) and in the impact of the changes proposed by the Treaty of Lisbon. (Blankart and Koester 2009, 12-19)

As a way out of the deadlock and an increased provision of public goods, the authors propose the introduction of a new, separate public good budget based on individual contributions, with an individual right of termination and granting every member state the right to propose new public good projects whose cost they should finance. This newly proposed public good budget could be implemented by using the existing option of enhanced cooperation. (Blankart and Koester 2009, 19-22)

Kauppi and Widgren (2004) argue that selfish power politics is likely to drive EU decision-making in general and the allocation of EU budget in particular, while needs play only a minor role: political power explains about 60% of the member states' budget receipts whereas the remaining 40% derive from member states' needs; when correlated preferences and cooperative voting patterns between member states are allowed, 95% of the budget shares can be explained by voting power measures. Kauppi and Widgren (2007) argue that budget shares can be explained solely by political power if Franco-German cooperation is taken into account.

Kauppi and Widgren (2009) focus on the allocation of EU budget funds and analyze how the budget is determined in the current system. The underlying research question is: why are some countries net contributors and others net beneficiaries? Thus the puzzle the authors want to address is what approach governs the determination of the EU budget allocations – the power politics view or the needs view. The power politics view argues that the EU budget is primarily

determined by selfish member states who use their political power to obtain as much return for their own country as they can. The needs view states that the principle of solidarity between member states governs the EU budget, such that the common funds are redistributed to the poorest regions of the EU. The authors' argument is that neither the power politics view nor the needs view alone can explain the EU budget allocations. (Kauppi and Widgren 2009, 2-5)

Kauppi and Widgren (2009) treat the EU budgetary negotiations as a divide-up-the-cake problem, the authors adopt a formal cooperative approach and evaluate actors' voting power by using the Shapley-Shubik Index (SSI) as a proxy for power distribution. The SSI evaluates the probability of an actor to be pivotal in a coalition (i.e. turn a losing coalition into winning): the percentage of an actor's pivotal positions out of all possible pivotal positions predicts her expected influence on the (voting) outcome, hence her share of the cake – share of receipts in the allocation of budget expenditure. However, the problem with the SSI measure is that it does not offer a very accurate description of the actual power distribution of member states. The SSI assumes that voters' preferences and thus the probabilities of voting yes are correlated in the same way regardless of the group of actors (i.e. the assumption of uniform distribution). However, in reality there are groups of member states with similar interests that cooperate more closely on a range of issues. If such cooperative groups of member states are repetitively formed, *the SSI* yields an imprecise measure of true power distribution among the member states. (Kauppi and Widgren 2009, 10-11)

Kauppi and Widgren (2009) argue that their findings show that selfish power politics is the driving force but the benchmark measure of power they use does not capture the power distribution right. Faced with this evidence, the authors hypothesize that actual budget allocation is partly determined by the contractual rules agreed in the FF and partly by the power

distribution, and member states may agree to contribute more to the EU budget if they are promised some money back on the spending side of the budget (bring the bacon home hypothesis). These hypotheses are based on some assumptions regarding the power distribution in the FF: newcomers have less power than the incumbent member states, big senior member states have more power than small senior member states and rich member states have more power than poor countries. To test these hypotheses, the authors regress the share of expenditures on political power (SSI), income per capita and share of contributions. The authors interpret the statistical significance of SSI and contributions as evidence that the budget shares are determined as a weighted average of political power and contribution, hence member states tend to get a portion of their money back automatically; in addition, solidarity might play a role in the determination of structural spending. The authors' conclusion is that on the total level of the budget power politics plays the key role. (Kauppi and Widgren 2009, 20-22)

3.3   DYNAMIC CHANGE IN THE EU BUDGET

I argue that exogenous and endogenous factors unlock the deadlock on the EU budget: due to the pressure created by exogenous shocks like enlargement, endogenized through processes like learning and reinforcement, the resources of member states change, as does the distribution of their benefits deriving from the institutional arrangements on the EU budget. As a result of this change, the budgetary institutions are no longer in equilibrium; the member states whose benefits decrease as a result of this change – the net contributors – will push for radical changes in the moment of renegotiation. Through the use of issue-linkages in renegotiation, the most powerful actors – the net contributors – become the drivers of change. As a result of exogenous pressure,

member states become aware of the altered distribution of benefits through the endogenous mechanism of learning, which thus changes their preferences. In parallel with the mechanism of learning, the institution of 'net balance' is endogenously reinforced: this institution becomes more and more salient for the main contributors to the EU budget, such that it determines them to use issue-linkage in renegotiations in order to obtain a favorable agreement. The rebate is another institution that is reinforced, in spite of its unpopularity, because it augments the distributional benefits of the net contributors. The result of institutional change in the EU budget resembles 'layering' and 'institutional refinement': old and new budgetary rules coexist in every new agreement on the budget. In particular, the reinforced institutions of balance and rebate are refined or layered on the other institutions that represent the distributional benefits of the budget.

Every budgetary outcome represents a change of the budgetary institutions. In EU budgetary matters, an absence of change would be recognized as the reversion point – last agreement on the budget:

> "Should the two arms of the budgetary authority fail to agree on a new financial perspective, and unless the existing financial perspective is expressly denounced by one of the parties to this Agreement, the ceilings for the last year covered by the existing financial perspective will be adjusted in accordance with paragraph 15 by applying to these amounts the average rate of increase observed over the preceding period, excluding any adjustments made to take account of enlargement of the Union." (Inter Institutional Agreement of 6 May 1999 C172/1).

While EU budgets change incrementally in the annual procedure, substantial change marks the negotiations of the FF. The institutions that make up the outcome of the FF negotiations are somewhat thin due to the renegotiation clause: change happens at a pre-defined point in time – every five or seven years – when the FF is renegotiated; this is explained by the

fact that, when the FF was introduced, the designers anticipated changes in both preferences and distributional benefits and wanted to ensure that the resulting disequilibrium would be corrected through renegotiation in due time.

Since the net contributors are the drivers of change in EU budgetary outcomes, the meaning of 'net contributor' needs to be properly understood. The concept of net contributor derives from the institution of net balance with the EU budget – an accounting exercise that shows the difference between the amounts a country contributes to the EU budget and the funds it receives from the EU budget through spending programs. It follows that a net contributor is a member state whose contribution to the EU budget exceeds the benefits it receives from the budget. However, the institution of net balance is more complicated than it actually seems because of its technical nature. On one hand, every country's contribution to the EU revenues is paid every month by the respective finance ministry based on forecasts of the VAT base and the GNI and corrections are made the following year. This contribution to EU revenues needs to be calculated into the national budget, since it is a constant payment made from the national budget. An increase in a state's contribution to the EU would mean an increase in its budgetary deficit, hence the concerns of breaking the rules of the Stability and Growth Pact. On the other hand, the funds that a country receives from the EU budget do not go as revenues into the national budget; on the contrary, for most program payments the conditionality of co-financing applies, therefore the national budget has to specify these co-financing amounts as payments from the national budget. The funds disbursed from the EU budget go through national paying agencies to the beneficiaries, therefore the finance ministry has difficulties in calculating with precision the net balance with the EU budget.

In fact, the monopoly of information on the technical calculation of net balances rests with the European Commission, which is somewhat reticent in making these balances public (the Annual Allocation Reports depict revenues and expenditures separately). Through the endogenous mechanism of learning, this information becomes available to member states and thus alters their preferences and their distributional benefits deriving from the EU budgetary agreements. However, the Commission is against the reinforcement of the institution of balance, arguing that one should not look at net balances because different rationales are behind the own resources system of the EU and spending programs; moreover, the benefits of integration derive from the integration into the single market. For instance, the Commission argues that the traditional own resources are Community resources because they follow from the common trade policy[29]. However, endogenous mechanisms draw a thin line between solidarity, fair burden sharing and 'juste retour'. As the number of poor regions has multiplied with the exogenous shock of enlargement, the net contributors have started to endogenously feel the burden: they want to support less developed countries but they feel that it is not fair to support poor countries and poor regions in developed countries, which should take a fair share of the burden. If enlargement had not have progressed, there would not have been any concerns with net balances and net payers would have been content to pay amounts that seem outrageous today: the Fontainebleau agreement on the UK rebate was possible in 1984 but such an agreement would have been impossible starting with the 1990s because of the shifting positions of the net payers.

Ackrill and Kay (2006) acknowledge this shift in preferences and benefits by arguing that the EU budget debate has shifted from distribution on policies and programs to the overall size of the budget and the net balance of each member state. On the contrary, Bache's (2002) argument

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[29]The member states with strategic points of import into the Community, like Rotterdam, received a reimbursement of 25% of the costs for the collection of custom duties.

on why there were no net balance concerns before 1992 is too simplistic and ignores the behavior of the other net contributors: in Bache's view, Germany did not let its Eastern Germany reconstruction efforts affect its EU budgetary contribution and thus offered to be the main payer for European integration. In fact, the preferences of the net payers point to the importance of resources and power in distributional bargaining: the ones who pay also want to be the ones who make the rules. The concerns with equity, embodied by the idea of 'juste retour', are just the packaging for an utility maximization argument in a zero-sum game: the net contributors want to increase their benefits from the EU and a way to do this is to decrease the benefits of those who are at the same level of development – i.e. the rich states. In the early days of European integration, the founding countries supported one another in the after-war recovery effort and none of them was concerned with who paid most – negotiation was in the mode of functional bargaining where the concern for the collective good prevailed; after the number of poor regions started to accumulate, net payers' positions started to gravitate on the institution of balance.

The causal inference in my theory is the impact of exogenous and endogenous factors on the EU actors' preferences – positions and saliences over issues – and the distributional outcome; as a result of these intervening variables, change in budgetary institutions-as-equilibria is obtained through the use of issue-linkages in renegotiation. The positions and saliences of EU actors have been historically constructed since the early days of the Union. The exogenous pressure created by every enlargement is endogenized through the mechanisms of learning and reinforcement, thus leading to changes in the preferences of the actors and their payoffs, in particular those of the net contributors. The pressure leading to institutional change thus becomes endogenous to the EU budget, as Ackrill and Kay argue (2006, 128).

The introduction of the UK rebate[30] in 1984 opened Pandora's box on net balances. This represents the first instance of a net contributor with a changed preference of 'juste retour': obtain at least what they put in. This is also the first case of exogenous 'pressure' that is endogenized: the accession of the UK created budgetary imbalances because the UK had to pay for the exploding costs for Community agriculture but had a small agricultural sector and therefore was getting little money back, hence the concerns with 'juste retour' (Laffan 1997, 51-54)

As enlargement progressed, the pressure on financial flows increased: "the Mediterranean enlargement brought pressure for more progressive budgetary transfers." (Laffan and Lindner 2005, 192) The 1988 budgetary reform resulted in significant institutional change: the amounts of regional spending increased considerably and the new members were the main beneficiaries; a new institution was introduced – the additional resource based on the GNP of member states; the role of the VAT resource was reduced – testimony of the endogenous process of undermining (the opposite of reinforcement) – through the capping of the VAT base at 55 % of the GNP of each member state; however, the UK rebate was reinforced: its calculation was modified so that its financing could be split among the other member states according to their share in total EC GNP, the share of Germany being reduced. (Council Decision 88/376).

This combined endogenous and exogenous change led to a significant increase in Germany's net contribution to the EU budget, in spite of the correction it got on its contribution

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[30] At its introduction, the UK rebate was calculated as a correction of the UK own resources payments: "66% of total EU allocated expenditure multiplied by the difference between the UK share of the EU uncapped VAT base and the UK share of total EU allocated expenditure." (Commission Document 2005, 6)

to the UK rebate[31]; as a result, the institution of net balance became very salient. Germany's financial burden was accentuated in 1992, when the Delors-2 package was negotiated. The final agreement is testimony of significant change: structural expenditures increased with 41% and introduced the Cohesion Fund to help the newer members: Portugal, Greece and Spain and the older but less wealthy Ireland. Further, a subsequent 1994 Decision introduced a progressive reduction over the period 1995-1999 of the capping of the VAT base down to 50 % and of the maximum VAT call rate down to 1 %, while leaving the calculation of the UK rebate unchanged. (Council Decision 94/728).

Germany's position consolidated on conservative spending from the EU budget. In spite of the benefits for Eastern Germany after unification, Germany benefited much less from the policies financed at EU level as compared to the financial flows transferred to the EU budget. This financial burden was complicated by the fact that German unification brought the country to the sixth place in terms of GDP per capita. (Laffan 1997, 55) Since the German Länder directly contributed to the EU budget, both the Länder and the federal government started to feature 'juste retour' as a preference. This pressure on Germany was complementary to the role Germany had as a hegemonic stabilizer in the region: the theory of hegemonic stability posits that the hegemon agrees to pay for integration because it benefits from the stability in the area and a larger market. (Krasner 1989; Kindleberger 1996)

Starting with 1990, the position of Netherlands suffered a similar dramatic change in preferences and distributional benefits: from net beneficiary (mainly from agricultural funds) Netherlands became a net contributor, the largest in terms of per capita contribution. The

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[31] While the other member states pay their contribution to the rebate in full, Germany obtained a correction from the beginning: "the share of Germany being reduced by • ", where "•" is supposed to be two thirds of its normal contribution to the UK rebate, so that Germany would have to pay only one third. (Commission Document 2005, 6)

alteration of distributional benefits in particular was due to the fact that the MacSharry CAP reform did not cover the sectors where the Dutch had most of their production; the Dutch did not benefit from the increase in structural funds either, as the Netherlands was one of the wealthiest member states, hence the Dutch position on equity against the wealthy member states that still benefited from regional support. (Laffan 1997, 57-58)

The 1995 accession of Austria, Finland and Sweden brought more net contributors into the Union, emphasizing the exogenous and endogenous pressure for institutional change. While these three countries made claims to the funds disbursed through agriculture and regional aid and obtained lump sum payments to correct for their net balances immediately after accession, their positions and preferences were those of net contributors to the EU budget.

By the time Agenda 2000 was negotiated, the endogenous mechanism of learning was well developed such that the net contributors were well aware of their financial burden; the institutions of balance and rebate were strongly reinforced, such that their position was to reduce spending from the budget through correction mechanisms. Richter (2005) rightly argues that enlargement brings poorer countries into the EU, but these countries feel the financial pressure related to enlargement. This was especially important because Agenda 2000 was laying the ground for the biggest enlargement in the history of the Union and the EMU convergence criteria started to weigh on national budgets. The 1999 agreement led to subsequent important changes, even though less radical than in the previous agreements: while transfers to cohesion were marginally reduced to account for enlargement, the reference to GNP was replaced by a reference to GNI; a further progressive reduction over the period 2002-2004 of the maximum VAT call rate was made down to 0.5 % and the collection costs for traditional own resources increased from 10 % to 25 %. The net contributors (Germany, the Netherlands, Austria and

Sweden) managed to change the rules in their favor and obtained a reinforcement of the rebate –
a reduction of their contributions to the UK rebate to ¼ of their normal shares, while the
remaining ¾ of their contribution to the UK rebate had to be financed by the remaining member
states. (Council Decision 2000/597). The fact that "the FF packages Delors-1 and Delors-2
massively increased EU financial resources, whereas the increases in Agenda 2000 were not of
similar magnitude," (Laffan and Lindner 2005, 193-194) can be explained by the fact that the
endogenous mechanisms of learning and reinforcement work gradually; in 1988 and 1992 these
mechanisms were in their incipient phase, therefore a functional approach and not distributive
bargaining prevailed, hence the significant increase of 'the pie'. On the contrary, in 1999 these
mechanisms were well at work, therefore concerns over the distributional benefits of the
previously enlarged pie dominated the renegotiation.

The negotiations for the 2007-2013 FF took place under the full-blown pressure of
enlargement, to which slower growth rates and the Lisbon goals (increase competitiveness and
invest in research and technology) were added. The positions of the net contributors were
endogenized such that they openly opposed any increases in expenditure, while the net
beneficiaries supported the expenditure increases proposed by the Commission in the name of
solidarity. The position of the older beneficiaries of regional aid was to denounce the so-called
'statistical effect' and demand transitional support, while the positions of the newer member
states were that the conservative spending promoted by the net contributors would reduce their
financial benefits. The final agreement obtained shows the layering/refinement effect: the
ceilings for own resources were maintained at their levels of 1.31% of EU GNI for commitments
and 1.24% of EU GNI for payments and a new decision was to follow stipulating the rate of call
for the VAT resource at 0.30%. The outcome of the negotiations shows an important influence of

the net contributors on the overall size of the budget (the net balance isntitution), as they managed to pull the final agreement very close to their ideal positions. However, it is worth emphasizing that the net beneficiaries also had an influence on the agreement, even though through a lesser extent; because cohesion is highly salient for the net beneficiaries, they drive the outcome on cohesion: the 'shopping list' on Cohesion that is contained in the final agreement shows that the net beneficiaries got additional funding, for example from the ERDF and the regions falling under the Regional Competitiveness and Employment Objective. In fact, the mechanism of renegotiation works through issue-linkages on these two issues – cohesion and balance: net contributors give up their position on cohesion in exchange for the net beneficiaries agreeing on a reduced budget. Because the balance issue/institution represents the overall size of the budget, it can be argued that the net contributors are more influential. This influence is also justified by the fact that the issues of agriculture and cohesion, when negotiated separately, cause negative externalities for the net contributors – i.e. they end up paying more into the budget. A high salience on the balance issue and sometimes extreme positions on balance determine exchanges that help the net contributors eliminate these negative externalities.

While the new member states obtained the exclusion of their share of CAP market expenditure from the calculation of the UK rebate, the net contributors obtained significant changes for the 2007-2013 period that reinforced the UK rebate: the rate of call of the VAT resource for Austria was fixed at 0.225%, for Germany at 0.15% and for the Netherlands and Sweden at 0.10%; in addition, the Netherlands benefited from a €605 million reduction in its annual GNI contribution, while Sweden benefited from a reduction of €150 million. Article 77 of the final agreement shows how the strong positions of the UK, Germany, the Netherlands, Sweden and Austria gravitated around the institution of rebate/ correction mechanisms:

The own resources arrangements should be guided by the overall objective of equity. These arrangements should therefore ensure, in line with the relevant conclusions of the 1984 Fontainebleau European Council, that no Member State sustains a budgetary burden which is excessive in relation to its relative prosperity. These arrangements should accordingly introduce provisions covering specific Member States. (Article 77 of the European Council December 05 Note, 29-30)

One can argue that the rebate and the balance institutions reinforce each other. While the UK compares its receipts to the EU average and claims that it was the fifth poorest member state before the 2004 enlargement, the UK rebate creates perverse incentives. This is because every enlargement increases the UK rebate: the more member states enter the Union, the more the UK gains in compensation. This creates the anomaly that a relatively developed member state like the UK does not contribute to the EU budget in a manner proportional to its economic development.

As a consequence of the fact that France had become the main contributor to the UK rebate – approximately one third – as a price for keeping the agricultural payments, the exchange of positions between France and the UK led to the agreement on a budgetary reform to follow:

The European Council therefore invites the Commission to undertake a full, wide ranging review covering all aspects of EU spending, including the CAP, and of resources, including the UK rebate, to report in 2008/9. On the basis of such a review, the European Council can take decisions on all the subjects covered by the review. The review will also be taken into account in the preparatory work on the following Financial Perspective. (Article 80 of the European Council December 05 Note, 32)

The pressure on the preferences and the benefits of the incumbent member states is visible in the exchanges that lead to the institutional outcome of the FF. The richer countries voted for enlargement and agreed to pay for European integration but their financial burden cannot increase indefinitely. When countries decide to join the union, they make a cost-benefit analysis and decide to join because the benefits from joining are higher than the costs of doing so. Relatively rich countries like Austria, Finland and Sweden, but also Slovenia and Cyprus made claims when acceding on structural funds for some of their less prosperous regions, thus showing sign of a potential exchange cohesion-balance in the FF negotiations following their accession.

The last wave of EU enlargement has been so spectacular that it almost invites the study of related changes in the budgetary institutions. If enlargement has indeed an impact on the EU budgetary processes, then one should look for evidence in this last round, as the effect of enlarging the Union with 10+2 countries is of such a magnitude that makes it easier to observe. In addition, if one wants to learn something from the way in which the EU solves the problem of resource allocation through renegotiation, then one needs to look at the EU with 27 member states, where these problems are indeed acute.

In my theory, the dependent variable is conceived as change in the institutions-as-equilibria, translated into an agreement on new budgetary rules. If agreement is not obtained, the status quo (last year's budget or the last FF) prevails; this addresses the puzzle surrounding the existence of deadlock in EU budgetary negotiations: if a new agreement is obtained, there is no deadlock and institutional change occurs, if not, deadlock prevails. In terms of measurement, the degree of change is given by the degree of layering – the number of new layers/sediments added

to the existing ones. If only one layer is added, change is incremental; if several new institutions emerge, change is substantial.

One issue that needs to be addressed is the possibility of every player to veto an agreement when unanimity is the rule of renegotiation (i.e. the FF negotiations). Players are utility maximizers, they increase their utility by entering in exchanges on different issues in successive rounds of negotiations. Therefore it is more likely for a player to veto an agreement early in the negotiations either because there are no profitable exchanges she could make or because she has not entered any such exchanges yet. This de facto situation reduces the possibility of vetoes as negotiations progress, such that agreement through issue-linkages becomes smoother and can be reached in a timely manner, in spite of the initial distributional conflict. One caveat should be mentioned: when players make exchanges, they increase their utilities but sometimes they can produce negative externalities for the players not involved in exchanges; this externalities could lead to a veto by the players affected. However, what we see empirically is that agreements contain a 'shopping list', whose goal is to address these negative externalities.

My independent variables are enlargement and economic development. These two exogenous factors are conceived in a broader sense as being more than the simple addition of new members: they encompass the exogenous factors that shape an increase in the number of players: an increase in the heterogeneity of states creates tensions between different levels of economic development (when poorer countries join) and different degrees of economic integration (when richer countries join). Conceptualizing the exogenous factors in this way offers the advantage that it adds an economic dimension to the simple expansion of the union that can control for confounding variables related to domestic constraints. Over time, this tension

encompassed by the exogenous factors affects the preferences of players – positions and saliences – and their payoffs in the budgetary agreement, which are the intervening variables that influence the new institutional outcome. With every round of enlargement, the issue of net balance is reinforced, it becomes more salient to net contributors and pushes their positions towards a more conservative budget; similarly, the issues of regional aid or agriculture become more salient to the net beneficiaries. A change in preferences and benefits due to exogenous factors influences the FF negotiations immediately following the respective enlargement (e.g. at time *t*) and thus the outcome results in institutional change. However, this institutional change becomes a factor that has an effect on the formation of preferences and distributional benefits related to the negotiations of the following FF, at time *t*+1. Empirically, as highlighted above, the institutional change can be seen in the reform of the agricultural policy, the adjustments of regional policy but mostly in the reversals of the net contributors' burden: first only Germany obtained a reduced contribution to the VAT resource (implying a reduced contribution to the UK rebate), then all net contributors obtained such a reduction, which was increased over time, and finally some of the net contributors obtained cash back.

While my main focus is on the dynamic of institutional change in the FF negotiations, as the main distributive decisions are taken there, one cannot ignore the EU annual budgetary negotiations where spending decisions are taken on the margins available under the FF agreement. The dynamic in the annual budgetary negotiations is quite different due to a different institutional set-up: the voting rule is QMV, the actors are the member states and the EP with the Commission as agenda-setter, there are formal rules (first and second readings of the budget) and informal rules (two trilogues and two conciliation meetings). In spite of this institutional difference, the model I propose shows that change is incremental when compared to change in

the FF negotiations. The net contributors remain influential in the annual budgetary outcome, as the outcome depends on the position of the net contributor that is able to build a coalition for reducing expenditures. The annual budgetary outcome also depends on the position of the EP, which pushed for an increase in the budget; the clash between these two opposing preferences for increasing and decreasing the budget leads to incremental change in the annual budgetary procedure. As Hix argues, the annual budget is about redistribution: within the amounts allocated on each issue by the FF, member states distribute the funds between regions, crops or projects. I argue that this redistribution happens only at the margin – what was not distributed by the FF institutional agreement.

It is worth emphasizing that my theory shows the existence of both significant and incremental change in the budget and the link between the FF and the annual budget is that the FF constrains the pie represented by the annual budget. My theory does not deal with the impact of the FF on the annual budget, which has been studied in the EU budget literature. Whereas Lindner (2006) looks at the stability effect the FF has had on the annual budget, I am interested in the effect of exogenous and endogenous factors on the FF (and annual) negotiations; I am exploring the way in which these factors change players' preferences and benefits, which leads to change in budgetary institutions. Figure 1 summarizes the causal path of my theory. It is worth emphasizing that there is disagreement in the literature on the stabilizing effect of the FF: Ackrill and Kay (2006) argue that the introduction of the FF was actually not enough to keep EU annual expenditures under control, hence the need of the 1992 MacSharry reform or the changes proposed by the Lisbon Treaty.
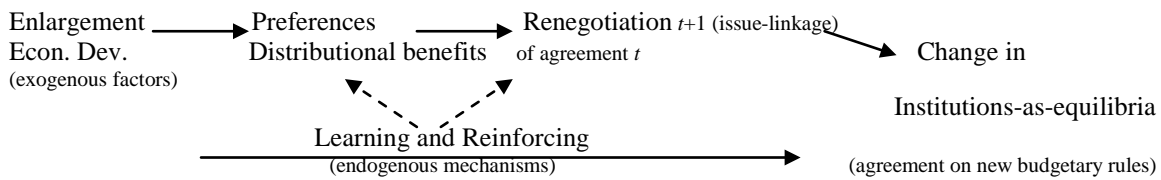
Enlargement ⟶ Preferences ⟶ Renegotiation *t*+1 (issue-linkage)   Change in
Econ. Dev.   Distributional benefits   of agreement *t*
(exogenous factors)   Institutions-as-equilibria

                            Learning and Reinforcing
                            (endogenous mechanisms)   (agreement on new budgetary rules)

Figure 1. Dynamic institutional change in EU budgetary negotiations

My theory disagrees with the claims of Baldwin and Portes (1997) who argue that small overrepresented countries are the winners of the budgetary game: when they enter the union, they change the budgetary rules in their favor. If this were the case, one would see a massive increase in the burden of the net contributors and no new members becoming net contributors immediately after accession. In addition, empirical evidence shows that Spain and Portugal, which entered relatively early into the union, did not manage to obtain a change of rules in their favor, as Greece blocked their accession and conditioned their entrance on the adoption of the Mediterranean Program. In a similar way, the Eastern European countries that have recently joined the EU did not manage to obtain the high amount of EU funds they had hoped for. However, my theory agrees with the fact that, when countries enter the union, no matter if small or large, they make a claim on the EU budget for either regional aid or agriculture. In spite of their net contributor positions, the main payers of the EU still receive EU funds for their regions or agricultural sectors.

My thesis on the influence of net contributors is in line with the argument of scholars who find a domination of power politics in the EU budget and argue that enlargement changes budgetary rules; (Heikki and Widgren 2004; Widgren 2004; Widgren 2006) as coalition size increases, divergent blocks become more likely in Council decision-making. (Hagemann and De Clerck-Sachsse 2007)

As in my theory issue-linkage represents the mechanism used in renegotiations, issue-linkage has indeed the effect found in the literature: the issues that are linked are those for which players have different saliences; (Morgan 1990; Sebenius 1983) bargaining is facilitated when there are blocks of players with similar preferences or when a particular group gains more players; (Tollison and Willett 1979) and the pressure of time heightens with the increase in the number of players (Sebenius 1983). Huelshoff (1994) looks at dynamic issue-linkages and their effect on absolute gains but does not analyze either the way in which issues are linked or the impact of linkages on the outcome and on the other players. Hix (1998) rightly argues that issue-linkage offers to net contributors a compensation for their negative balance with the EU budget, hence their favorably changing the rules on the VAT rate or the UK rebate; the FF negotiations are about allocation and allocation problems are solved by issue-linkages: some win on some issues and lose on others that are less important to them.

In order to see how endogenous mechanisms and exogenous factors lead to institutional change in the EU budgetary arrangements, I develop two analytical narratives on the FF negotiations and the annual budgetary procedure using a bargaining and a procedural model, respectively. The implicit hypothesis (1) to be tested is that the bargaining and the procedural models describing the FF negotiations and the annual budgetary negotiations, respectively, accurately predict the actual FF ceilings (the new institutional outcome) and the (incrementally changed) annual budget adopted.

Before empirically testing my theory, it is worth emphasizing that applying the theoretical models to data poses some challenging issues of measurement. Given the extreme difficulty of conducting technical interviews to construct utility functions, the actors' preferences (positions and saliences over issues) must be assessed by experts and observers familiar with

them. External assessment of the most preferred point seems to be straightforward. However, "there is no guarantee that experts used the measurement scales in precisely the same way that any one interpretation of the theory might require."(Achen 2006, 121) In order to collect historical data on positions and salience, I used semi-structured interviews with officials from the Commission, the member states and the EP, EU document analysis, archival materials and attendance in the budgetary committee meetings of the Council and the EP[32]. Where it was possible, the questions the national experts were asked were: "What was your country's position on issue *x*?" and "How important was issue *x* to your country?" When Commission and EP experts were interviewed, they were asked for which countries a given issue was most salient and which countries had the most extreme positions on a given issue. The caveat is that, in spite of how carefully positions and salience are measured, they might be somewhat noisy.

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[32] I conducted 25 interviews in May-June 2006 in Brussels. In the period July 2007 – February 2008, I conducted 30 interviews, I did research in the Library of the European Commission and I sat in the meetings of the Budgetary Committee (*CoBu*) in the EP and the Budget Committee of the Council in Brussels.

4.0 FINANCIAL FRAMEWORK NEGOTIATIONS – AN ANALYTICAL NARRATIVE

4.1 THE EMBEDDED FRAMEWORK OF THE FINANCIAL FRAMEWORK NEGOTIATIONS

In order to analyze the dynamic negotiations on the FF, I use and adapt the position exchange model proposed by Stockman and Van Oosten (1994). Since the FF is decided under unanimity at European Councils, the players are the member states; the Commission and the EP have a marginal influence on the agreement. This assumption is in accordance with the literature that finds that the EP and the Commission have a limited influence when unanimity and European Councils are involved. (Thomson and Hosli 2006; Heikki and Widgren 2004; Widgren 2006; Tsebelis and Yataganas 2002; Baldwin and Portes 1997; Hagemann and De Clerck-Sachsse 2007) However, the roles of the Commission and the EP are more prominent in the annual budgetary procedure, as explained in a further section.

The position exchange model is appropriate for modeling the FF negotiations for several reasons. First, there are no precise formal rules for the FF negotiations written down in the Treaties. As there is no strict procedure to follow, the negotiations take place between member states in an 'informal' way and culminate with agreement in European Councils. The Commission makes an initial proposal and then the country holding the Council Presidency

reacts to it by proposing a compromise to which the other member states respond; if no agreement is reached, the following country holding the Presidency proposes a new compromise and this procedure continues until agreement is reached. While there is no clear deadline, agreement must be reached before the ongoing FF ends, otherwise the ceilings of the previous FF apply. Since the position exchange model is a bargaining model that stresses the importance of informal institutions, it is the most appropriate model for the description of the institutional framework that characterizes the FF negotiations. It is worth noting that, by contrast, the annual budgetary procedure takes place according to rules stipulated by the Treaties, therefore a procedural model is more appropriate for analyzing it.

Second, during the FF negotiations member states shift their positions; initially, their preferences are more extreme but after several bargaining rounds they realize what is feasible and thus their positions converge towards a compromise. While EU collective decision-making is characterized by pressure to have agreement (the 'consensual' culture), member states still follow their national interests: "member governments grappled with their desire to reach agreement, on the one hand, and with their determination that the terms of the agreement be as favorable as possible to their own viewpoint, on the other hand." (Laffan and Lindner 2005, 200) The position exchange model has the advantage that it allows players to shift positions in order to increase their utility.

Third, the convergence towards an outcome is facilitated by the 'horse-trading' that players engage in. There is empirical evidence that member states use bilateral meetings in which they attempt to influence each other, such that the final FF outcome is a compromise in which countries have moved away from their initial positions. The position exchange game is a

bargaining model that describes the way in which players link different issues to which they attach different saliences in order to increase their utility.

Fourth, the position exchange model performs better than other bargaining models (the compromise model, the challenging model) applied to EU decision-making. This model is "the only model that is insensitive to the level of measurement on the issues." (Arregui, Stokman and Thomson 2006, 152) Given that the measurement of member states' preferences (positions and saliences) might contain some noise, as pointed out in the previous section, this finding is particularly reassuring.

I adapt the position exchange model in order to account for the unanimity rule that governs the FF negotiations. Under unanimity, all member states have equal voting power, no matter if they are large or small, therefore they have equal weights in influencing the collective outcome. Consequently, I assume that member states' power deriving from their voting weights need not be taken into account when unanimity is the voting rule, as all countries have in theory the same veto power. Therefore, I adapt the compromise model so that the expected outcome on issue a is a function of the n players' ideal positions p_{ia} and the salience s_{ia} they attach to the issues negotiated under the FF framework:

$$X_a = \sum_{i=1}^{n} p_{ia} s_{ia} / \sum_{i=1}^{n} s_{ia} \qquad (1)$$

Players' preferences are represented by the utility loss function proposed by Stokman and Van Oosten (1994, 108):

$$EU_i = \sum_{a=1}^{m} - s_{ia} |P_{ia} - X_a| \qquad (2)$$

The n players of the game are the EU member states at the moment when FF negotiations start; given the history of the EU integration and the FF, $n \in [12, 27]$. For example, the current

FF was negotiated with 25 member states, as negotiations started soon after the 2004 enlargement and ended before the 2007 accession of Romania and Bulgaria.

The issues that players make exchanges on are viewed as uni-dimensional continua and represent the main elements of the debates raised during negotiations; these are the most controversial issues and do not include subordinate/auxiliary points. The points on the issue continuum are alternative decision outcomes that players favor or possible compromise outcomes. These issues are in fact policy questions on which at least some of the actors involved take different positions; if the actors take the same positions on an issue then there is no political problem to be analyzed. Players' preferences are defined over these issues rather than on underlying dimensions of preferences, like a 'left-right' dimension or an 'integration' dimension, on which it would have been more difficult to align players.

In budgetary matters, the issues have a scale level of measurement, such that all points on the continuum have meanings – they refer to the size of the budget to be allocated to a particular policy/program. The FF has a maximum of 8 headings, to which the overall size of the budget is added, therefore the possible m issues are defined as $m \in [1, 9]$. However, not all issues are debated politically; the most controversial issues are agriculture and regional aid (structural funds and cohesion) which make up roughly 90% of the EU budget and the overall size of the budget, defined as a percentage of EU GDP/GNI, hence $m = 3$ and the measurement scale is 0-100 such that $P_{ia} \in [0, 100]$ and $X_a \in [0, 100]$.

A player's salience s_{ia} has a measurement scale 0-100: $s_{ia} \in [0, 100]$; it represents the importance a player attaches to a given issue, therefore a score of 0 means no importance whatsoever, 100 is the highest importance and 50 represents an average level of priority. The

absolute values of salience matter less, as the critical differences are those between different actors on an issue and between different issues for the same actors.

The game proceeds as follows. At the beginning of the game, players express their ideal positions in response to a proposal made by the Commission. After the initial proposal, the Commission does not participate in negotiations and thus cannot influence the outcome. In the first stage of the game, the member state holding the Presidency proposes a compromise package that represents the mean of all players' ideal positions on every issue weighted by the saliences they attached to each issue; this compromise outcome is computed by equation (1). Member states react to the Presidency proposal by computing their expected utility on every issue according to equation (2); then, they start inquiring if they could increase their utility by making some exchanges with other players on some issues. As mentioned above, (Stokman and Van Oosten 1994) for two actors to engage in an exchange on a pair of issues they must attach different saliences to these issues: an actor shifts her position on an issue that is less important to her in order to obtain gains on an issue that is more salient to her. For the issue-linkage to take place, both actors must be on opposite sides of the expected outcome on both issues and their utility gains from the exchange must be equal; the exchanges that bring the highest utility gains take place first, thus foregoing some possible exchanges with lower utility; maximum utility gain is obtained when an actor shifts to the position of another actor an the less salient issue, while the latter partially shifts toward the former on the issue more salient to the former; these shifts can be obtained in subsequent exchanges. As the Presidency's stated goal is to obtain agreement among all member states, after some issue-linkages take place, the Presidency might propose a follow-up package that is equivalent to a new compromise outcome calculated by equation (1) based on players' revised positions. Or, if agreement has not been reached in 6 months, the incoming

94

Presidency will propose a new compromise outcome based on players' revised positions. Due to their substantial funding, the most prominent issues where linkages occur in the FF are structural actions (cohesion), agriculture and the overall size of the budget (net balance). For instance, the Netherlands is a net contributor to the budget and prefers a reduced overall budget and lower funding for structural actions, whereas Spain is the main beneficiary from structural funds, and thus prefers a large budget for this issue but also a considerable increase in the overall budget. If they are on opposite sides of the expected outcome on both issues and if they attach different saliences to these two issues, the Netherlands and Spain could engage in a mutually beneficial trade, where, in exchange for getting support for a large structural action budget, Spain agrees to a reduction in the total budget and thus moves to the Dutch position on this issue, while the Netherlands moves towards Spain on structural actions.

Once issues have been linked during several successive rounds (in between the European Councils organized by each Presidency) and players have switched to their revised positions, agreement is reached in the second and last stage of the game which for the FF is the last European Council of the ongoing FF period. The outcome X_{FF} on every issue is given by equation (1), where the revised positions have replaced players' initial preferences. The outcome of this game X_{FF} is linked to the game that describes the annual budgetary procedure, as the following section will show.

The position exchange model applied to the FF reveals the process through which actors reach agreement on the FF. The saliences over issues and the initial positions of players are historically constructed before the negotiations on each FF start. After the Commission has made the FF proposal and the Presidency has proposed a compromise, actors shift their positions

during the informal bargaining phase of negotiations in order to obtain a compromise in the final stage of voting.

Besides their gains, actors engaged in an exchange might cause positive or negative externalities for the other players of the game. Arregui et al (2006, 147) note that, when negative externalities are larger than the utility gains generated by the game, exchanges between pairs of actors serve parochial interests, rather than producing agreements acceptable to all. Empirical evidence on the FF negotiations shows that, in order to correct for these externalities, a so-called 'shopping list' has been added to the final agreement.

4.2   A DYNAMIC APPROACH TO PREFERENCES

The issues over which budgetary preferences are defined are agriculture (the expenditure ceilings for agriculture) and 'cohesion' (the expenditure ceilings for structural funds and the cohesion fund). The third issue is the overall size of the budget, expressed as a percentage of EU GNI; given its direct link with the institution of 'balance', this issues is called 'balance' to emphasize the link with the net balance concern of the net contributors (the balance is reduced when the net contributors obtain corrections).

The positions of players and their saliences over issues vis-à-vis the Commission proposal at the start of the 2000-2006 FF and the 2007-2013 FF negotiations, respectively are not taken as given but change due to endogenous and exogenous mechanisms. I construct these preferences historically through the use of archival material, EU official documents and interviews with experts; my main finding is that the saliences and the positions of players on each of the three issues are critical for determining the expenditure ceilings of the FF. The goal

of every member state is to obtain an outcome as close as possible to its preferences; through successive rounds of negotiations, the actors who are most influential manage to pull the outcome towards their ideal positions.

As the theoretical section argues, the main finding is that, as enlargement progressed and as the mechanism of learning developed, member states started to become aware of changes in preferences and in the distributional implications of previous institutional arrangements; the institution of 'balance' reinforced itself, it became more and more salient for the main contributors to the EU budget such that their positions consolidated on a conservative budget; the institution of the rebate was also reinforced in each agreement over budgetary institutions. The net beneficiaries of regional aid (Spain, Portugal, Greece, the new member states) assigned a high salience to structural funds/cohesion, for which their position was 'increased expenditure' from the very beginning (i.e. since their accession), whereas for France and Poland agriculture was very salient from the very beginning. The empirical evidence shows considerable variation in players' preferences, which intensified the competition over resources and created the need to reform the EU largest spenders – regional and agricultural programs.

Of the net contributors, the Netherlands turned from a net beneficiary in 1988 to the second largest net contributor in 1993 and became the largest per capita contributor in 1995. Like Belgium and Ireland, the Netherlands pays a relative large amount of custom duties to the EU budget because of the size and composition of her imports. (Hendrik Jan Brouwer[33] 1995, 19) The Dutch did not benefit from the increase in structural funds that happened in 1988 and 1992, as the Netherlands was one of the wealthiest member states. This consolidated the Dutch position on arguing that the inefficient redistribution of cohesion funds to non-cohesion countries led to a

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[33] Hendrik Jan Brouwer is the Treasurer-General of the Dutch Ministry of Finance in 1994-1995.

situation in which richer countries benefited from EU aid: the Netherlands and the UK received less per capita funds than Germany, France and Italy, which had a higher or similar per capita income. (Brouwer 1995, 21). Like Denmark, Finland and the UK, the Netherlands promoted the 'whole-country' approach for cohesion support, in order to avoid a situation in which poor regions in rich countries still benefit (Richter 2005). Given that the MacSharry CAP reform did not cover most of the Dutch production sectors, the Netherlands supported a revision of CAP by limiting the agricultural budget and returning some responsibility to national level (partial nationalization to respect the principle of subsidiarity). Consequently, the position of the Netherlands is to stop the increase of the EU budget and create a general system of compensations to ease the financial burden of the net contributors[34].

Germany's position is that it is not fair that Germany contributes more to the EU budget than the UK and France combined, which are relatively rich countries; the revenue system should take both GDP and population into account, especially because Germany's contribution to the EU budget is still higher than its share in EU GDP [35]. Germany's position consolidated on conservative spending from the EU budget in 1988 and then in 1992, when the Delors-2 package increased the structural expenditures with 41% and Germany's unification increased its overall financial burden. In agriculture, Germany supported a market system – supply and demand should determine prices and production – hence no necessity of agricultural spending from the EU budget (Friedmann 1995, 48). Germany's position consolidated on the argument that EU funding should focus on regions with specific structural problems, like the German Länder (funded under Objective 1 of structural funds) affected by the statistical effect. As a consequence, Germany started to promote the replacement of structural assistance with

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[34] Interviews with the Dutch representatives in the budget committee of the Council, June 2006 and February 2008.
[35] Interview with the German representative in the budget committee of the Council, January 2008.

subsidized loans or tax reductions for investment, arguing that the numerous cases of fraud showed that German taxpayers' money was not properly spent, as the beneficiary member states did not properly control the spending of EU money due to a lack of appropriate incentives: if irregularities were uncovered, the beneficiaries just had to return the money. (Bernhard Friedmann[36] 1995, 46) Like the UK, Germany has a 'lopsided' position on the EU allocation of expenditures: Germany benefits mainly politically and indirectly economically from the single market, as it exports goods, services and capital to the new member states. (Richter 2005, 103) As a result of all these developments influenced by enlargement, the issue of net balance became very salient for Germany; this high salience is underscored by the fact that Germany requested to deduct the deficit on the EU budget from the general government deficit in order to comply with the Stability and Growth Pact. (Richter 2005, 110) Germany's position for the 2007-2013 FF was that expenditure should be kept under 1% of EU GNI in commitment appropriations[37].

The 1995 accession of Austria, Finland and Sweden brought more net contributors into the Union. Like Germany, Austria became a net payer whose contribution to the EU budget was higher than its share in EU GDP, therefore Austria's position is that prosperous countries should use fewer EU resources but does not support the radical Dutch and UK approach that 'rich' countries do not need cohesion support. Unlike Germany, Austria had a balanced position in terms of allocation of expenditures, benefiting from both agriculture and cohesion. As Austria has one region that benefited form Objective 1 funding since accession, Austria found that the effect of cohesion transfers was important to citizens, also alleviating the fear of relocation of production away to the newer member states. (Richter 2005,104-106)

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[36] Bernhard Friedmann is a member of the European Court of Auditors.
[37] Interview with the German representative in the budget committee of the Council, January 2008.

The two other countries that joined the Union with Austria, Sweden and Finland, have a position similar to an older Northern member – Denmark. As the Northern countries have the highest level of development, they do not benefit from cohesion, except Finland whose scarcely populated areas are covered by Objective 1. These countries believe in the partial renationalization of both agriculture and cohesion and argue that EU funds should be used instead on research and development[38]. Of the three countries, Sweden has been since the beginning a net contributor to the budget, hence the salience of the 'balance' issue.

From its accession in 1972, UK's position and salience on balance developed gradually due to the fact that it was not a significant beneficiary from EU agricultural expenditure. The introduction of the UK rebate in 1984 represents a maximum in terms of salience on 'balance'. "The 1984 introduction of the institution of the UK rebate was accepted because the Community needed to increase the own resources, and UK prime-minister Thatcher agreed to vote for the increase only in exchange of reducing her 'unacceptable' contribution". (Butler[39] 1995, 35) Given that the UK did not enjoy the benefits of agriculture and cohesion, the UK has been favoring a renationalization of both regional aid and agriculture. While the other member states consider the UK rebate as an unfair correction, the UK's position is that an alternative to the current system would be net contributions based on prosperity, but that would be extremely hard to negotiate. (Butler 1995, 36)

Ireland is the member state that has benefited the longest time from structural and cohesion funds and agricultural subsidies. While in the 1980s and 1990s it was part of the cohesion countries, in the 2000s it reached a level of development that decreased its salience for 'cohesion': after the 2004 enlargement, Ireland's position was to ask for transitory provisions for

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[38] Interviews with the Swedish and Danish representatives in the budget committee of the Council, May 2006.
[39] Michael Butler, former UK representative, and Hans Tietmeyer are the 'inventors' of the UK rebate system.

the regions that were phased out from cohesion but insist on agricultural subsidies[40]. While the effect of enlargement on the Irish preferences is apparent through this 'statistical effect', Ireland represents an outlier in the sense that its accession to the EU (i.e. 'enlargement') led to economic development and thus a change in preferences.

Belgium and Luxembourg are two special cases in the sense that they benefit from having the seats of the EU institutions on their territory. With every enlargement, these benefits increased, such that Belgium and Luxembourg over time became 'honest brokers' (neutral on balance) and supporters of the Commission's proposals. Belgium's preference on cohesion is given by the fact that one of its regions (Wallonie) benefits from Objective 1 funding, whereas Luxembourg is interested in the social dimension of Cohesion (Objective 3)[41].

Like Portugal, Spain has been a long time beneficiary of regional aid and has been known as a fierce advocate of cohesion funding, arguably in order to secure the success of enlargement and of the economic and monetary union. (Carlos Westendorp Cabeza[42] 1995) While enlargement maintained this high salience of cohesion, the last enlargement placed Spain in the category of countries affected by the statistical effect, therefore Spain's position is for a very high budget for cohesion so that the phased out transition regions could profit as well[43].

Greece has been a long time beneficiary of cohesion and therefore its position is to maintain the same levels of flows from the structural funds from before the last enlargement.

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[40] Interviews with the Irish representatives in the budget committee of the Council, May 2006 and December 2007.
[41] Interviews with the representative of Luxembourg in the budget committee of the Council, May 2006 and October 2007 and the former representative of Luxembourg in the budget committee of the Council, January 2008.
[42] Carlos Westendorp Cabeza was Secretary of State for European Affairs in 1995.
[43] Interview with the Spanish representative in the budget committee of the Council, February 2008.

Like Spain, Greece wants an increase in cohesion expenditure to ensure it is not phased out by the newer member states. (Efthymios Christodoulou[44], 1995)

The 2004 member states tend to have relatively homogeneous positions and saliences on the three issues. There are slight differences on cohesion: the Visegrad group (Hungary, Poland, the Czech Republic and Slovakia) and Lithuania favor high level of expenditures for cohesion (more than 4% of GDP), whereas Latvia favors regional aid for infrastructure.

Slovenia is the most prosperous of the new member states, therefore in principle it supports the net contributors, provided that the expenditure cuts should affect structural policy but agriculture as well (Slovenia has limited arable area and considers the CAP over-dimensioned and inefficient, therefore some of the agricultural resources should be shifted to structural policy). In terms of the 'statistical effect', Slovenia rejects the idea of distinguishing between old and new countries and finds it unacceptable that the old cohesion countries, having been at a level of development similar to Slovenia, received structural funds for many years, whereas Slovenia will be 'phased out' in 3 years after accession, without being fully 'phased in'. (Richter 2005, 94)

Poland is less prosperous but the largest of the new member states, therefore it used its political weight in the final accession negotiations at the Copenhagen Summit (December 2002) and in the Lisbon treaty debate. Richter (2005) argues that Poland was surprisingly flexible in the FF negotiations: it wanted the highest possible level of own resources (1,24%) but it was also not opposed to 1%, as a higher budget implies a higher national contribution. (Richter 2005, 97-99) While Poland did not accept a reduction of direct payments to farmers and supported an increase in the share of rural development under the agriculture heading. Poland rejected both a conflict

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[44] Efthymios Christodoulou is MEP and former Governor of the Bank of Greece.

between old and new member states and the focus on the neediest countries, but supported special claims by groups of states. Poland was against the (partial) re-nationalization of regional policy[45], considering that solidarity was important to the EU construction and re-nationalization would constitute a first step towards withdrawal from integration. However, Poland argued for fairness in the allocation of structural aid: transfers/capita for the regions affected by the statistical effect should not exceed those of the regions of the poorest member states. Poland proposed lower national co-financing rate for programs related to the Lisbon Strategy and her position was that the EU budget should serve to finance common policies from Community sources and not as a battleground for net contributions[46].

Hungary supported the Commission proposal of 1.24% and rejected the 1% threshold, arguing that the EU policies need appropriate funding and budgetary discipline should not be achieved by reducing the EU budget. Hungary claimed that there were two conflicts of interests: net payers versus net beneficiaries on the size of the budget but also the allocation problem between old and new member states. On the former, Hungary was against any correction mechanism, seen as a regressive contribution where poorer states pay more. On the latter, Hungary wanted to keep the agreement on CAP up to 2013 and argued for rural development but its main interest was cohesion: like Lithuania, it requested an increase in the 4% of EU GDP to be spent on Cohesion. (Richter 2005, 99-103) Hungary argued that, in practice a country's eligibility was calculated anyway below the 4% limit due to the difference between the official exchange rate and purchasing power parity. In terms of the Berlin methodology used to calculate transfers for individual regions, Hungary argues for the reduction of payments for the regions of

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[45] The argument for the (partial) re-nationalization of regional policy is that member states with per capita GDP higher than 90% of EU average should take care of their own regional problems using their national resources.
[46] Interviews with the Polish representative in the budget committee of the Council, June 2006 and September 2007.

old prosperous member states, but requested a reduction of co-financing for structural funds for new member states from 25% to 20% [47].

Given that member states respond to the Commission's proposal, it is worth noting the Commission's position on the three issues. In the 1990s, the Commission favored an increase in the democratic control of spending, a phasing out of the UK rebate and an adjustment of the balance of costs and benefits. (Christiane Scrivener[48] 1995) The Commission has always favored an increase in the resources for European policies, hence an increased budget for agriculture and cohesion. While opposed to calculating net balances, the Commission argued that in 1999 gross contributions to the budget were reasonably proportional to member states' GNI: the UK, because of the rebate, paid the least, then Italy paid the next smallest contribution, whereas the Dutch contributed the most.[49] "The Commission, not without reason, argues that the gains from economic integration greatly outweigh the (fairly modest) net financial contributions, with the result that the focus on 'juste retour' is especially unhelpful." (Begg 1999, 14)

The description above tracks the effect of enlargement on players' preferences. The main effect found is that enlargement determines more 'extreme' preferences and a higher salience on 'balance' for the net contributors, who argue that the EU budgetary system is too unbalanced: their gains from integration (market and capital movements) in an enlarged union have been exceeded by the financial costs of the EU budget contribution. While the 'balance' issue is polarized by conservative expenditure versus an increase in spending (especially cohesion), it is dominated by the UK rebate. The effect of enlargement on net contributors is particularly visible on this issue due to the way in which the UK rebate is designed and calculated: every

[47] Interview with the Hungarian representative in the budget committee of the Council, June 2006.
[48] Christiane Scrivener is a former Commissioner for Taxation and Customs.
[49] Interviews with Commission officials, May 2006 and July 2007-February 2008.

enlargement increases the amount the UK is compensated through the rebate: the more member states enter the union, the more the UK receives back.

In 1999, net contributors argued for a decrease in financing, while net beneficiaries opposed any national co-financing of CAP or regional spending. In 2005, the main effect of enlargement is that the positions of the 'old' beneficiaries from cohesion (Spain, Portugal, Greece, Finland, Luxembourg, Italy) became more extreme because of the 'phasing out' of their less developed regions: they emphasized the gains per capita, argued that the least off regions should be helped to maintain public investment and advocated greater progressivity in gross contributions. This position could be explained by the fact that, before the number of regions multiplied with enlargement, the union member states were happy to support one another's poor regions. However, this multiplication of poor regions increased the burden of the net contributors until their position became that it was not equitable to support poor regions of prosperous member states. The 'statistical effect' redefined poverty according to lower standards and shifted the focus of structural funds. In the net contributors' view, the lowering of standards needed to be accompanied by a change in rules that would maintain equity and put some financial pressure on rich countries with less developed regions.

The positions of the net contributors were clearly expressed in 2004 by the "letter of the six", which argued that the EU budget should not exceed 1% of EU-GNI, at that time not specifying whether in commitment appropriations or payments. All the other member states wanted a counterweight vis-a-vis the block of 6 – which represented more than 70% of both population and contribution – so they positioned themselves close to the Commission's proposal and signaled they could accept a compromise around 1.10% – 1.15% of EU GNI. Even though agriculture was decided by the December 2002 deal, the Netherlands and the UK wanted the

question reopened, arguing that Romania and Bulgaria could be accommodated under the ceilings foreseen for EU-25. Since rural development had not been decided in 2002, for the new member states most of rural development money came from Cohesion transfers, hence their main interest in Cohesion[50].

The initial positions of players and the saliences they attach to the three issues are presented in Table 1 and Figure 4 below. Given that there was a change in the denomination of the FF headings in the 2007-2013 FF, the cohesion issue includes all expenditure under heading 1 and the agriculture issue consists of all heading 2 expenditure. As described above, the scale on positions and saliences is from 0 to 100. For the agriculture and cohesion issues, 0 means an ideal position where players favor no increase in EU funding for the issue in question (the status quo – last FF ceiling), whereas 100 stands for as much EU funding as possible. On the 'balance' issue, 0 is the position of a player who favors a reduced level of the EU budget revenue (the status quo equal to the last FF) and therefore a high level of compensations, a position of 50 implies a moderate level of revenue and indifference on the correction mechanism and 100 is the position of players who want a high revenue level (1.24% of EU GNI[51]) and therefore a low level of compensations. On the salience measure, 0 is given when players pay no attention to the issue in question, 50 when the issue stands for an average priority (the country is neutral on the issue) and finally 100 represents an issue of the highest importance.

Table 1 presents the positions and saliences for the 2007-13 FF negotiations. The figures in red signal a change from the 2000-06 FF negotiations, as indicated below. Germany is the main contributor to the EU budget, therefore it favors a reduced budget of 1% and corrections,

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[50] Interviews with Commission officials, November 2007 and January 2008.
[51] The EU possible expenditure ranges between 0.9%, minimum of expenditure, and 1.24% of EU GNI - the maximum established by the rules (interview with a Commission official from DG Budget, September 2007).

hence the position of 20 on 'balance'. Germany's salience for the issue of 'balance' has increased from 70 in 1999 to 90 in 2004. The Netherlands is a net contributor with the highest contribution per capita, therefore its position on 'balance' is at 15 (slightly more conservative than Germany). Similarly to Germany, its salience on 'balance' has increased from 70 in 1999 to 90 in 2004. The salience on 'balance' of the other two main contributors, Austria and Sweden also increases from 60 in 1999 to 80 in 2004. Given the development of Ireland, its position on cohesion decreases from 70 in 1999 to 50 in 2004, whereas its salience changes from 60 in 1999 to 40 in 2004. The main beneficiaries of cohesion in 1999 – Spain, Portugal and Greece – are phased out in 2007-13, therefore they change their positions from 80 in 1999 to 90 in 2004. Because of the UK rebate, the UK ranks at 100 on the salience of 'balance', whereas its position on balance is at 10 (low revenue and high compensation). France attaches the highest importance to agriculture, therefore it ranks at 100 on the salience of agriculture; however, its salience on balance increases from 60 in 1999 to 70 in 2004. In 2004, the preferences of the newer member states were somewhat homogeneous: their salience on balance was 50 (neutral in terms of the importance of correction mechanisms and revenue level), but most of them were at position 70 on balance (higher level of revenue).

Table 1. Country saliences and positions for the 2007-13 FF negotiations

country	Salience Balance	Salience Cohesion	Salience Agriculture	Position Balance	Position Cohesion	Position Agriculture
Germany	90	40	10	20	50	20
UK	100	10	10	10	10	10
France	70	40	100	60	50	90
Spain	60	80	70	80	90	60
Italy	60	70	60	80	80	60
Portugal	60	70	60	80	90	60
Ireland	60	40	80	80	50	60
Greece	60	70	80	80	90	60
Denmark	60	15	40	40	15	20
Sweden	80	10	40	25	10	20
Finland	60	70	60	40	50	30
Austria	80	50	50	25	50	30
Netherlands	90	10	40	15	10	20
Luxembourg	10	20	50	50	50	50
Belgium	10	60	50	50	50	50
Poland	50	90	90	90	100	90
Hungary	50	90	80	70	100	70
Czech Rep	50	90	80	70	100	70
Malta	50	70	40	70	80	50
Cyprus	50	70	40	70	80	50
Letonia	50	80	80	70	90	70
Lithuania	50	90	80	70	100	70
Estonia	50	70	80	70	80	70
Slovakia	50	90	80	70	100	70
Slovenia	50	60	40	60	70	50

balance

Uk   Nl   Ge   Au,Sw   Fi,Dk   Be,Lx   compr. outcome   Fr   Sl   Hu,Cz,Le,Lt, Es,Sk,Ma,Cy   Sp,Gr It,Pt,Ir   Po

10 15 20 25   28.33   40   50   53.46   60   70   80   90

cohesion

Uk, Nl,Sw   Dk   Ge,Au   Fi,Fr,Ir,Be,Lx   Sl   compr. outcome Es, It   Ma,Cy Le,Gr Sp,Pt   Hu,Cz,Lt Po,Sk

10 15   50   70   79.12 80   82.01   90   100

agriculture

Uk   Sw,Dk Nl,Ge   Au,Fi   Ma,Cy,Sl Be,Lx   compr. outcome Sp,Gr,Ir It,Pt   Hu,Cz,Le Es,Sk,Lt   Po,Fr

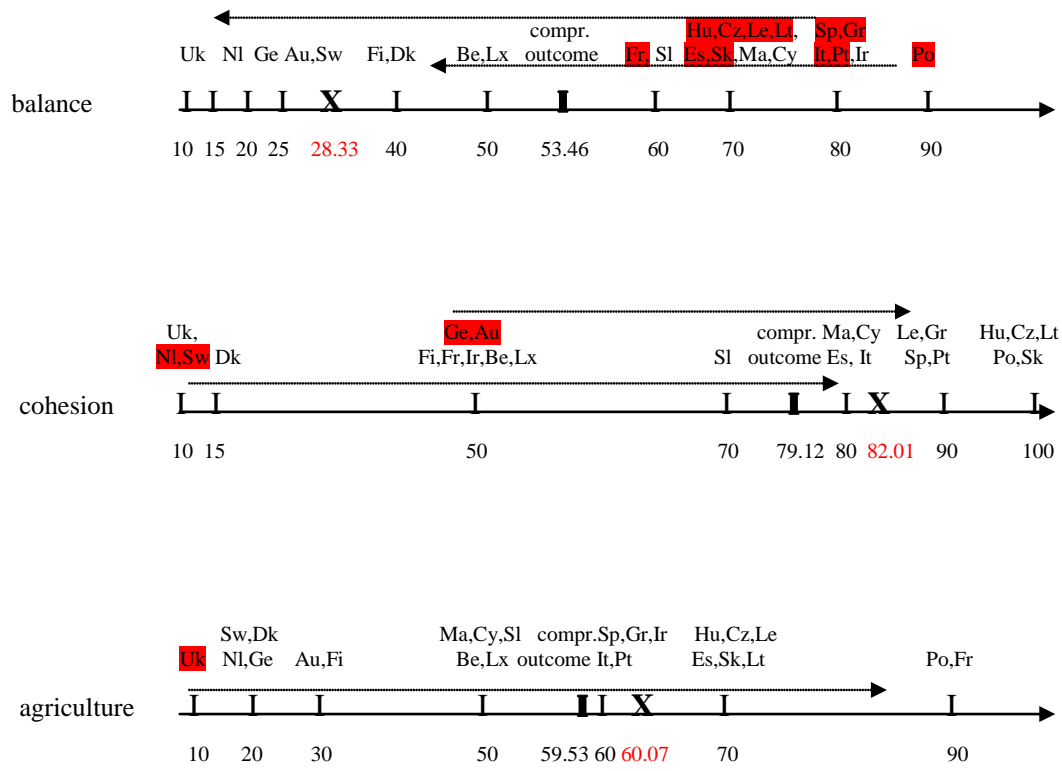10   20   30   50   59.53 60 60.07   70   90

Figure 2. Positions and exchanges in the 2007-13 FF negotiations

4.3   NEGOTIATIONS ON THE 2000-2006 FF AND 2007-2013 FF

4.3.1   Negotiations on the 2000-2006 FF, an Analytical Narrative (shadow case)

The 1999 negotiations on the 2000-2006 FF took place in a difficult context. The net contributors expressed their preferences: reduced CAP intervention prices (low saliences and positions on agriculture), change in the rules for structural actions (moderate positions and saliences) and compensations on the 'balance' issue (low position and high salience). The Commission was aware of the pressure on the net contributors, therefore in the proposal for the 2000-2006 FF it

recommended a generalized system of corrections that would be 'equitable' and acceptable to all[52]. It is worth noting that the Commission tried to pass the same proposal in 2004, but without success.

During the first stage of the position exchange game, equation (1) is used to compute the expected outcome on all three issues, according to the compromise model: the average of the ideal positions weighted by salience. The predictions of the compromise model are position 46.34 on the balance issue, position 62.11 on cohesion and position 51.25 on agriculture. According to equation (2), players compute their expected utilities from these expected outcomes and identify mutual beneficial exchanges on pairs of issues. The most prominent exchanges happen when players are farther away from the expected outcomes and attach different saliences to the issues traded; the comparison of saliences determines the direction of exchange – which actors will move in which direction during the exchange. Players can enter a trade only if they are on opposite sides of both issues traded, otherwise they can increase their utility just by choosing a more extreme position. Table 2 shows the position of actors in relation to the expected outcome and identifies the potential exchanges of voting positions. According to the table, the most likely exchange partners are the net contributors, on the left side of the expected outcomes on all issues and the net beneficiaries, on the right side of the expected outcomes on all issues.

One of the likely exchanges is that between France and the net contributors, given that France has no possible linkages other than agriculture and balance (on the latter Germany and the Netherlands have the highest saliences). Consequently, France is willing to move on balance in exchange of influencing the outcome on agriculture, whereas Germany is willing to move on

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[52] Interviews with Commission officials, September 2007-February 2008.

agriculture (salience 10) in exchange of increasing her utility on balance. Germany moves to the position of France on agriculture and in exchange France moves towards Germany's position on balance and ends up in position 42.1. The rate of the exchange is equal utility gain, equal to 87.5, according to equation (2) of the position exchange model. The new prediction is 52.125 on agriculture and 45.09 on balance, calculated by applying equation (1) to the new positions.

Of the net beneficiaries, Spain attaches the highest salience to cohesion (80), therefore a likely exchange is between Spain and the net contributors on the issues of cohesion and balance. Given that, of the two net contributors with the highest salience on balance (70), Germany has the presidency, the exchange will happen between Spain and Germany. Spain moves towards Germany's position on balance ending up in position 50.9 and in exchange Germany moves to Spain's position on cohesion. The utility gain of the trade is 142.222. The new prediction is 63.889 on cohesion and 43.058 on balance.

In subsequent exchanges, France continues to move towards the position of the remaining net contributors (the Netherlands, Sweden and Austria), while they move towards France's position on agriculture. The final predictions are 63.89 on cohesion, 55.375 on agriculture and 41.17 on balance.

Table 2. Potential exchanges of positions 1999

Issue 1: balance	**Issue 2**: agriculture		
		left	right
	left	Uk, Ge, Nl, Dk, Sw, Au, Fi	
	right	Be, Lx	Fr, Gr, Ir, It, Sp, Pt
Issue 1: balance	**Issue 3**: cohesion		
		left	right
	left	Uk, Ge, Nl, Dk, Sw, Au, Fi	
	right	Be, Lx, Fr	Gr, Ir, It, Sp, Pt
Issue 3: cohesion	**Issue 2**: agriculture		
		left	right
	left	Uk, Ge, Nl, Dk, Sw, Au, Fi, Be, Lx	Fr
	right		Gr, Ir, It, Sp, Pt

The model can be empirically tested in two ways. First, one needs to check if the predicted exchanges are indeed the linkages that happened between players during negotiations. Empirical evidence shows that Germany, who had the presidency during negotiations, orchestrated the main issue linkages. One of this exchanges happens with France on agriculture: "Following a bilateral meeting between the French and the German Agricultural Ministers […], a representative of the German government finally conceded that cofinancing had little chance of surviving as a part of the package given the continuing opposition of the French." (Laffan 2000, 12) In exchange, France had to agree to support a higher share of the financing of the UK rebate (35% instead of 24%), thus increasing France's contribution by 263 million per year, traded for a 75% reduction of the four main contributors' financing of the UK rebate[53]. From the exchange with Germany, Spain obtained a 5.6 % increase in structural aid: in exchange of its support on the balance issue, Spain maintained substantial net transfers. (Begg 1999, 16-17)

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[53] Interviews with Commission officials, September 2007-February 2008.

Second, one needs to check the difference between the prediction of the model and the actual outcome of the final Berlin agreement in 1999, which in fact represents a collection of old and new layers/sediments. On the agriculture issue, the prediction of 55.375 represents a moderate budget for agriculture, which corresponds to the following layers: the agreed reduction in CAP intervention prices (arable cultures, milk and beef), compensated by an increase in direct aids to producers. Given that the UK did not exchange positions with any of the players, the UK rebate was maintained. When compared to the initial prediction of the model (46.34), the prediction of 41.17 on the balance issue represents an outcome in favor of net contributors, even though modest in magnitude. This measure of their success means that they managed to stabilize the budget – i.e. no sizeable increases, including the 4% GDP cap for regional aid – even though the expenditure are higher than their ideal positions. However, the net contributors did obtain corrections in their favor, represented by the following layers: a payment of only 25% of their UK rebate share and a progressive reduction of the VAT call rate to 0.75% in 2002 and 0.50% in 2004. Evidence of the fact that the exchanges took place between pairs of actors and did not involve the net contributors as a group is the fact that the compensations for the net contributors differ, i.e. involve different layers: Germany benefits the least, the Netherlands profits from an additional increase of the collection rate on customs duties to 25%, and Austria and Sweden receive different types of ad hoc payments through structural funds (mainly under objectives 1 and 3). The side-payments for Austria and Sweden are part of a 'shopping list' of layers with 13 'specific situations', added to the agreement on cohesion/structural funds; these compensations correct for the negative externalities that the model predicts, in this case the regions no longer eligible and a reduction in the Cohesion Fund depending on progress towards convergence. (Bache 1999)

4.3.2   Negotiations on the 2007-2013 FF, an Analytical Narrative

The negotiations on the 2007-2013 FF took place under the full effect of both enlargement and the endogenous mechanisms of learning and reinforcement. Historical documents and interviewed officials[54] agreed that, compared to 1999, the 2007-2013 FF negotiations exhibited a more pronounced interest on the balance issue. Some officials[55] argued that the situation was even clearer than in 1999 because the net contributors had expressed their positions well in advance, before the negotiations started. Even though in February 2004 the Commission proposed a package[56] for the FF with an overall level of 1.26% of EU GNI in commitments and 1.14% in payments, negotiations actually started much earlier in 2002 when the accession packages were agreed on with the candidate countries. Although the candidate countries were in a much weaker negotiating position and no issue-linkages per se were possible, the agreement reached in December 2002 fixed agricultural support until 2013 and technically eliminated the agriculture issue from the subsequent FF negotiations. However, as negotiations progressed, some member states thought about reopening negotiations to trade agriculture with other issues.

In December 2003 a group of six countries (Germany, the Netherlands, Austria, Sweden, the UK and France) wrote a letter advocating a maximum of 1% of EU GNI for the EU budget. While it was not clear if the 1% referred to commitments or payments, as negotiations progressed, 1% became the reference for commitments with an equivalent 0.9% in payments – a

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[54] Interviews with Council and Commission officials, May-June 2006 and July 2007-February 2008.

[55] Interviews with Commission officials and former member state representatives that participated in the 2004-2005 presidencies.

[56] Commission's proposal changed the titles of headings, while keeping agriculture and structural aid as the most funded issues: the new Headings 1 and 2 contained sustainable development with cohesion and competitiveness and natural resources, respectively, Heading 3 was strengthening European citizenship and Heading 4 – Europe as a global partner.

dramatic cut in the budget[57]. This letter is the evidence for the pressure exercised by enlargement on the preferences of net contributors. By announcing their positions ahead of the main rounds of negotiations, the net contributors signaled the high salience they attached to the balance issue, their low positions on the issue and their dissatisfaction with the status quo. In the group of six, the UK was the net contributor in the best position, as it received a huge correction through the UK rebate; the UK signed the letter to signal the high salience it attached to the UK rebate. Well aware that enlargement increased the UK rebate, France had opposing interest to the UK: it wanted to decrease its share in the financing of the UK rebate while still preserving the benefits from agricultural funding, hence its higher position on balance (60).

For net beneficiaries, given that the deal on agriculture was closed, cohesion was the most salient issue. While net contributors argued that rich countries should support their poor regions, the beneficiaries equated cohesion with solidarity between all regions and citizens: more developed member states should help the less developed ones. Given that the funding available under cohesion was capped at 4% of GNI, most new member states fixed their ideal positions according to this figure: the Visegrad countries wanted an increase in the 4% (position 100 on cohesion), Letonia was very interested in receiving the full 4% (90) while Estonia was more interested in the innovation aspect of cohesion (80).

The main effect of enlargement was that the older member states previously benefiting from cohesion were phased out due to the statistical effect, therefore their position was to maintain their pre-enlargement level of benefits (position 90 for Spain, Portugal and Greece). In

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[57] According to interviews with Commission officials, 1% in commitments and 0.9% in payments represented a 9 billion €uro cut in the 2007 budget as compared to 2006.

fact, the Commission wanted to avoid this conflict between old and new cohesion countries and proposed an approximate 50:50 division of funds[58].

After the May 2004 enlargement, the Irish and Dutch presidencies examined the Commission proposals in detail but did not start the real negotiations. The Dutch presidency proposed some 'building blocks' on different policies, with cohesion being the most important one, which in fact clarified the major issues to be negotiated and the ideal positions of member states[59]. The first real rounds of negotiations started under the Luxembourg presidency in the first half of 2005.

The Luxembourg presidency was very active in organizing bilateral meetings, which facilitated the exchanges between pairs of actors on the main issues: cohesion and balance. As with the previous negotiations, in the position exchange model equation (1) is used to compute the expected outcome (the average of the positions weighted by salience) on both cohesion and balance, according to the compromise model; the predictions are position 53.46 on the balance issue and 79.12 on cohesion (the outcome on agriculture, previously decided, remains at 59.53). Players compute their expected utilities according to equation (2) and identify mutual beneficial exchanges, under the conditions that players are on opposite sides of the expected outcomes and attach different saliences to the issues traded. Table 3 shows the positions of the actors in relation to the expected outcomes and identifies the potential exchanges. The difference in saliences determines the direction of trade – which actors will move more on which issues. As with the previous negotiations, the net contributors attach higher salience to the balance issue, therefore they are interested in shifting their positions on cohesion in exchange for obtaining support on

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[58] Interviews with DG Budget officials, June 2006 and September-October 2007.
[59] Interviews with Dutch representatives in charge of budgetary matters, May 2006 and November 2007.

balance. As before, the potential trading partners are the net contributors – on the left side of the expected outcome – and the cohesion countries – on the right side, who attach a higher salience to cohesion than to balance. The most prominent exchange happens between the countries with the highest salience on both issues and the most extreme positions, Spain and the Netherlands. The Netherlands moves to Spain's position on cohesion (90) and in exchange Spain moves towards the Dutch position on balance, ending up at position 68.1; the exchange rate is an equal utility gain of 43.99. The new predictions are 79.67 on cohesion and 52.97 on balance, calculated by applying equation (1) to the new positions. Similar exchanges happen between Spain and Germany, Spain and Sweden, such that Spain continues to drift towards the net contributors (through positions 44.3, 30.9) until it ends in position 14.2. Similar successive exchanges happen between pairs of net contributors and the Visegrad countries, Italy, Portugal, Greece, Latvia, Lithuania and Estonia. The new predictions are 82.01 on cohesion and 28.87 on balance.

Table 3. Potential exchanges of positions 2004-2005

Issue 1: balance	**Issue 2**: agriculture		
		left	right
	left	Uk, Ge, Nl, Dk, Sw, Au, Fi, Be, Lx	
	right	Ma, Cy, Sl	Fr, Gr, Ir, It, Sp, Pt, Po, Hu, Cz, Le, Lt, Es, Sk
Issue 1: balance	**Issue 3**: cohesion		
		left	right
	left	Uk, Ge, Nl, Dk, Sw, Au, Fi, Be, Lx, Fr	
	right	Fr, Ir, Sl	Gr, It, Sp, Pt, Po, Hu, Cz, Le, Lt, Es, Sk, Ma, Cy
Issue 3: cohesion	**Issue 2**: agriculture		
		left	right
	left	Uk, Ge, Nl, Dk, Sw, Au, Fi, Be, Lx, Sl,	Fr, Ir
	right	Ma, Cy	Gr, It, Sp, Pt, Po, Hu, Cz, Le, Lt, Es, Sk

In spite of the fact that the Luxembourg presidency predicted an agreement, negotiations

failed on June 17, 2005. Luxembourg officials[60] argued that in June 2005 the delegations were very close to an agreement, as the main differences on the overall level of FF had been smoothened out, with the exception of the UK who had declared that the approach on the UK rebate was unacceptable. As mentioned before, UK's position was motivated by the fact that enlargement increased the benefits from the UK rebate and the UK wanted to keep those benefits. Montagnon[61] (2006, 441) argues that the demand of budgetary reform, which meant a reform of agriculture, had not been previously debated and the UK used it in a surprising way to block an agreement in June 2005 and then decided not to analyze it in depth in order to increase the chances of agreement in December 2005 under the UK presidency.

From the point of view of the position exchange game, agreement was not obtained because member states had not exhausted all possibilities of trade that would increase their utilities. In fact, the UK had not been engaged in exchanges during the first half of 2005 and, like Germany in 1999, the UK used the opportunity of the presidency in the second half of 2005 to engage in issue-linkages. From this perspective, June 2005 marks the end of a negotiation round and the start of a new round.

The next negotiation round started de facto in November 2005, when President Barroso sent a letter to the Presidents of the Council and the EP emphasizing the balance issue and its global character[62]; this letter mentioned the 'clause de rendez-vous' for the budgetary reform 2008/2009. This was an opportunity for the UK to reopen the agriculture deal and trade the reform of agriculture with the UK rebate, since agriculture was the historic cause behind this correction mechanism. Since France was the country with the highest salience on agriculture, the

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[60] Interview January 2008.
[61] Montagnon (2006) is citing officials involved in negotiations.
[62] Interview with Commission officials, February 2008.

UK entered an exchange with France on balance and agriculture: France wanted the UK to decrease its compensation obtained through the UK rebate, whereas the UK wanted France to reform agriculture in order to reduce the EU funds spent on farmers. Consequently, the UK moves to France's position on agriculture in successive stages and France moves towards the UK's position on balance ending up at position 48.8; the utility gain is 53.69. The new prediction is 28.33 on balance and 60.07 on agriculture, calculated by applying equation (1) to the new positions.

In order to estimate the predictive power of the position exchange model, one needs to test the predicted exchanges and the outcomes of the game (the old and new layers) with those that happened in negotiations. One interviewed official[63] confirmed the utility of a weighted average model in computing the outcome and argued that the compromise proposed by the Luxembourg presidency – 1.056% of EU GNI – was indeed computed as a weighted average, taking into account the Commission proposal of 1.21% of EU GNI and the net contributors arguing for 1%. While it is difficult to compare the 28.87 outcome on balance in the Luxembourg negotiations with the Luxembourg package, one could compare the two outcomes with the initial positions. On one hand, given how close the 1.056% is to 1%, one could argue that the Luxembourg package was strongly influenced by the net contributors. On the other hand, the initial prediction of the 'compromise' model is 53.46, whereas the position exchange model predicts 28.87 for the Luxembourg compromise – a move of approximately 50% towards the net contributors. The magnitude of this distance is considerable compared to the distances between the outcomes and the initial positions on the other issues, therefore one could conclude that the position exchange model accurately predicts an outcome heavily favoring the net contributors.

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[63] Interview January 2008.

The same is true about the final outcome of the game – 28.33 – and the final expenditure ceiling adopted for the 2007-13 FF – 1.045% of EU GNI (862.3 billion €uro[64] in commitments and 0.99% EU GNI in payments – 819.4 billion €uro). While interviews[65] confirm that the actual FF outcome was driven by Germany, the prediction of the game shows a heavy influence by the net contributors. In fact, if one considers 1% as being close to 0 on the balance issue and 100 representing 1.24% (maximum possible expenditure), then 28.33 would be equivalent to approximately 1.068%. It follows that the prediction error of the position exchange model applied to the FF negotiations is 0.023%. On the 0-100 scale, this prediction error[66] is 9.43, smaller comparable to the average error of 23.4 reported by Arregui et al (2006, 143) for scale issues and 20 players.

The measure of institutional change – the layers added – reflected by the outcome is in favor of the net contributors as follows: while the rate on the VAT resource is frozen at 0.30%, Germany obtained a reduction of 0.15%, Austria 0.225%, and the Netherlands and Sweden 0.10%; further, the contribution of the Netherlands is reduced with 605 million €uro per year and that of Sweden with 150 million per year. (Montagnon 2006, 441 -442) This difference in layers/compensations obtained by the net contributors is further evidence for the fact that the exchanges took place between pairs of actors and did not involve the net contributors as a group.

Empirical evidence also confirms that Luxembourg presidency favored bilateral talks and thus encouraged exchanges. The Netherlands and Sweden were extremely keen on obtaining money back on balance, the Netherlands had requested 1 billion Euro per year and so did

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[64] Since the initial proposal of the Commission was tabled in February 2004, all the figures are expressed in 2004 prices to avoid further confusion. Given that the annual budgets are established in current prices, the Commission will make technical adjustments to the Financial Framework ceilings each year using a deflator of 2% a year.
[65] January-February 2008.
[66] On the 0-100 scale, the 1.045% outcome represents a point of 18.9, hence the prediction error is 28.33-18.9=9.43.

Sweden; since the most possible cuts were on cohesion, they were ready to trade; the Spanish officials were also keen on making issue linkages involving cohesion[67]. The other cohesion countries followed the examples of the Spanish in making issue linkages, with Poland being the most prominent example[68]. The shopping list containing 17 'cadeaux' stipulating transition measures for cohesion is a result of the bilateral trades of the cohesion beneficiaries.

The exchange between the UK and France is empirically grounded in the successive exchanges that happened in December 2005. First, the UK proposed a 1.5 billion/year cut in the rebate, accompanied by a 10% cut in the regional aid to enlargement countries (as negative externality), in exchange of a reform of the system of direct payments in agriculture; then the UK offered a 8 billion cut for the entire period. In exchange for accepting the review of the budget and thus a reform of the agricultural system, France asked for a 14 billion cut in the UK rebate. The final deal agreed was a budget review 2008/2009 and a 12 billion cut – a 10.5 billion cut in the UK rebate and a reduction of 1.5 billion in the funding received by enlargement countries[69]. To compensate for this negative externality that decreased the utility of new member states, and given that the UK rebate augments significantly as a result of enlargement – 15% increase in 2004 and 64% in 2007-2013 – the rebate is not to be calculated on the agricultural expenditure for the new member states[70]. While the 2008/2009 budget review was intended to overhaul EU agricultural funds, given the influence of the net contributors on the outcome, there is a high likelihood they will take the opportunity to further influence the outcome in their favor.

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[67] Interviews with the Dutch and Spanish representatives, November 2007 and February 2008.
[68] Interviews with the Polish representatives, May-June 2006 and October 2007.
[69] *Financial Times* December 2005.
[70] In 2003, 40% of the UK rebate represented agricultural expenditure, according to DG Budget officials.

The position exchange model predicts reasonably well the changes resulting from the two subsequent FF negotiations; in addition to emphasizing the role of power, embodied by the net contributors, it points out to the role of the EU presidency as a facilitator of issue-linkages and compromise packages. The reinforced institution of balance, with its adjacent institution of rebate incurs the most significant changes – the most important layer – hence its prominence as a vehicle of change. In 1999, before the big enlargement of 2004, the outcome of negotiations on balance was 41.17, whereas in 2005 the outcome decreased to 28.33, thus moving closer to the positions of net contributors. For a weighted average model, this difference between the two outcomes is substantial. While comparing the exchanges realized in 1999 and 2005, one could see that with more players more issue-linkages are possible (as the literature on issue-linkages argues) hence a larger scope for the influential players to draw agreement towards their preferred outcome.

5.0   NEGOTIATIONS ON THE EU ANNUAL BUDGET – AN ANALYTICAL NARRATIVE

5.1   THE EMBEDDED FRAMEWORK FOR EU BUDGETARY NEGOTIATIONS

The EU annual budgetary negotiations are analyzed using a variation of the procedural bargaining model proposed by Crombez (1997)– a sequential game of complete information – that takes into account the formal rules for the EU budgetary procedure (as stipulated by Articles 268 to 280 of the Treaty establishing the European Community). This model helps to characterize the set of annual budgetary equilibrium outcomes that can be adopted as a function of the ideal positions of the EU member states and the EP; like in the FF negotiations, some players are pivotal in influencing the agreement on the annual budgetary institutions.

Similar to the bargaining model used for the FF negotiations, as a result of the endogenous mechanism of learning, all actors know each other's ideal positions, the location of the status quo, and the rules of the game: before negotiations start, players state their positions, which are well known given the annual character of the game and the fact that there is little change in these positions from one year to the other. Different from the FF negotiations, in this game the players are the Commission, the EP and the Council. All actors have Euclidean

preferences[71] over a one-dimensional policy space that represents the EU budget – a global issue similar to the 'balance' issue featuring in the FF game. The assumption of unidimensionality is motivated by the fact that this game redistributes the margin available from the FF ceiling and there are no issue-linkages; each player's strategy involves a proposal on a given redistribution of EU funds.

The ideal positions of the Commission and the EP are represented by the median[72] Commissioner (Com) and the median MEP (P), respectively. The policies that are closer to the median Commissioner's ideal policy defeat any other policies in the Commission. Similarly, the median MEP stands for a policy that cannot be defeated in the EP. On the contrary, the Council is not represented as a unitary actor because it makes decisions by QMV; the Council's position is represented by the countries pivotal under QMV. The QMV threshold represents approximately 71% of the total votes in the Council: between 1986 and 1994 (the first period), the QMV threshold was 54 votes; this number increased to 62 between 1995 and 2003 (the second period), due to the accession of Austria, Finland and Sweden, and then to 232 between 2004-2006 (the third period) due to the accession of the ten new member states. There are two pivotal countries under QMV: country 1 (C1) is the country that represents the blocking minority and is pivotal for a move to the right; it is the country with the 23rd vote from the left in the first period, 26th vote in the second and 90th in the third period. C1 and the countries to her right constitute a qualified majority. Similarly, country 2 (C2) is pivotal for a move to the left; it is the country with the 54th, 62nd and 232nd vote from the left, respectively. Given the global character of the policy space and the fact that a move to the right represents an increase in the EU budget,

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[71] Each player has a most preferred outcome – her ideal positions and prefers policy outcomes that are closer to, rather than farther away from her ideal position.
[72] According to Black's median voter theorem.

one can easily see that C1 stands for a net beneficiary whereas C2 is a net contributor. As well, given that the number of votes needed for QMV increases with enlargement (from 54 to 62 and then to 232), the position and the influence on the outcome of the net contributor represented by C2 is strengthened by an increase in the number of votes.

The first line in Figure 3 presents the configuration of ideal positions on the EU budget. Since the budget needs to be adjusted according to inflation, all players are placed to the right[73] of the status quo q – last year's budget. The Commission is located the farthest to the right[74] because it is the advocate of the highest expenditures for financing the EU policies; every year, the Commission proposes a high preliminary budget, although within the FF margins – the outcome X_{FF}– and argues that, without proper financing, the Commission cannot do its job of implementing the EU policies. There are three cases for the location of the EP and the two pivotal countries C1 and C2: EP is situated to the left of C1 and C2, EP is situated to the right of C1 and C2 and EP is situated in between C1 and C2. Given that solving for equilibria produces the same results in all three cases, I consider only the first situation[75].

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[73] Equation (1) used to compute the outcome of the FF negotiations also shows that the EU budget is bound to increase with enlargement.
[74] The outcome of the FF negotiations X_{FF} is placed farther to the right of the Commission.
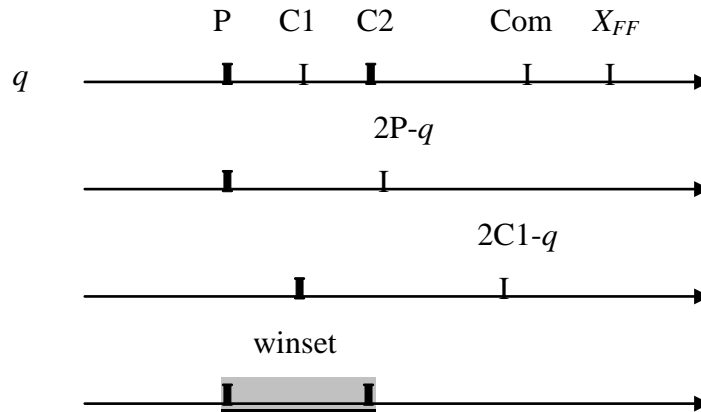[75] The other two cases are presented in a footnote in the section describing the equilibrium.

Figure 3. Spatial representation of the annual budgetary game

The strategies available to each actor and the stylized budgetary procedure are presented in Figure 4. The Commission proposes a preliminary budget b, such that $q < b < X_{FF}$. Next, the Council, under QMV, can either reject b or accept it and propose its own modifications x; in case of rejection, the procedure ends with the status quo q. x is sent to the EP, which by majority can either accept x, and the procedure ends, or amend it with $\grave{b}$. The amended $\grave{b}$ is then presented in the Conciliation Committee. Next the Council moves: by QMV it can either accept the amendments, case in which the game ends with the adoption of $\grave{b}$, or reject the amendments and propose its own amendments b^*; if accepted by a qualified majority, b^* is sent to the EP; if b^* is rejected by the Council, the reversion point is again q. If the EP rejects b^*, the reversion point is q, according to the provision of twelfths[76]. If b^* is accepted by the EP, b^* is the adopted budget and the outcome of the game. The set of possible amendments $\grave{b}$ and b^* are continuous intervals of the entire set of possible budgets delimited by the status quo and the ceiling X_{FF} set by the FF: $q< \grave{b} < X_{FF}$ and $q< b^*< X_{FF}$. When the EP accepts the budget, the final outcome of the game reflects the Council's preferences.

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[76] If the budget is rejected, the provision of twelfths stipulates that, until the budget is adopted, the EU will function every month on a twelfth of last year's budget.
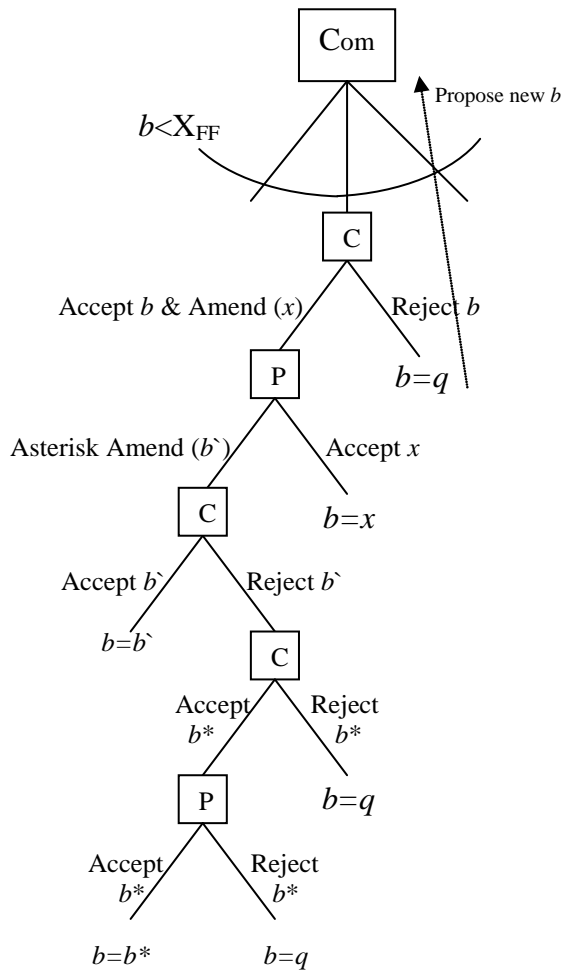
Figure 4. The Extensive form of the game

The game described above is solved[77] by using backwards induction and the concept of subgame perfect Nash equilibrium[78]; the equilibrium describes the optimal strategy for every player in every stage of the game, given the actions taken in prior stages. Backwards induction requires that, when players make a proposal, they do not necessarily propose their ideal positions but think ahead of subsequent stages and propose something that actually can become the EU budget.

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[77] Crombez (1997) solves a different variant of the game in a similar way.

[78] The subgame perfect Nash equilibrium describes a strategy that satisfies the Nash equilibrium condition (is optimal) in every subgame of the game, including the game itself.

The last two stages of the game are reached if there is no agreement on amendments to b, case in which both the Council and the EP vote on b^*. If the EP and a qualified majority in the Council prefer b^* to q, b^* is approved and becomes the annual budget; the set of possible outcomes b^* is described by the segment $[q, 2P\text{-}q]$. In the fourth stage, the Council compares $\grave{b}$ (the amended b) to b^*; if a qualified majority prefers $\grave{b}$ to b^*, the EP can successfully propose $\grave{b}$ in the third stage, given that $\grave{b}$ has the majority of EP. In Figure 2, the segment $[P, C2]$ represents the set of all possible outcomes $\grave{b}$ and b^*. If b^* is to the left of P (the ideal position of EP), the EP successfully proposes $\grave{b}$ to the right of P (the EP, C1 and QMV in the Council prefer an outcome to the right of $\grave{b}$). If b^* is to the right of C2, the EP successfully proposes $\grave{b}$ to the left of C2 (the EP, C2, and QMV in the Council prefer an outcome to the left of $\grave{b}$). If b^* is between P and C1, the EP cannot propose $\grave{b}$ as the EP prefers policies to the left of b^*, whereas QMV in the Council wants policies to the right of b^*, hence the outcome of the game is b^*. If b^* is between C1 and C2, it reaches the last stage of the game as QMV in the Council cannot agree on any policy change[79]. In the second stage, the Council compares b^* to q, and, since $b^* > q$, the Council always accepts the Commission's proposal. In the first stage, the Commission proposes the b that is closest to her ideal position, such that b=C2.

Proposition[80]: The set b* $\in$ [P, C2] of budgets that can be adopted under the EU budgetary procedure is the set of proposals that the EP and a qualified majority in the Council prefer to the status quo and there are no other proposals the EP and the Council prefer to them.

From this Proposition if follows that the Commission proposes a budget b^* that both the EP and QMV in the Council prefer to q (there is no other b that the EP and the Council prefer to

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[79] The other two cases produce a similar solution. When P is located between C1 and C2, [C1,C2] defines the solution set, with the difference that $\grave{b}$, not b^* is the adopted budget. When P is located to the right of C1 and C2, the solution set is [C1,P], with the difference that [C1,C2] represents $\grave{b}$ and [C2,P] describes b^*.
[80] Proposition similar to those used by Crombez (1997) to solve the game.

b*). In the second stage of the game, the Council approves *b**, neither the EP nor the Council can amend it, therefore the proposal reaches the last two stages of the game where it is approved by both the EP and the Council. Since the Commission is the advocate of an increase in the budget, it will make a proposal from the segment [P, C2] that is closest to her position – the ideal position of country C2.

As specified above, C2 is a member state pivotal for a move to the left that produces a lower budget, therefore it represents a net contributor. The likely outcome of the budget is the ideal position of C2, therefore C2 is the member state with the highest influence on the budgetary outcome. As more countries join the EU, the number of votes needed for QMV increases: before 1995, 54 votes were necessary, before 2004 the number increased to 62 and then to 232 after May 2004. This increase in the QMV strengthens the position of C2: not only does it influence the outcome, it becomes part of a more numerous coalition.

The winset [P, C2] described by the proposition depends on the median voter in the EP. When the winset is small, the EP's position becomes closer to that of C2, which influences agreement. The largest two European parties in the EP are the Christian Democrats and the Socialists. Even though these are European parties and behave somewhat differently than the traditional national parties, an increase in the number of Christian Democrats in the EP would move the position of P slightly to the left, as they favor more moderate budgets, whereas an increase in the number of Socialists would push P slightly to the right, as they advocate an increase in spending for the EU policies. Empirically, the number of Christian Democrats has increased since the creation of the EU not only as a result of enlargement but also as a consequence of government changes in Europe. However, when a country joins the EU, the total number of MEPs it brings to the EU is divided between its parliamentary parties, as the EP

129

election results usually mirror the party distribution in the Parliament of the acceding country[81]. Given this dispersion, enlargement has a rather weak effect on the location of P, which changes only marginally: the EP's influence on the budgetary outcome is not significant.

5.2 NEGOTIATIONS FOR THE 2008 EU ANNUAL BUDGET AND THE EMPIRICAL TEST

In order to test the predictions of the procedural game describing the EU annual budgetary procedure and the influence of the net contributors on the outcome I use a case study on the 2007 negotiations for the 2008 EU budget. This case study on the annual budget is also intended to test the incremental change that each annual budgetary outcome represents. This analytical narrative is based on data gathered through interviews, document analysis and 'soaking and poking' – participation in the budgetary committees of the Council and the EP[82]. This study of the 2008 budget is an appropriate choice because there were high distributional tensions in negotiations and the threat to have no agreement and thus no change was extremely credible. If endogenous and exogenous factors affect preferences and distributional benefits and increase the domination of net contributors in such a difficult case as the 2008 budget, than this effect is present in other cases of EU annual budgetary negotiations.

As pointed out in a previous section, the annual budgetary negotiations observe the ceilings established by the outcome of the FF negotiations and are mainly concerned with the

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[81] When a new country joins the EU, it organizes a special EP election in order to fill the positions of MEPs allocated by the Accession Treaty.
[82] The empirical research was conducted during the period July – December 2007 in Brussels.

redistribution of the margin available. The negotiations on the 2008 EU budget were centered on the margin available for financing the Galileo program that manages the European satellite navigation system. Launched in 2001, this program accumulated a delay of five years on its initial calendar and was confronted with difficulties regarding industrial governance and the transfer of risk to the private sector[83]. The Galileo joint undertaking launched a concession call in October 2003 and in July 2005 agreed to the creation of a consortium located in Toulouse and composed of eight partners[84], most of them operating in the big member states. The concession contract negotiations, intended to decide the deployment and exploitation of the Galileo system, started in January 2006, with pronounced conflict on the division of responsibilities and the location of ground installations; at the beginning of 2007, negotiations came to a halt. In June 2007, the Transport, Telecommunications and Energy Council acknowledged the failure of the concession contract negotiations and asked the Commission to present alternative proposals for the financing of Galileo. Further, the June 2007 European Council called on the Council to make a decision[85] in the fall.

These developments transformed the 2008 annual budget negotiations into a debate on the redistribution of funds to finance Galileo. On 19 September 2007, the Commission proposed a revision of the FF to increase the financing of Galileo[86] (proposal *b* in the game). The Commission claimed 3.4 billion Euro additional funding for a Galileo full operational capability by 2013, out of which only 1 billion is stipulated by the FF, the remaining 2.4 billion to be obtained by an increase in the FF ceilings. This implied an increase in the ceiling of heading 1A – 'Competition for growth and employment', where Galileo and the European Institute of

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[83] Commission Communication COM/2007/0261.
[84] The eight partner companies are: AENA, Alcatel, EADS, Finmeccanica, Hispasat, Inmarsat, Thales and TeleOp.
[85] This decision is subject to QMV.
[86] Commission Communication COM/2007/0534.

Technology (EIT) are included, by 2 409 million Euro for 2008-2013, while decreasing with the same amount headings 2 – 'Preservation and management of natural resources' and 5 – 'Administration' for 2007 and 2008. In addition, a redeployment of 300 million Euro from the 7th Research Framework Program – the transport section was granted in favor of research funding for Galileo and 309 million Euro for the financing of EIT. Even though the Commission claimed that this proposed redistribution did not require additional funding, in practice it increased member states' contributions because it used an unusual amount of the margin of the FF (otherwise left mostly unspent). This was motivated by the fact that Galileo was crowded out by enlargement expenditure in headings 2 and 5.

The Commission's proposal was strongly supported by the EP, which conditioned the negotiations on the 2008 budget, in particular the success of the November 23 conciliation meeting (acceptance of b^*), on finding a favorable solution for the financing of Galileo. The Council disagreed with the approach of the Commission and urged it to draft a different proposal that did not increase the ceilings of the FF (in this respect $b=q$ and the Commission considers a new proposal). The EP was willing to revise the FF but opposed any form of inter-governmental funding proposed by the Council and the financing of Galileo from the redistribution of funds under heading 1A. On 25 October, in the first reading the EP voted the following 'asterisk' amendments ($\grave{b}$): for the financing of Galileo and EIT—739.1 million Euro (higher than the FF ceilings for heading 1A); it placed in reserve some administrative and operational budget lines, to be released under certain conditions; it voted a series of Pilot projects and Preparatory actions and it restored the amounts cut by the Council in first reading (x) for heading 2 – 'Preservation and management of natural resources' and decentralized agencies; on heading 3A, the EP increased appropriations for the Frontex agency; on heading 4, it reduced the CFSP budget by 40

million (20%) to be used for external under-funded programs; it also included 47 million for Kosovo and Palestine. The total budget amount proposed by the EP was 129.69 billion Euro in commitment appropriations and 124.2 billion in payment appropriations (0.99% of EU GNI).

In the second reading, the Council responded to the EP's amendments by maintaining the Council's first reading amount for headings 1, 2, 3B and 4 (proposed $b^*=x$) and added 85 million for the CFSP mission in Kosovo but accepted the appropriations proposed for Frontex (heading 3A). The Council also released a declaration arguing for the funding of Galileo within heading 1A. The total amount proposed by the Council (proposal $b^*>x$) was 127.92 billion in commitments and 118.66 in payments (0.94% of EU GNI).

Some of the net contributors favored a redeployment within heading 1 A to finance Galileo (and the EIT). The UK, Sweden and the Netherlands signed a declaration[87] requesting the Commission to seek redistribution of funds within heading 1A. Germany also supported a redistribution within heading 1A. In the beginning, Germany proposed that the additional 2.4 billion for Galileo could be financed either by national contributions of the member states and the European Space Agency (ESA) or by 50% national and ESA contributions and 50% from heading 1A - the additional 700 million from unused commitment appropriations within heading 1A[88]. With the support of the net contributors, the proposal of redistribution within heading 1A met the QMV threshold in the Council's first reading. On the contrary, Austria had a singular position, as it did not support a reprioritization within heading 1A, claiming that Galileo cannot be treated as more important than programs like the Research FP or the Trans-European Networks; Austria called into question the total of 3.4 billion requested, emphasizing the lack of an appropriate assessment of the risks (and costs) implied by Galileo. In their turn, France,

[87] Available in the meetings of the Budget Committee of the Council, October 2007.
[88] COMBUD 243/07 used in the Budget Committee of the Council (October 2007).

Spain, Poland and Greece did not agree with a reduction in ceiling 2 for agriculture, Ireland, Finland, the Czech Republic, Romania and Poland agreed with a redeployment within heading 1A, Finland and Latvia argued for a use of heading 1A margin, Spain was for a financing of Galileo from the 7th FP and Belgium and Luxembourg continued their tradition of supporting the Commission[89].

The most important issue to be solved between the Council and the EP was the funding of Galileo and the EIT and to a lesser extent the CFSP appropriations for Kosovo. As predicted by the game, if agreement is reached in the conciliation meeting, than the last two stages of the game are not reached. This prediction is supported empirically: agreement was reached in the conciliation meeting: 120.35 billion in payments – 0.96% of EU GNI – (285.25 million for CFSP, as requested by the Council, out of which 70 million mobilized by the flexibility instrument, as requested by the EP). The agreement stipulated the revision of the 2007-2013 FF to finance Galileo as follows: 400 million from the transport section of 7th Research Framework Program, 200 million redeployed within heading 1A, 300 million from the FF margin for heading 1A in 2008-2013; 1600 million increase in heading 1A commitments (2008-2013) offset by the same amount in commitments for heading 2 for 2007 (a reduction in agriculture was accepted only for 2007, a particularly good year for European agriculture and thus for taxpayers). For the 2008 budget, Galileo obtained 940 million in commitments (151 were already in the Commission's initial proposal for 2008, 50 million from 7th FP and 200 million from the flexibility instrument) and 300 million in payments (100 million already in the proposal) and the EIT received 2.9 million (same amount as the Council's first reading).

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[89] Participation in the meetings of the Budget Committee of the Council (September – December 2007).

The annual budgetary outcome represents incremental change. While the final agreement on Galileo contains some elements from the proposal of the Commission – i.e. the reduction in heading 2 ceilings offset by an increase in heading 1 and redistribution from the transport section of the 7th FP – it is dominated by the positions of the net contributors – use of margins and redeployment within heading 1A – who refused to increase their contributions to the budget. This outcome is consistent with the predictions of the procedural game on the annual budgetary negotiations: knowing the equilibrium of the game, the Commission will propose country C2's ideal point, as this proposal will meet the QMV threshold.

The agreement on Galileo represents the ideal position of three net contributors who formed the center of the QMV coalition. The position of these net contributors (use of margin and redeployment within heading 1A of the FF) is an effect of the exogenous shock of enlargement and the endogenous mechanism of reinforcement and learning about preferences and distributive implications. In the annual budget, the mechanism that is reinforced is the FF itself, through its margin, hence the insistence of net contributors to maintain as large a margin as possible but use the margin instead of an increase in the FF ceilings, which would have meant an increase in their contributions to the EU budget. Given that Galileo was a European priority, the alternative to a FF revision would have been intergovernmental financing, which would have increased the financial burden of the net contributors even further, thus undermining instead of reinforcing the institution of balance. The outcome of negotiations shows that the FF is an institution that reinforces itself in the annual budgetary procedure: an increase of the FF ceilings is not possible and the role of the annual budget is to redistribute funds within the FF ceilings in order to finance European projects. The link between the distributional benefits insured by the FF outcome and the annual budget becomes explicit: in the FF, net contributors claim

distributional compensations, whereas in the annual budget they try to maintain as large a margin as possible in order to preserve the benefits deriving from these compensations.

The Commission opposed the positions of the net contributors, as it considered that the heading 1 A margin should be left unallocated to accommodate any unforeseen events; as well, the Commission opposed a redeployment within heading 1A, arguing that the programs under this heading are subject to co-decision and therefore very difficult to renegotiate[90]. The final agreement is accompanied by a declaration stating that the outcome on Galileo (redeployment but no increase in FF ceilings) does not constitute a precedent and "the use of funds from the margin of the previous year is an exceptional measure and will in no way set a precedent for future revisions."[91] However, it should be noted that budgetary discipline requires that the margins should be exhausted before the flexibility instrument could be used; therefore the 300 million increase in the margin represents a match for the mobilization of the flexibility instrument in the funding of Galileo, thus preserving the interests of the net contributors.

While in the annual budget net contributors try to maintain as large a margin as possible in order to preserve their distributional benefits, the EP wants to increase expenditures, therefore every year the EP proposes a full use of the margins: officials working on the budget argue that the annual procedure is in fact a battle on the margins[92]. While there is always a net contributor that is pivotal for a decrease of the budget, a country that is not a net contributor is less influential on the annual outcome: on the 2007 budget for instance, Finland insisted on reducing the number of administrative posts allocated to the European institutions; even though it held the

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[90] Participation in the meetings of the Budget Committee of the Council (September – December 2007).
[91] Council Document 15717/07.
[92] Interviews with officials working on the budget.

Presidency of the Council and thus managed to push the issue high up on the Council's agenda, it failed to influence the outcome[93].

6.0   CONCLUSIONS AND FURTHER IMPLICATIONS

6.1   SUMMARY OF FINDINGS

This dissertation proposed and tested a dynamic model of institutional change that analyzed the exogenous and endogenous factors that contributed to changes in preferences and distributional implications of institutional arrangements; the exogenous factors are economic – a difference in levels of economic development – and political –EU enlargement. The endogenous processes identified are learning – awareness of a change in preferences and benefits – and reinforcement of institutions that are part of the older institutional arrangement but have the potential to restore/increase distributional benefits for the disadvantaged players. The theory related these endogenous and exogenous gradual changes to changes in institutional equilibria, initiated by the inconsistency between preferences and benefits obtained from (past) agreements: the players whose benefits decrease push for renegotiating the institutional bargain that is no longer in equilibrium. The game theoretical bargaining model demonstrated how renegotiation is realized through issue-linkages and how the most powerful players obtain an outcome as close as possible to their preferences. The outcome of (re)negotiations is characterized by layering – the co-existence of old and new institutions that are added as a result of the influence of the disadvantaged players.

The empirical evidence presented in Chapters 4 and 5 supports the propositions of the model, showing that institutions-as-equilibria create strategic opportunities for institutional change. When the FF is negotiated, every five to seven years, depending on the time horizon of the negotiators, dramatic changes occur. On the contrary, in the EU annual budgetary negotiations changes are incremental, at the margin left by the FF, which in this case represents institutions-as-constraints.

The analytical narratives of the last two FF negotiations show that the exogenous political factor of enlargement and the lower degree of economic development of the newer member states led to a change in the preferences of the net contributors, enabled by a deterioration of the implications of the FF. The endogenous mechanism of reinforcement made the 'balance' issue more salient and pointed to the rebate as an equilibrium solution. Net contributors became aware of a change in preferences and distributional benefits and, at the moment of FF renegotiation, used issue-linkage to restore their advantages; they managed to obtain an outcome as close as possible to their preferences. This dominance of the net contributors is also revealed in the annual budgetary negotiations, where institutions change incrementally, within the margin stipulated by the FF. Last but not least, the empirical results prove the dual face of isntitutions: while the FF outcomes represent institutions-as-equilibria, they act as institutions-as-constraints for the annual budget.

In spite of the realization of both significant and incremental change, the empirical findings underline the fact that past/locked-in institutions coexist with new ones, as a result of the process of layering. This is to say that the new equilibrium that emerges does not represent a complete break with the past but contains some elements of continuity. It is fair to say that the net payers are the masters of both continuity and change, as they managed to keep a low level of

EU finances – very close to 1% – and succeeded to obtain correction mechanisms that reduced their financial burden.

The analytical narratives on the FF negotiations test the predictions of the bargaining model and the impact of the differences in preferences and payoffs on the institutional outcome. In addition to the implications for institutional change, the last FF negotiations can be taken as an example of how a heterogeneous collective body solves the problem of resource allocation: the exchanges that happen during negotiations are such that the net contributors give up their position on cohesion in exchange for the net beneficiaries agreeing to move on balance towards the positions of the net contributors. Because the balance issue is an institution that represents the overall size of the budget, an outcome on this issue that is close to the position of the net contributors gives the measure of their bargaining success. This influence of the net contributors on the size of the budget and its institutions does not imply that the players with high salience on agriculture and cohesion are not influential on the respective issues. On the contrary, given the directions of the exchanges, the outcomes on those two issues are influenced by the net beneficiaries; however, the magnitude of this influence (computed as the difference between the initial prediction of the 'compromise model' and the final prediction of the game) is much smaller and it represents the concessions ('shopping list') obtained by the net beneficiaries.

The analytical narrative on the EU annual budget shows a residual influence of the net contributors on the distribution of the margin between the actual expenditure and the FF ceilings. In spite of the small magnitude of the margin, the net contributors maintain their influence on the outcome. When compared to the unanimity rule that governs the FF negotiations, the influence of the net contributors follows a different dynamic due to the fact that the voting rule for the annual budget is QMV. The prediction of the procedural game rightly shows that the net

contributors succeed in influencing agreement by building a coalition on their conservative preferences. Specifically, the analytical narrative on the 2008 budget proves that the outcome on the funding of the Galileo program was highly influenced by the preferences of the net contributors.

6.2   CONTRIBUTION TO THE LITERATURE

This dissertation improves our understanding of political processes and outcomes. By explaining both radical and incremental change, it contributes to the literature that has attempted to explain institutional change – a complex process whose complexity has eluded most political scientists. Most importantly, the empirical findings explain how locked-in institutions can be changed, in spite of high competition for scarce resources; besides exogenous and endogenous factors, the distribution of benefits and the power of players are the defining factors that affect institutional change. Players bargain for the distributional implications of the institutions-as-equilibria and institutional change occurs through renegotiation, as each actor wants to scrap the rules that are no longer advantageous and create new ones that bring more benefits. The asymmetries of power are reflected by the outcome, as the final agreement is determined by the players with more resources who advance the rules closer to their distributional preferences.

The game theoretical elements of the dissertation show that the dynamic component that has been long missing in bargaining games can be added by simply allowing preferences and payoffs to vary; in this way, the rational choice oversight of taking preferences as given is avoided. Further, the classical notion of preferences is enriched through the conception of two input variables that represent preferences: a player's position on an issue and the salience it

attaches to the issue negotiated. The specificity of the bargaining and procedural games presented by this dissertation allows a logical and precise description of players' strategies in every round of negotiations, their influence on one another through issue-linkages, and their influence on the final outcome.

This dissertation enriches the historical institutionalist literature with an analysis of both exogenous and endogenous mechanisms of change. While institutions represent the equilibria of bargaining games, economic and political exogenous factors and the endogenous mechanisms of learning and reinforcement work gradually in between the moments in which new equilibria are constructed. This dynamic account of institutional change proves that time matters not only for stability but also for change.

In the realm of the European Union studies, this dissertation advances our understanding of EU budgetary procedures but also of mechanisms that affect member states' interests and benefits deriving from European integration. First, the bargaining and procedural models proposed contain specifications of EU decision-making that could be applied to other legislative negotiations, thus accommodating the search for generalizations in political science.

Second, the empirical findings add to the explanations of European integration, in particular economic and financial integration. The story of the EU budgets shows how integration has progressed through the EU budget and how it was affected by enlargement. The findings are also telling on prospects of future enlargements for both old and new members: a country that joins the union as a net contributor could have a significant impact on the dynamics of the EU budgetary negotiations, whereas a potential net beneficiary could further polarize the issue of balance.

Third, while the budget is small compared to national budgets and has little macroeconomic significance for the Union, it represents a very important autonomous source of financing for the European policies. These European policies have had a tremendous impact on the development of EU member states, hence the acrimonious battles over the 'tiny' pool that is the EU budget. The results of EU budgetary negotiations demonstrate that any increase in this pool would have to be initiated by the net contributors.

Fourth, this dissertation increases the transparency of EU budgets and EU decision-making by explaining the interplay between intergovernmental and supranational institutions. While it is difficult to obtain an exact account of what happened, some theoretical lenses like rational choice historical institutionalism could be useful for understanding EU decision-making. In particular, the outcomes of the EU budgetary negotiations prove that the intergovernmental aspect of EU decision-making is critical. This is a lesson that the supranational bodies, the Commission and the EP could profit from if they want to increase their influence on EU policy outcomes. In particular, the facilitator role of the Council Presidency is a good model to follow: the Commission and the EP could try to boost their power by facilitating issue-linkages in a manner similar to that of the presidency in the FF negotiations.

From an international relations perspective, this dissertation adds to the negotiation models that have tried to explain how preferences and institutional constraints are translated into equilibrium outcomes. The preferences of actors and the distributive payoffs accompanying the agreement are critical for determining political outcomes: the goal of every player is to obtain an outcome as close as possible to her preferences. The solution offered by the EU budgetary negotiations enriches the negotiations literature by offering a model for the allocation of scarce resources in spite of high political conflict and an increased heterogeneity of players. Obtaining

agreement through issue-linkage is a good solution in politically difficult bargaining situations and could be replicated in other situations where players have equal weights (i.e. unanimity is the voting rule).

Last but not least, it is worth pointing out that the explanations of institutional change offered by this dissertation cannot explain every case of institutional change. In particular, because the model proposed depends on exogenous and endogenous factors affecting preferences and payoffs, it cannot explain how change happens in an institutional arrangement that does not have distributional implications. As well, the model proposed cannot explain a case where preferences change but the distributional benefits deriving from an agreement do not vary and it leaves open the question of what happens if only some exogenous or endogenous mechanisms, but not all are at work.

6.3   IMPLICATIONS FOR SUBSEQUENT FF NEGOTIATIONS

The main lesson for any EU budgetary negotiations/reform is twofold. First, while change in the annual budget is incremental, the FF negotiations provide the opportunity for radical change. Second, in any reform, old and new must coexist. In addition but similar to the renegotiation clause that exists in every FF, the 2007-2013 FF contains a clause for future change – the 2008/2009 budgetary review. This represents the resolution to undertake a wide-ranging budget review in 2008/09, covering all aspects of both spending – including the CAP – and resources – including the UK rebate. This is testimony of the fact that the distributional benefits are expected to deteriorate and the member states mostly affected wanted to ensure that renegotiation would be timely such that the benefits could be restored/reinforced. The presence of the budgetary

review clause in the final agreement also shows that the learning process has reached maturity and those affected by exogenous and endogenous factors have learned to better protect their interests.

Due to its potential for institutional change, the 2008/2009 budget review represents an important element in the European construction. The EU budget review was effectively launched in September 2007 with a public consultation inviting all interested parties to express their views on the matter[94]. In November 2008, the Commission also organized a public conference on the results of the public consultation. However, at the moment uncertainty is very high regarding both the political willingness and the content of the reform.

The current structure and implementation of the EU budget is highly redistributive and not necessarily related to actions justified at EU level. One of the main restraining factors for the EU in a globalized world is the disconnection between the EU policies and their financing. While the launching of the Lisbon Strategy was an important step towards coping with the dynamics of globalization, the financial resources available at the EU level – approximately 1% of EU GNI – are minor when compared to the size of national budgets – 40 to 50% of the national GNI.

This dissertation emphasizes the possibility of change that can be applied to the EU budget review; most importantly, it prescribes that radical change can be obtained only in the FF negotiations, and not otherwise. The 2008/2009 budgetary review has the task of proposing change and this change is bound to take into account the diverging preferences of the EU actors. While net contributors are extremely influential in obtaining change in the form of distributive corrections, this does not mean that all budgetary institutions can be changed. It is fair to say that

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[94] As part of the consultation process, the Bureau of European Policy Advisers of the European Commission organized an academic conference in April 2008 on the EU public finances and a series of 4 workshop in January-March 2009 on the possibility of changing the EU budget.

some parts of the budgetary framework are difficult to change, for example the governance of the EU budget– the rule of unanimity voting in the FF negotiations. However, the so-called 'passarelle clause' of the Lisbon Treaty tries to offer a solution of change for this governance problem: while the decisions on own resources still require unanimity in the Council, the Council may act by qualified majority on the FF but only following a unanimous decision of the European Council.

There have been some proposals to change the EU budget. The *Boege* and *Sapir Reports* (2004) propose reforms of the main EU policies. The authors argue that there should be a shift in spending from redistributive agricultural and structural programs to public goods provision, which would be welfare-enhancing. The *Sapir Report* recommends that 45% of total spending should be used for public goods (especially in infrastructure and research), 35% for industrial convergence and only 20% for restructuring programs including agriculture. The *Boege Report* proposes changes on the revenue side – 25% co-financing by member states of EU agricultural spending; if total EU spending remains stable, this should increase the room for EU spending on public goods and moderate member states' incentives to ask for more EU spending.

Another possibility for change is the introduction of a new, separate public goods budget encompassing all or a subgroup of member states and based on individual contributions rather than general rate based payments. This new budget could be implemented by using the existing option of enhanced cooperation; the member states agreeing on a separate provision of public goods should not only profit from the benefits of these goods, they should also bear their costs. There should be an individual right of termination, so that member states could commit in the short-term but drop out in the long term if they so wish. To make sure that pareto-improving public goods projects are supported, every member state should have the right to propose new

projects within the public good budget. (Blankart and Koester 2009) However, one needs to be aware that there are management problems created by funds outside the EU budget, like the management of the European Development Fund has demonstrated.

Coalition theory argues that the larger the size of the winning coalition, the more public goods are provided; the smaller the coalition for changing the status quo, the higher the chance for pork barrel. According to this theory, given that the EU has a high threshold for changing the status quo (like the US), the likelihood for producing public goods at European level increases. However, put in historical perspective, this theory implies that there are public goods already provided at EU level and financed through the EU budget. Some existing policies, like the cohesion policy or the neighborhood policy are redistributive but to some extent could be considered public goods.

A question that could be raised is if the agreement on producing public goods at European level is a zero-sum game. One could argue that public goods cannot be clearly separated from redistribution: member states will still have a distributive interest in European public goods, as the public goods that should be provided at European level are those that member states cannot produce efficiently (the subsidiarity test). Since public goods have a distributive component, a political debate in the context of economic and political integration is necessary in order to decide which European public goods should be financed from the EU budget.

A more realistic proposal for change is to increase the flexibility of the FF. The FF establishes ceilings for each heading of expenditure, while the annual budgetary procedure determines the spending in each category. However, historical evidence shows that actual spending is below the authorized spending ceilings agreed under the FF. The case study on the

annual budget demonstrates that proposals for revising the FF ceilings due to unforeseen events occur in the annual budgetary negotiations. Further evidence in this respect is the most recent Commission proposal to revise the FF in order to provide additional resources for the European Recovery Plan. To account for the unspent margins of the FF ceilings, Buti and Nava (2008) propose a 'constrained flexibility' clause to allow flexibility across different headings of the FF and accross different years. This proposal implies that the total ceilings of the FF should be respected for the overall period of the FF, rather than in every single year; in this way, the overall size of the multi-annual package is preserved but an increase in a ceiling in a given year could be compensated by a decrease in another ceiling or in a different year. This flexibility has the advantage that it would allow the reallocation of expenditure towards Lisbon-related programs.

Another alternative for change in the EU budget is the channeling of some independent resources to the EU budget. There are some true EU resource that belong to the EU level, therefore they should be included in the budget: the two most obvious examples are the receipts from the emissions trading scheme and the monetary income of the European Central Bank. (Begg et al 2008) However, one could make a case for the independence of these resources: the climate change package could be viewed as an example of a common interest – i.e. public good – that has a successful mechanism outside the EU budget that generates resources, therefore one could question the need to integrate it in the EU budget.

Last but not least, the EU budget could be changed to have a macroeconomic role, i.e. a role in the financial and economic crisis. One possibility in this respect could be the creation of a 'rainy-day' fund, an enhanced globalization fund or a solidarity fund that could channel aid through the EU budget. (Begg et al 2008) This 'rainy-day' fund could be built up in good times and spent in bad times and it could be financed either by individual contributions of member

states or through some European tax. However, such a fund could raise problems related to political control and the temptation to spend the money in good times.

The goal of this dissertation was to explain institutional change in the EU decision-making and to determine how preferences of member states change over time and translate into institutional outcomes. The theory on how institutions-as-equilibria change provides a compelling account for these processes. This research will act as a catalyst for scholars who will seek to better understand how institutions change, particularly how institutions go in and out of equilibrium

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