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Eurozone Crisis Management in Neofunctionalist Approach

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EUROZONE CRISIS MANAGEMENT IN NEOFUNCTIONALIST APPROACH

Ph.D. dissertation

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This dissertation is dedicated to my parents.

1. INTRODUCTION

1.1. Delimitation and overview of the research project

Following the Second World War, six Western European nation-states (Germany[1], France, Italy, Belgium, the Netherlands, and Luxembourg) created a brand new political entity. The new organization soon became a unique phenomenon in the international relations. This uniqueness was the result of its institutional, decision-making and legal system. The new enterprise of independent states can be evaluated as a great success story of the European history. This is because the European Community (EC) – now the European Union (EU) – has been able to guarantee a long-lasting peace among the participant countries. Furthermore, eleven members introduced a single currency – the euro – on 1 January 1999, which resulted in a new phase of cooperation.

Partly due to these facts, the future (development trajectory) of the EU has always been a key question in the history of the integration. The significance of this issue became even more topical after the global financial and economic crisis of 2008-2009, which further exacerbated the economic, social and political problems of the Community[2].

The negative impacts of the crisis were most evident in the Eurozone (Euro Area), since the sovereign debt problems in certain member states jeopardized the entire Economic and Monetary Union (EMU). The potential collapse of the Eurozone and the single currency became a real threat to the European project (Aslett and Caporaso [2016]; Dyson [2017]). The depression made it clear that the EMU had been malfunctioning for many reasons. On the one hand, it became evident that little emphasis had been put on the coordination of the member states' economic policies in the original architecture of the monetary integration in the beginning of the 1990s. While monetary and exchange rate policy became a truly common policy in the case of Euro Area members, the economic side of the EMU (i.e. the fiscal policy) remained in the hands of the nation-states. On the other hand, the EU did not have any risk mitigation tools and mechanisms at all to manage potential crises. These failures and

[1] Of course, this meant West Germany until 1990.
[2] In order to avoid repetition, I use the terms European Community, European Union, and European integration interchangeably in the thesis. Of course, it has to be noted that these terms are not exactly the same.

shortcomings altogether made it impossible for the Community to take effective measures to manage the situation.

Copelovitch et al. [2016], in their comprehensive article, study the political economy of the Eurozone crisis. The authors emphasize that a growing consensus can be perceived among economists about the causes of the crisis. They mention four unresolved issues (macroeconomic divergence, lack of fiscal policy coordination, fragmented financial regulation and lack of a credible no-bailout commitment) that contributed to the eruption of the crisis. The issue of significant *macroeconomic differences* between the core and peripheral countries was one of the underlying problems. Since the establishment of the EMU led to the monetary integration of highly differentiated economies, this heterogeneous community could not meet the criteria of an optimal currency union. It was simply impossible for the European Central Bank to conduct different monetary policies for 'Northern' and 'Southern' member states. As a result, core countries with moderate GDP-growth rates and low inflation faced with positive real interest rates, while peripheral states with higher growth and inflation experienced low or negative real interest rates. These differences resulted in capital flows from core countries to less developed economies within the EMU, and caused serious balance-of-payments imbalances. Simply put, initial macroeconomic divergence among the members generated asymmetric capital flows, which accelerated the underlying divergences. In addition, EMU-members *did not coordinate their fiscal policies* to alleviate the above-mentioned problems. Although the Stability and Growth Pact was introduced in 1997, it was unable to enforce the rules in many cases. Besides macroeconomic divergences and insufficient fiscal coordination, *decentralized financial regulations* also contributed to the outbreak and escalation of the Eurozone crisis. The high degree of interconnectedness of European financial markets intensified systemic (macro-prudential) risks. However, in the absence of a monitoring mechanism, these problems remained unnoticed until the crisis. Finally, financial markets did not believe the *no-bailout commitment*. As a result, spreads on borrowing by economic players fell sharply following the introduction of the single currency (Copelovitch et al. [2016]).

Recognizing these failures, member states decided to launch reforms with the aim of strengthening the European Economic Governance (EEG). However, sovereignty and economic nationalism (protectionism) came again to the forefront of public debates, which made it difficult to improve the functioning of EMU.

The story is important from a *theoretical* perspective too. The ambivalent reactions of the member countries raise the question (or "puzzle") of which integration theories have the capacity to explain these processes adequately. The history of the European integration has clearly shown that major crises always led to the strengthening (deepening) of the cooperation. However, this statement is now not obvious due to the complexity of the Eurozone crisis and crisis management. The strengthening of European Economic Governance raises a number of issues and conflicts that make the outcome of the integration uncertain (Benczes and Kollárik [2021]; Benczes [2020]).

The dissertation examines the Eurozone crisis management from a theoretical aspect in order to answer, whether neofunctionalism can provide a useful theoretical framework following the crisis. Accordingly, the thesis has three major interrelated *research questions*. These are as follows:
1) Can spillover triggers be detected that are strong enough to make the initial equilibrium unstable?
2) Do spillover triggers lead to vertical institutional outcomes that result in the deepening of Economic and Monetary Union?
3) Can endogenous spillover triggers and/or vertical institutional outcomes be identified in terms of the European Banking Union (EBU) and the European Fiscal Union (EFU)?
Based on the research questions, we formulate the following hypotheses:

<u>Hypothesis 1 (H1)</u>: The global financial and economic crisis of 2008 and 2009, as an exogenous spillover trigger, generates through the sovereign debt crisis further endogenous spillover triggers in the Economic and Monetary Union. The dissertation departs from the hypothesis that the global financial and economic crisis of 2008-2009 can be assessed as a critical economic exogenous shock. By the term 'critical' we mean that the shock was strong enough to have a serious impact on the system of the Economic and Monetary Union (and the European Union). The crisis revealed the latent problems and weaknesses of the EMU's original architecture. This external shock contributed to a large extent to the outbreak of the European sovereign debt crisis in the beginning of 2010, thus having become an endogenous shock. As a result, functional, political and institutional spillover triggers arose. Simply speaking, an initial exogenous trigger led to a critical juncture within the EMU, which generated internal triggers. This process can be defined as the first pillar of the spillover mechanism. The hypothesis also suggests that European integration may progress not just through its own internal dynamics, but due to external factors as well.

Hypothesis 2 (H2): Endogenous triggers lead to institutional outcomes that result in the deepening of the Economic and Monetary Union. This hypothesis claims that endogenous pressures arising from the dysfunctionalities of the EMU result in answers (actions) that contribute to vertical integration. Vertical integration (deepening), the second pillar of the spillover mechanism, may take different forms. This issue of operationalization will be discussed in detail in subsection 2.3.

Vertical (institutional) outcomes, in principle, end up in the improvement of the functioning of the EMU. However, spillover mechanism may have different types of feedback. If vertical integration takes place, the effect of institutional outcomes may generate positive or negative feedback. In this context, a single positive feedback means that an improvement in the functioning of the integration eliminates the initial triggers (dysfunctionalities). However, in the case of a dynamic positive feedback, an outcome may generate further endogenous triggers or critical junctures. For instance, these triggers may be the need for the modification (or fine-tuning) of previous vertical outcomes. Alternatively, new critical junctures (triggers) may arise which lead to the deepening again. This is in line with the theory's original version that emphasizes the internal dynamics of integration. The presence of negative feedback may be a third scenario when spillover outcomes finally turn out to be inadequate or even harmful to the integration process. Practically, it means that member states did not manage to respond to the triggers effectively. Consequently, dysfunctionalities need to be resolved in other ways.

In the case of *no vertical institutional outcomes* (no vertical integration), the functioning of the EMU does not improve because dysfunctionalities, and thus the triggers continue to exist.

Hypothesis 3 (H3): Spillover triggers and outcomes can be detected and identified regarding the plan and implementation of the European Banking Union (EBU)

and/or the European Fiscal Union (EFU). European sovereign debt crisis compelled the member states to take effective measures in order to safeguard the single currency. Consequently, the strengthening of the European Economic Governance became an indispensable task within the Eurozone. Nevertheless, crisis management proved to be a difficult process as (economic) nationalism got new momentum. Furthermore, the issue of burden-sharing among the members made the reforms even more troublesome. Despite these hardships, significant steps have been made, however, they took multiple forms. H3 alleges that European Banking Union and European Fiscal Union prove to be good examples of spillover triggers and outcomes.

Accepting the hypotheses has theoretical and practical consequences as well. From theoretical point of view, this means that neofunctionalism is not an obsolete approach, and it can make a meaningful contribution to the explanation of the integration process in the long run. From a practical aspect, on the other hand, it extrapolates the deepening of the EMU that may finally improve the efficiency of the European Economic Governance and the functioning of the Eurozone.

The dissertation intends to *contribute to the existing scholarly literature* in three different ways. First of all, integration theory and its application is an underresearched area in Hungary. Accordingly, works on the European Union that study the integration in neofunctionalist framework, cannot be found in the Hungarian literature. Primarily, the thesis intends to fill this gap. Secondly, the work examines the Eurozone after the crisis of 2008-2009, so it extends the time horizon of the application of the theory to the post-crisis period. Generally speaking, it scrutinizes whether the theory has a satisfactory explanatory power regarding the reforms of the economic governance. Finally, in the thesis we apply an own analytical framework which is a slightly modified and transformed version of the neofunctionalist theory. It means that – on the basis of previous neofunctionalist works – we establish a new conceptual and methodological framework, and apply it in the case of European Economic Governance. In relation to this, new spillovers may be discovered.

Considering the fact that this is an extraordinarily complex field, it is also important to detail what is not addressed in the thesis. First, since we chose neofunctionalism as a theoretical framework, we do not deal with other approaches in detail. We do not claim that neofunctionalism is the only adequate theory. On the contrary, there are several coexisting approaches, and each tries to capture the processes from a different angle. Second, the thesis focuses exclusively on the Economic and Monetary Union following the sovereign debt crisis, however, neofunctionalism could be examined in the case of other common policies too (e.g. Common Foreign and Security Policy – CFSP). Third, in spite of the fact that European Economic Governance comprises many elements, we decide on the hypothesis based on the selected case studies. Of course, other mechanisms could be examined as well. Fourth, we do not deal with ongoing political and public debates about the future of Europe. Fifth, the thesis does not analyze the issue of disintegration in spite of the fact that it can be one of the possible scenarios as well. The outburst and impacts of the Coronavirus (Covid-19) crisis in the beginning of 2020 also provide a good field to test different integration theories, however, we do not deal with it in the thesis.

1.2. Theoretical and methodological framework of the thesis

The dissertation takes a *multidisciplinary approach*. It comes from the fact that we intend to study economic processes in a framework related to political science and International Relations Theory. The integration theory we chose as a *theoretical framework is neofunctionalism*. This is because, the crisis management and the underlying problems of the EMU's architecture provide a good field to test the theory. Of course, this is not to say that neofunctionalism is the only acceptable and adequate theory. Nevertheless, we argue that neofunctionalism is probably the best approach that has the capacity to explain the long-run transformation and development of the integration. As Cooper [2011] puts it, a theory such as neofunctonalism can only describe general trends, not laws of human behavior (Cooper [2011]). Niemann et al. [2019] enumerate several reasons why neofunctionalism should be a matter of research. First, the theory is transformative of nature. This feature means that neofunctionalism has the capacity to incorporate changes while retaining the core concepts and hypotheses. Second, the theory treats institutions as agents trying to improve the existing order. From this perspective, institutions are different from those of intergovernmental organizations, which are non-transformative and aspire to sustain the *status quo*. Of course, the success of transformation depends largely on the response of the key actors. Third, neofunctionalism focuses not exclusively on states and governmental players, but also on non-governmental actors as well. The assumption that non-governmental agents do play an important role in shaping the integration, has a great significance in the world of growing interdependence. Fourth, the theory is also dynamic in the sense of human behavior. According to this, actors are rational units who actually learn from the experiences of repeated interactions (‘repeated games’), and thus, the development of the integration is influenced by this practice. Fifth, in a broader sense, neofunctionalism may potentially be applicable in the case of other regional integrations. Finally, neofunctionalism, in its original version, deals with endogenous events, albeit the theory may also explain exogenous shocks (Niemann et al. [2019]). This argument is especially important from the perspective of the thesis since the global financial and economic crisis of 2008 was obviously an exogenous effect.

Besides the fact that neofunctionalism is worth to study, our objective is to introduce and apply a modified version of the theory by using an *own analytical framework*. Since the very beginning of the 1970s, many variations of the school have been established. All of them have added something to the theory, and thus, contributed to the literature of neofunctionalism. Based on these works, we focus on the spillover mechanism, which has always been the central methodological element of the neofunctionalist thinking. While retaining the theory’s basics, we amalgamate the different versions into a new analytical framework. The framework incorporates – *inter alia* – some conceptual and operationalizational amendments. The reasons why we intend to introduce a new analytical ‘toolkit’ are threefold. First, due to the significant level of interdependence, contemporary regional integrations cannot be isolated from external factors. Shocks coming from outside the EU may be strong enough to become endogenous and compel the integration to react by deepening. As Hansen [1969] notes, spillover process was largely seen as an internal phenomenon but external factors and the global environment were not included in the original neofunctionalist framework. He criticizes the Haas-Schmitter model, because it does not isolate and measure external factors that have an impact on the integration process (Hansen [1969]). Nye [1970] also stresses that external factors and players did not get sufficient attention in the original formulation (Nye [1970]). Incorporating the potential effects of exogenous triggers, the model can provide a more complex picture of the spillover mechanism. Second, it is reasonable to see the spillover mechanism as a complex and long-run process, which can be separated into causes (triggers) and results (outcomes) in a single model. Third, it is useful to establish a framework that can be adapted better to the features of contemporary world economy by taking relatively new non-governmental actors into account. Shortly, we offer a modified neofunctionalist framework, which is parsimonious, but amalgamates the major analytical elements of the previous versions of the theory. Furthermore, incorporating the influence of external triggers, neofunctionalist reasoning can be interpreted in a broader sense.

The thesis examines the explanatory power of neofunctionalism based on *exploratory case studies*. O'Brien and Williams [2020] argue that case study is one of the most common methods of studying phenomena in the field of International Political Economy (IPE). We accept and follow their definition, according to which *"[a] case study is a detailed investigation of a particular event or issue"* (O'Brien and Williams [2020: p. 28]). There are multiple reasons why we have chosen case study as a methodological tool. First, our goal is to investigate a contemporary phenomenon extensively. More precisely, we intend to test the explanatory power of neofunctionalism by analyzing two (potential) elements of European Economic Governance. In relation to this, we want to explore through the case studies whether spillover triggers and/or institutional outcomes can be detected. Put differently, exploratory cases serve as a field for testing our modified neofunctionalist framework (see *Figure 9*). Using the concept of Dul and Hak [2008], in the dissertation we use theory-testing case studies (Dul and Hak [2008]) in order to decide whether neofunctionalism provide an adequate explanation for the crisis management. Second, taking into account that we study contemporary events over which we do not have control, case study seems to be an appropriate methodological tool (see e.g. Yin [2014]). Third, the nature and complexity of the research topic and our model makes it (almost) impossible to apply other methods such as experiment, survey, econometrics, etc. As János Kornai [2019] emphasizes, there are systems, organizations and phenomena that are too complex to be modeled mathematically (Kornai [2019]). Fourth, the major neofunctionalist works also preferred this type of method to test the explanatory power of the theory (e.g. Haas [1958], Tranholm-Mikkelsen [1991]). Thus, we argue that case study can help the understanding of the crisis management process by making it possible to examine whether actual and/or potential spillover triggers and spillover outcomes can be detected. Put differently, the relevance of the neofunctionalist theory can be tested through the analysis of different cases. In this respect, our own analytical framework and the exploratory case studies are tightly intertwined since we apply the modified model to the cases. We draw on the case studies to test our own neofunctionalist framework. Accordingly, we intend to explore spillover triggers and institutional outcomes with the help of the model (see *Figure 1*). Finally, the results of the studies will make it possible to decide on the hypotheses.

Taking into account that EMU and the issue of economic governance are the focal points of the dissertation, we have selected two cases: the *European Fiscal Union (EFU)* and the *European Banking Union (EBU)*. The *case selection* can be justified by the following arguments. Prior to the crisis, there was no efficient instrument for the fiscal and financial pillars of European Economic Governance (Szijártó [2018]). However, tight interconnectedness between these two areas in the form of the so-called 'diabolic loop' makes the whole system vulnerable. The significance and risks of this relationship were also emphasized in the 'Four Presidents Report' in 2012, which envisaged the plan of the 'genuine Economic and Monetary Union' (Rompuy [2012b]). As a consequence, the simultaneous creation of the Banking Union and Fiscal Union would result in a qualitative change in the architecture of the EMU. Nevertheless, mostly due to divergent preferences, an asymmetric progress can be experienced in the two areas (Benczes and Kollárik [2021]).

The sovereign debt crisis has brought to the surface a series of problems, shortcomings and asymmetries of the Economic and Monetary Union. The fact that fiscal policies remained in the hands of the Eurozone member states resulted in a functional tension, which had to be handled by the countries. Therefore, the creation of a (potential) fiscal union came to the forefront of the debates in 2012 (Rompuy [2012a]). Although the idea of a fiscal union is quite controversial because there are several different and diverging preferences among the member countries. It is true that the protection of the Euro Area (as a public good) is a common interest, but the issue of burden-sharing leads at the same time to the clash of interests (Benczes [2020]). From this perspective one can easily argue that the existence of spillover triggers and effects is not obvious. Consequently, the case of the fiscal union is a good choice for testing neofunctionalism. Accordingly, European Fiscal Union is one of the case studies.

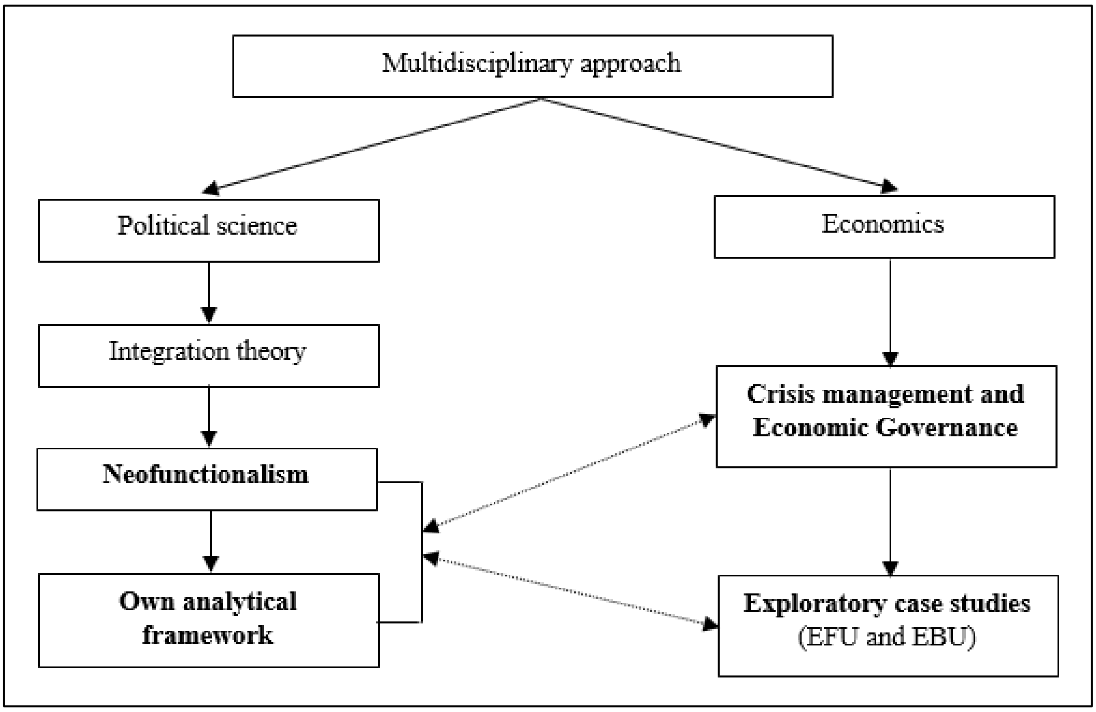
Prior to the crisis, countries exercised considerable authority over their banks (Epstein and Rhodes [2016]). Regulation and supervision of the financial institutions were in the hands of the member states in spite of the fact that the Single Market had come to existence already in 1993 (Benczes [2019]; Buda [2015]). However, as De Rynck [2016] notes, the idea of a supranational supervisory power has been floating in policy circles for more than two decades. Following the outbreak of the debt crisis, in June 2012, the EU decided to delegate banking supervision to the supranational level. On the one hand, it could be assessed as a breakthrough on the road to the Banking Union. At the same time, the loss of national control over certain competences was stressed by many member states (De Rynck [2016]. This ambivalence is described by Donnelly [2014] as the mismatch between functional and political demand for new mechanisms and the supply of financial stability (Donnelly [2014]). From another standpoint, this is a classical allocation problem of International Political Economy. In this context, providing financial stability should be perceived as a public good, and the debate is about the two major questions. The first question is about the financing (burden-sharing) of the Banking Union (the public good) while the second question focuses on the sharing of competences between states and the EU. From the perspective of neofunctionalism, one can raise the issue as follows: is it possible to explore spillover triggers and outcomes that (may) lead to the deepening of the EU? Accordingly, the other case study is about the Banking Union.

To summarize, common interests and diverging (colliding) national preferences can be detected in both cases. The costs of burden-sharing induce political conflicts among the member states and hamper the shift from the status quo. Put differently, the Pareto-improvement is hindered by the allocation conflicts (Benczes [2020]). From the perspective of neofunctionalism Pareto-improvement would be the result of the spillover mechanism.

Of course, the applied methodology has *limitations*. Here, the so-called generalization problem has to be mentioned which is the major disadvantage (limitation) of using case studies. Based on the two cases, it is impossible to draw conclusions regarding all areas of the EMU. However, the aim of the thesis is to test neofunctionalism as a ‘hypothesis’ during the post-crisis period. In this respect, if spillover triggers, or triggers and outcomes can be identified at least in one case, then decisions can be made on the hypotheses. If these tendencies or phenomena cannot be detected, the hypotheses have to be rejected. This would mean that in the case of Banking Union and Fiscal Union, neofunctionalism is not a relevant theory. Nevertheless, it does not indicate necessarily that the theory is obsolete or inadequate concerning the EMU (or EU) as a whole.

Figure 1 represents the methodological and theoretical framework of the research project in a schematic form.

Figure 1: The theoretical and methodological framework of the thesis



Source: Own figure

Given the nature and approach of the research topic, the thesis is based on the *processing of secondary literature* including books, scientific journal articles, policy papers, positions papers, public letters and speeches. In addition, the websites of European Union organizations and institutions are also among the sources. The following subsection contains the structure of the dissertation and the literature review, which summarizes the major references.

1.3. The structure of the thesis and the literature review

The thesis is divided into five chapters. Following the *Introduction, Chapter 2* (*Integration Theory and the Neofunctionalist Research Program)* provides a short overview on the field of Integration Theory and presents briefly the so-called proto-integration approaches. Section 2.2 elaborate the theoretical foundations and developmental trajectory of the Neofunctionalist Research Program. Finally, Section 2.3 presents the modified conceptual and analytical framework, which constitutes the methodological basis of the applied exploratory case studies.

In the scholarly literature, one can find some great books providing comprehensive description about integration theories. The best summaries are presented by Rosamond [2000], Bieling and Lerch [eds., 2006], Leuffen, Rittberger and Schimmelfennig [2013], and Wiener, Börzel and Risse [eds., 2019]. Surprisingly, as Diez and Wiener [2019] note, in spite of the fact that studying European integration is a booming field of research, only very few books deal with the integration theories (Diez and Wiener [2019]).

The classical model of neofunctionalism is based on the works of Haas [1958; 1961; 1964], Lindberg [1963], and Haas and Schmitter [1964]. In his seminal book, *The Uniting of Europe*, Haas [1958] scrutinizes the phenomenon of political integration in detail, and presents the expansive logic of sector integration (Haas [1958]). In a subsequent article (Haas [1961]), the author describes three different types of conflict resolution and tries to identify these modes of accommodation in Europe and other regions. He concludes that the European integration proceeds at a more rapid pace than universal integration (Haas [1961]). In *'Beyond the Nation-State'* (Haas [1964]), Haas elaborates and encapsulates the major elements of functionalism in a regional context (Haas [1964]). In their article, Haas and Schmitter [1964] establish a model to assess the chance of automatic politization in case of several regional integrations from Europe to Africa and Latin America. They find that, given the pattern variables, only Europe has a good chance to develop into a political union (Haas and Schmitter [1964]). Based on the works of Haas, Lindberg [1963] deals with *'The Political Dynamics of European Economic Integration'*, however, compared to Haas, he provides a somewhat different definition of the integration process. The major difference is that Lindberg does not postulate the transfer of loyalty and the existence of an end point, i.e. a dependent variable (Lindberg [1963]).

By the mid-1960s, neofunctionalism lost its dominance in explaining the European integration. At the same time, realist thinking gained momentum, and the article of Hoffmann [1966] led to the emergence of a new approach, the (classical) intergovernmentalism. Hoffmann stresses that nation-states remain the primary actors, and the spillover is limited by the coexistence of the logic of integration and the logic of diversity (Hoffmann [1966]).

From the end of the 1960s onwards, many scholars, including the founding fathers of the theory, have started to criticize and modify the neofunctionalist research program. Haas [1967], in his study, revises the original version of the theory in the light of the so-called 'De Gaulle phenomenon'. Furthermore, he questions the hypothesis that economic integration leads automatically political unity (Haas [1967]). According to Nye [1968], the concept of integration should be divided into three categories, economic, social and political integration. These types then can be broken down into further subtypes with a measurement (Nye [1968]). Schmitter [1969] elaborates three neofunctional hypotheses in order to clarify the theoretical premises. While the spillover hypothesis remains the focal point, the author introduces the concepts of two subsidiary hypotheses, externalization hypothesis and politicization hypothesis (Schmitter [1969]). Haas [1970], based on the initial experiences of the European integration project, scrutinizes the so-called 'dependent variable problem', i.e. the terminal condition of the integration process (Haas [1970]). Schmitter [1970] presents a revised theory of neofunctionalism. He defines several alternative actor strategies as dependent variables from which actors may choose to respond recurrent crises (Schmitter [1970]). Nye [1970] makes revisions in order to make the theory useful for comparative analysis. He introduces modifications regarding the dependent variable, actors, process mechanism and integrative potential (Nye [1970]). Lindberg and Scheingold [1970], in their book, focus on the potential scenarios of the European Community, i.e. on growth, stabilization and decline. The work presents numerous analytical models and case studies to give a better understanding of the integration (Lindberg and Scheingold [1970]). In spite of the efforts of revising neofunctionalism, Haas [1976] declared the theory obsolescent in the mid-1970s (Haas [1976]).

In 1986, the adoption of the Single European Act (SEA) gave new momentum to the evolution of the European Community. The implementation of the Single Market and the plan of the Economic and Monetary Union contributed to the deepening of the integration. In his essay, Tranholm-Mikkelsen [1991] intended to re-open the academic discussion on the relevance of neofunctionalism by examining the events between 1985 and 1990 (Tranholm-Mikkelsen [1991]). The debate on the integration theories in the 1990s was dominated by two emerging schools. Liberal Intergovernmentalism (LI), based on the works of Moravcsik [1993, 1995 and 1998], is a major revision of classical intergovernmentalism (Moravcsik and Schimmelfennig [2019]). In the Hungarian literature, Benczes [2018a] provides a very good overview on the theory and its major critiques. The other theory, supranational governance or supranational institutionalism, can be seen as a significant modification of neofunctionalism, however, its adherents refer to it as a separate school. While there are numerous elements showing similarity with the features of neofunctionalism, important differences can also be noticed (Stone Sweet and Sandholtz [1997]).

Regarding the uncertainty phase (subsection 2.2.5), we reflect on two major developments, postfunctionalism and the 'New EU Governance'. Here, we draw on the works of Hooghe and Marks [2009], Schimmelfennig [2014], Bickerton et al. [2015], Dehousse [2015] and Schmidt [2016].

Following the extensive theoretical and methodological foundation, *Chapter 3* (*Eurozone crisis and the strengthening of European Economic Governance*) deals with the causes and consequences of the sovereign debt crisis, i.e. the Eurozone crisis. Accordingly, this subsection describes the original architecture of the EMU, and encapsulates its major problems and shortages. We depart from a short summary of the theories of Optimum Currency Area (OCA), which deliver the theoretical foundation of the EMU. Baldwin and Wyplosz [2020], De Grauwe [2018], Szijártó [2014; 2017; 2018] and Mongelli [2002] provide an extensive analysis of the OCA-theories. On the original structure and historical overview of the EMU, there exists a very extensive literature. For instance, it is worth to mention the works of Baldwin and Wyplosz [2020], Benczes and Kutasi [2010], De Grauwe [2018], Horváth [2011], Lőrincné [2007], Rácz [2007] and Szijártó [2018]. Subsection 3.2 presents briefly the anatomy and chronology of the Eurozone crisis, and emphasizes the major pressures (incompleteness) that led to the reforms. Baldwin and Wyplosz [2020], Benczes and Kutasi [2010], Copelovitch et al. [2016], De Grauwe [2018], Losoncz [2014], Marján [2013], Baldwin and Giavazzi [2015] provide a very detailed overview on this topic. Subsection 3.3 focuses on the strengthening of the European Economic Governance.

Chapter 4 (*Eurozone crisis management in neofunctionalist approach: exploratory case studies*) examines the selected cases, the European Banking Union and the

European Fiscal Union. The analysis (hypothesis testing) is carried out based on the modified analytical framework presented in Chapter 2.

Finally, *Chapter 5* (*Summary*) summarizes the research project, draws the conclusions of the dissertation and decides on the hypotheses. In addition, this section outlines and recommends further research directions.

2. INTEGRATION THEORY AND THE NEOFUNCTIONALIST RESEARCH PROGRAM

2.1. Integration Theory within the field of International Relations

2.1.1. The role and importance of integration theories

Social sciences and their disciplines cannot exist without different theories. The emergence of International Relations (IR) Theory, immediately after the First World War also demanded theoretical frameworks through which the political (and subsequently economic) interactions between nation-states could be studied. In the wake of Woodrow Wilson, idealist liberalism became the first major theory in the interwar period, which assumed the peaceful nature of sovereign states. This positive feature, in principle, creates the condition for lasting cooperation among countries, and stabilizes the international system as a whole. Unfortunately, the events of the 1940s and 1950s (World War II and the subsequent Cold War) refuted this optimistic assumption. Due to the negative experiences of the Second World War, the so-called 'Ontological Debate' of IR Theory eventually led to the victory of realism (Jackson, Sorensen and Moller [2018]).

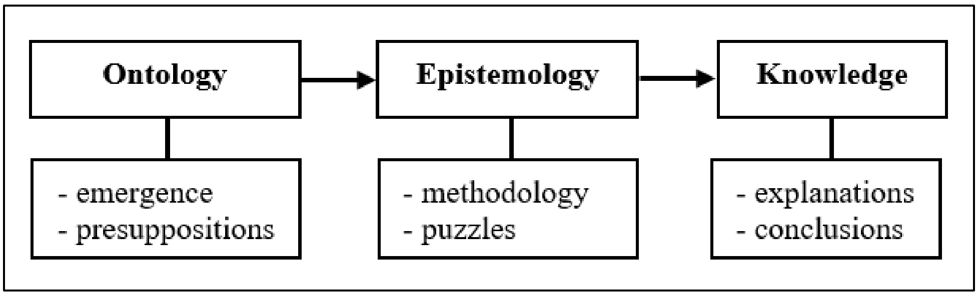
From the second half of the 1940s, the creation of the first regional integrations and new international organizations (such as the United Nations, the Council of Europe, the Organization for European Economic Cooperation, and the European Coal and Steel Community) raised anew the importance of and the potential for interstate cooperation. Regionalism became a new tendency in the world politics and world economy, and Europe was the continent where the first steps of integration took place.

Of course, different IR theories (especially liberalism) could have been used as analytical tools to explain the cooperation of countries. However, it was a completely new type of cooperation that could not be compared to the events of previous periods. As a result, this novel architecture gave way to the formation of a new (sub-)discipline within the IR Theory (Schimmelfennig [2018]), and later became known as '*Integration Theory'*. As Rosamond [2000] puts it, Integration Theory is the theoretical wing of EU studies that applies existing theories and develops new ones (Rosamond [2000]). Diez and Wiener [2019] provide a somewhat different definition and make a difference between the concepts of 'Integration Theory' and 'theoretical approaches'. In their vocabulary, Integration Theory means the field of theorizing the process and outcome of regional integrations, while theoretical approaches refer to different schools and theories, which can be used as individual analytical frameworks (Diez and Wiener [2019]).

What are integration theories good for? First of all, it has to be noted that several schools and approaches exist, which try to explain the genesis, development, operation and limits of regional integrations from different perspectives (Puchala [1971]; Schimmelfennig [2018]). Hooghe and Marks [2019] state that *"[e]ach* [theory – F. K.] *has something to offer in explaining the course of European integration, but they do so from different standpoints with different puzzles in mind"* (Hooghe and Marks [2019: p. 1113]). Moreover, it should not be forgotten that classical IR theories can also be used in the discipline of Integration Theory. In other words, IR, as an academic subject, has remained relevant in explaining processes of integration.

In general, theories (theoretical frameworks) are needed if we want to order and structure the observations of complex social phenomena such as the European integration. However, we need to be aware that different theoretical approaches lead to different types of knowledge. This is because each theory has its own presuppositions (ontology), which have an impact on the epistemology as well (Rosamond [2000]). This phenomenon can be interpreted as the '*path dependence of theories*'.

Figure 2: The path dependence of theories



Source: Own figure

Diez and Wiener [2019] identify three major arguments why studying integration theories can be useful. First, theories facilitate the explanation of the processes and possible outcomes of integration and make it possible to formulate expectations about the future developments. Second, theories help us to get a better understanding of democratic reform and legitimacy. Third, and probably this is the most important factor, empirical knowledge, in itself, cannot lead to a deeper understanding of the events. The authors divide the development of Integration Theory into three stages, which is preceded by a so-called proto-integration phase. *Table 1* shows this categorization with a slight modification (we consider proto-integration stage as the first phase).

Table 1: The main stages of Integration Theory

Stage	When?	Main themes	Main theoretical reference point
Proto-integration	1940s onwards	1. What are the causes and objectives of integrations (in general)? 2. What are the sources of conflicts?	Liberalism, neo-liberalism
Explaining integration	1960s onwards	1. How can integration outcomes be explained? 2. Why does European integration take place?	Liberalism, realism, neo-liberalism
Analyzing governance	1980s onwards	1. What kind of political system is the EU? 2. How can the political processes within the EU described? 3. How does the EU's regulatory policy work?	Governance, comparative politics, policy analysis
Constructing the EU	1990s onwards	1. How and with which social and political consequences does integration develop? 2. How are integration and governance conceptualized? 3. How should they be applied in practice?	Social constructivism, post-structuralism, international political economy, normative political theory, gender approaches

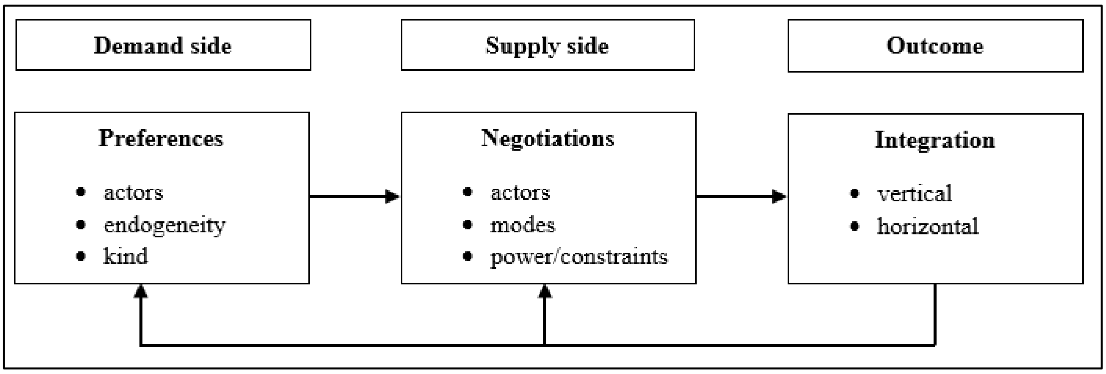
Source: Own table based on Diez and Wiener [2019: p. 8] with a slight modification

The *proto-integration phase* typically involves approaches that investigate the causes of integration on a regional and/or global level (these will be discussed in more detail later). The *explanation stage* focuses on the integration process, which has been taking place in Europe from the 1950s onwards. Until the end of the 1980s, neofunctionalism and intergovernmentalism were the two main competitor theories. The phase of *Analyzing governance* deals with the operation of the EU using further approaches such as comparative politics, governance and policy analysis. The fourth stage (*Constructing the EU*) concentrates on the practical issues of the integration process such as governance or the social and political consequences of the EU's development (Diez and Wiener [2019]).

Of course, other divisions can also be found in the scholarly literature. For instance, Wiener [2006] offers another typology, which puts emphasis on the levels of place, dynamic and institutions. In her work, she distinguishes the phases of integration, Europeanization and politicization (Wiener [2006]).

Leuffen et al. [2013] provide a general analytical framework for the process of integration, which can be seen in *Figure 3*.

Figure 3: The analytical framework of regional integrations



Source: Own figure based on Leuffen, Rittberger and Schimmelfennig [2013: p. 36]

Demand side of integration describes various types of preferences originating from different (governmental and non-governmental) actors, depending on the theory in question. On the one hand, emerging preferences may be exogenous and/or endogenous. Exogeneity means that certain preferences come from outside the integration, whereas endogenous preferences arise within the integration (for instance, as a result of a feedback). Furthermore, the authors make a difference between material and ideational (non-material) preferences in order to separate economic, political and security affairs and the issue of values, ideas, culture and identity. Meeting the demands is largely depends on the success or failure of negotiations. The supply side of integration represents the key actors (negotiators), their modes of bargaining and the constraints they face during the negotiations. In terms of modes, one can distinguish hard bargaining, soft bargaining and arguing. During the process of hard bargaining actors follow exclusively their own goals and may use threats as potential tools too. By contrast, soft bargaining is characterized by actors who follow collective goals and common interests without threatening each other. Finally, the mode of arguing consists in the exchange of information and arguments with the aim of persuading the partners. Depending on various theories, there may be factors that shape and constrain the bargaining power of the actors. The interaction of demand and supply side (i.e. preferences and negotiations) may lead to vertical or horizontal integration (Leuffen et al. [2013]). Nevertheless, it is also possible that vertical and horizontal effects occur simultaneously resulting in a ‘mixed outcome’. The outcomes finally feed back into the first two blocks – into demand and supply. However, it has to be emphasized that integration theories do not give equal significance to the feedback mechanism (Leuffen et al. [2013]).

To sum up, integration theories offer diverse analytical and methodological frameworks with which it is possible to analyze and explain regional integrations. On the one hand, these are contending theories with different ontology, epistemology and knowledge (path dependency of theories). On the other hand, various approaches complement one another, and each can be applied to a different situation. In the subsection 2.2. we provide a detailed description on the ontology, evolution and methodology of neofunctionalism. But before turning to neofunctionalism, we encapsulate shortly the major proto-integration theories to deliver a full picture about the causes of integration. These theories also play important role in the evolution of the Neofunctionalist Research Program.

2.1.2. Proto-integration theories

From the 1940s onwards, numerous theoretical approaches had been established, which paved the way for the discipline of integration theory. In spite of the fact that these theories depart from different fields, they all emphasize the peaceful way of international cooperation. As a result, supranationalist integration theories, like neofunctionalism, build to some extent on them. From this perspective, it may be useful and convenient to think of them as a separate cluster. Taking into account that neofunctionalism is considered to be the first real integration theory, we call these approaches proto-integration theories.

Federalism is the type of cooperation, which means the division of competences and resources between different levels of governance (Große Hüttmann and Fischer [2006]). The idea of federalism stretches back for centuries, but it came to the forefront of political debates in the 20th century. Based on the experiences of the Second World War, federalist structure is seen as the constitutional guarantee of avoiding wars in the future. As Rosamond [2000] notes, the federalist formula has two major advantages.

First, it has the capacity to prevent the emergence of totalitarian political systems and second, a federated polity (state) becomes a stronger entity against external threat. Nevertheless, this kind of 'integration' leads to a potential dilemma with respect to conflictual tendencies. While a federal structure may significantly decrease the probability of wars and violence among the member countries, it reproduces the state-like entities at a supranational level, which may lead to a global system of superstates (Rosamond [2000]). Most of the federalists promote the global political integration, while the so-called 'Eurofederalists' would like to create a kind of 'United States of Europe' (Palánkai and Kengyel [2011]).

In spite of the fact that federalism is not a single theory, it may be a useful approach in analyzing the European integration. Kelemen [2019], in his chapter, stresses that federalism can be treated either as an institutional outcome, or as an institutional framework. The former approach enables us to explain the emergence, existence and collapse of federal systems while using the latter, one can study the impact of federal entities on policy-making dynamics or policy outcomes. According to Kelemen, the biggest advantage of the federalism framework is that it helps to eliminate the so-called 'n = 1 problem'. Treating the EU as a federal polity, and not a *sui generis* entity, it becomes possible to carry out comparative studies, and thus, the field of Integration Theory may get out of the 'theoretical isolation' (Kelemen [2019]).[3]

Functionalism was elaborated in the first half of the 20th century. In spite of the fact that the theory is hallmarked by the name and works[4] of David Mitrany, other scholars had already written about the functionalist model in the very beginning of the century (Alexandrescu [2007]). Functionalism is similar to federalism in many ways. The starting point of the theory is that nation-states are unable to meet economic, political and social tasks efficiently. As a result, more and more common goals and functions (i.e. tasks) have to be delegated to post-territorial institutions (Palánkai and Kengyel [2011]). As Rosamond [2000] writes, *"[f]unctionalism was primarily a theory of post-territorial governance, whereas neofunctionalism was an early theory of regionalism"* (Rosamond [2000: p. 69]). In the functionalist theory, international agencies

[3] As Kelemen notes, the EU already meets the minimum criteria to be treated as a federal structure. Furthermore, he underlines that the federalism perspective does not require anybody to think of the European integration as a teleological process or a federal state (Kelemen [2019]).
[4] The book entitled *'A Working Peace System'* (1943/1966) is probably the most well-known work of David Mitrany.

(institutions) play the central role as they have functional responsibilities for certain tasks and competences. The so-called ramification process refers to the transfer of functions and authority, which leads to a domino effect, i.e. to a process whereby a cooperation in a given area may lead to a cooperation in another field. The final institutional outcome of this economic domino effect may be a world federation (Alexandrescu [2007]; Mitrany [1948]). Simply speaking, functionalism is concerned with international rather than regional cooperation (Tsoukalis [2017]). Despite functionalism shows important similarities to federalism, there is a difference between them. While federalism focuses on institutions, functionalism put the emphasis on the importance of the regulation's efficiency. Furthermore, federalism, in contrast with functionalism, does not reject the possibility of regionalism (Alexandrescu [2007]; Kengyel and Palánkai [2011]).

Transactionalist (or *communication*s, or *pluralist*) *theories* are primarily based on the works of Karl W. Deutsch who defined integration as a '*security community*' (or zones of peace). In his view, the primary role and objective of an integration is to decrease tensions and probability of violence among the participant countries. In this respect, international integration can be interpreted as a region in which security prevails. Put differently, the main goal is to operate security communities (political communities) with the aim of minimizing the expectation of war (Deutsch [1957], cited by Rosamond [2000]).

For a long time, political science did not really address the issue of communication/transactions. However, if we take quantitative densities of transactions into account, it will be possible to estimate the extent to which people and states are connected with each other. Deutsch [1964] argues as follows: *"[I]f there are three units, A, B, C, and at the beginning of the period, A and B are united and C is alien, while at the end of the period the link between A and C has become much stronger and the link between A and B has greatly weakened, the result may be a secession movement between A and B and an integration movement between A and C. In politics, these events depend on leadership, parties, historical events, and so on, but they also must have a favorite societal climate, a condition that can be studied and forecast from transaction flows"* (Deutsch [1964: p. 51]). In other words, when the number of transactions increases between two or more countries, the mutual importance (mutual relevance) will increase accordingly (Palánkai [2011]).

Distance theories, strongly related to transaction theories, try to capture the potential sources of conflicts between different entities. According to these theories, conflicts can be explained by the discrepancies existing in several areas such as culture, economy, religion, politics, etc. In this sense, integration is a ‘tool’, which contributes to the elimination of ‘distances’ (Palánkai [2011]). According to liberalism, international relations can be characterized by shrinking distances, which creates opportunity for mutual gains while realist thinking is more pessimistic (Krasner [1996], cited by Sullivan [2001]).

Theorists often argue that distance has been eliminated as a significant variable. The spread of Internet, economic interdependencies, increasing migration, and new (supranational) forms of political entities support this statement (Maier [2000], cited by Berezin and Díez-Medrano [2008]). Nevertheless, Berezin and Díez-Medrano [2008] dispute this assertion with regard to the European Union. In addition to interest-based and culture-based approaches, the authors also examined the role and effect of location/geography. Using statistical methods, they find that distance really matters, and the support for the EU decreases as the distance from the polity’s center (i.e. from ’Brussels’) increases. The relationship between distance and political support becomes evident if one holds budgetary transfers constant. The result suggests that the negative effect of geographical distance can partly be offset through economic incentives (Berezin and Díez-Medrano [2008]).

As we have seen, proto-integration theories played (and still play) a very important role in the field of Integration Theory. In the following subsection we present the Neofunctionalist Research Program, i.e. the ontology, methodology and evolution of neofunctionalism.

2.2. The Neofunctionalist Research Program

2.2.1. Ontology of neofunctionalism: the formation phase

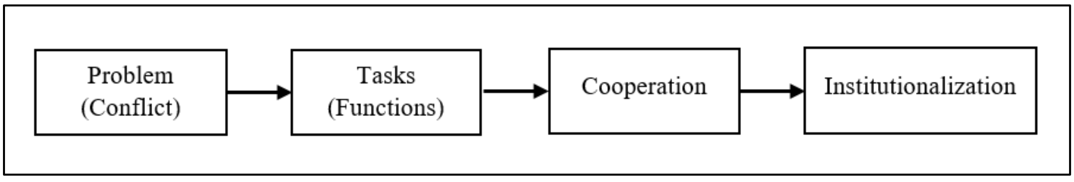
Following the Second World War, a new type of cooperation began on the European continent, in which sovereign states created a unique regional entity (integration). This new, partly supranational organization in terms of its institutional system and decision-making mechanism, became a *sui generis* actor of the international relations. In the words of Haas [1961]: “*[t]he established nation-state was in full retreat in Europe*

[…]" (Haas [1961]: p. 366). As a result of regionalism, theoretical approaches did not remain intact either. Schools seeking to explain the emergence and function of integration (i.e. integration theories) appeared among international political theories.

The first major integration theory – neofunctionalism – was elaborated at the end of the 1950s and at the beginning of the 1960s in the works of Haas [1958; 1961; 1964], Lindberg [1963], and Haas and Schmitter [1964]. The intention of the founding fathers of this school was to lay down a framework, which had the toolkit to explain the dynamics of the cooperation. Haas saw the postwar Europe as a laboratory of international cooperation, and he started to study the European Coal and Steel Community (ECSC), which was the institutional seed of the European Union (Cooper [2011]).

The new approach built on the behavioral revolution in political science, which took place in the United States after the Second World War (Groom [1978]; Rosamond [2000]). According to this school, there are certain uniformities in human behavior that can be verified by emprical tests. As a result, behavioralism focuses on human actors and their behavior to explain why things happen. In other words, decisions are rooted in the behavior of human beings (Easton [1985]). From the perspective of integration, behavioralism (political behavior) can be combined with the logic of functionalism. That is, for certain reasons, actors decide to resolve their conflicts by engaging in specific tasks (functions), which lead to cooperation with others. If these tasks are satisfactorily accomplished, the cooperation may become institutionalized in the end of the process. In the case of regional integrations the initial actors are independent countries (nation-states) and innovative, supranationally motivated politicians or administrators (Niemann et al. [2019]). *Figure 4* represents the functional channel of political behavior.

Figure 4: The 'functional channel' of political behavior



Source: Own figure based on Niemann et al. [2019]

Adapting the channel to the case of Europe, the line of thinking was as follows: security and economic conflicts among European states must have been managed by the strengthening of cooperation. In order to achieve this objective, based on the proposal of Jean Monnet and Robert Schuman, six countries decided to establish the common market of coal and steel production. Accordingly, the institutional result was the European Coal and Steel Community in 1951.

Besides behavioralism, interdependence liberalism was the other intellectual root of neofunctionalism. Interdependence liberalism is one of the strands of liberal theory and claims that large number of transnational relations caused by different factors (e.g. modernization) leads to increasing interdependence (mutual dependence) among political entities. According to the categorization of Jackson, Sorensen and Moller [2018], neofunctionalism should be interpreted as a kind of sub-theory of interdependence liberalism (Jackson, Sorensen and Moller [2018]).

It can be seen now that proto-integration theories, behavioralism and interdependence liberalism paved the way for Integration Theory and neofunctionalism respectively. *Table 2* summarizes the intellectual roots, proto-integration theories and their main features.

Table 2: Intellectual roots and proto-theories of neofunctionalism

Theory	Main features
Federalism	supranational political entity as an end-goal
Functionalism	functional cooperation as the driving force of integration
Transactionalism	number of transactions determine the mutual importance (mutual relevance)
Distance theories	heterogeneity as the main source of conflicts
Behavioralism	behavior of political actors determine outcomes
Interdependence liberalism	large number of transnational relations leads to increasing interdependence

Source: Own compilation and table

2.2.2. The original design and methodology of the theory

The famous book of Ernst B. Haas (*The Uniting of Europe – Political, Social and Economic Forces 1950–1957*) was the first work that laid down the cornerstones of neofunctionalism. This approach later became the reference point of the debates about integration theories (Wolf [2006]).

What does the word ‘integration’ mean? The conceptualization of integration is the starting point of the study of regional integrations. However, this is not easy, because scholars disagree about whether integration is a condition, a process, or both (Haas

[1964]). Haas defines (political) integration as *"[t]he process whereby political actors in several distinct national settings are persuaded to shift their loyalties, expectations and political activities toward a new centre, whose institutions possess or demand jurisdiction over the pre-existing national states. The end result of a process of political integration is a new political community, superimposed over the pre-existing ones"* (Haas [1958/2004]: p. 16). This definition suggests that Haas saw the integration as a dynamic process, and he was interested in the driving forces and stumbling blocks of it (Wolf [2006]).

First of all, it has to be determined who the *relevant political actors* are in the scheme of the integration. According to the neofunctionalist view, the key political actors have a manipulative role, which can be used to influence the motion (i.e. the development) of the regional cooperation. In the words of Haas, *political elites* can be defined as relevant political groups and players who participate in the making of public decisions. They include – *inter alia* – officials of trade associations, higher civil servants, lobbyists, interest group leaders and active politicians (Haas [1958/2004]; Lindberg [1963]).[5] In short, various layers of the society have an indirect role in decision-making. The participation of non-governmental actors in the political process of integration means that states are not the only crucial agents. This assumption became central to the theory and has to do with dynamics of the integration.

In the view of Haas *loyalty* refers to the phenomenon when a population habitually and predictably over long periods obeys the injunctions of the authority of certain institutions and turns to them for the satisfaction of significant expectations. In relation to this, the existence of loyalty can be verified by the regularity of popular compliance with fundamental government decisions (Haas [1958/2004]). As Haas [1964] writes, gradual transfer of loyalty is likely to happen if actors are satisfied with the performance of critical functions by a supranational institution (Haas [1964]).

Neofunctionalism is different from other approaches, and presumes the learning process of political players which is based on the perceptions of self-interested actors. In case of realizing that their interest can be best achieved by involving larger entities (institutions), then this learning process may give rise to integration. It also means the

[5] Haas focused primarily on the role of non-governmental elites while Lindberg dealt especially with governmental elites (Niemann et al. [2019]).

redefinition of an earlier conception of self-interest regarding welfare, which leads to the adoption of new rules (Haas [1964]).

Regarding the issue of (political) expectations, Haas [1958/2004] distinguishes four types (*Table 3*).

Table 3: Types and features of political expectations

	Short-run	**Long-run**
Positive	• unconnected individual measures • element of continuity is absent	• long-range economic planning • supranational institutions
Negative	• prevent supranational institutions from undertaking a specific policy • ad hoc alliance to block a specific policy	• bring about withdrawal from supranational bodies and block the creation of new ones

Source: Own table based on Haas [1958/2004]

Short-run positive expectations mean different, unconnected individual measures where the element of continuity is absent. Put differently, the achievement of a given objective does not induce further long-range actions from supranational institutions. However, if continuing administrative measures exist, initially short-run expectations may lead to long-run ones (this relationship is indicated by a dashed arrow in Table 3). *Long-run positive* expectations are characterized by collective goals of national elites, long-range economic planning, and the activity of supranational institutions. This scenario, of course, assumes the long-run preferences in the member states to converge. *Short run negative* expectations refer to the phenomenon that member countries try to hinder the integration by preventing supranational bodies from engaging in a specific policy. In order to attain this preference, they may form ad hoc alliances to block the policy area in question. Finally, actors with *long-run negative* expectations prefer the withdrawal from supranational institutions and block the setting up of new ones (Haas [1958/2004]).

Haas's definition of integration is a teleological one as assumes that in the end of the process, a new political community emerge in which *"[s]pecific groups and individuals show more loyalty to their central political institutions than to any other political authority, in a specific period of time and in a definable geographic space"* (Haas [1958/2004: p. 5]). In relation to this, it has to be emphasized that the new political community does not mean necessarily a federal entity (a federal state), however, it may be a possible end result. As Haas notes, unitary, federal or confederate structures are all among potential scenarios. In contrast to Deutsch's security community, Haas sees the integration as a process.[6] Furthermore, the neofunctionalist interpretation postulates the presence of political institutions capable of transmitting ideologies and values into law, while the absence of violence is the focal point in both theories (Haas [1958/2004]). *Table 4* juxtaposes the two concepts of political community.

Table 4: Interpretations of the concepts of political community

	Political community (Deutsch)	Political community (Haas)
Conceptualization	Condition	Process
Absence of violence	Yes	Yes
Existence of political institutions	Not necessary	Yes

Source: Own table based on Haas [1958/2004] and Lindberg [1963]

Leon N. Lindberg [1963] provides another definition to political integration without referring to the shift in loyalties and to a final outcome (a dependent variable).[7] In his view, integration is *"(1) [t]he process whereby nations forgo the desire and ability to conduct foreign and key domestic policies independently of each other, seeking instead to make joint decisions or to delegate the decision-making process to new central organs; and (2) the process whereby political actors in several distinct settings are persuaded to shift their expectations and political activities to a new center"* (Lindberg [1963: p. 6]).

The central concept of the theory is the so called '*spillover*' effect, which gives momentum to the integration from time to time. In the second half of the 1950s, this was exactly the case when the Treaties of Rome integrated the economies of the founding countries further. However, it has to be noted that sectoral integration was seen as the first step on the road to full integration. Initial economic integration was believed to lead to a greater degree of political unity and full economic integration. Haas projected the political community to be established before the end of the transitional period specified in the Treaty Establishing the European Economic

[6] Prior to the emergence of neofunctionalism, authors such as Deutsch, North, Koch or Zinnes looked at political integration as a *condition*. Unfortunately, this static approach was not able to grasp the change and the development of the integration. This kind of conceptualization was later criticized.
[7] According to Lindberg, changes in values (i.e. changes in loyalty) could be expected to take place only as a result of new patterns of political activities.

Community (Haas [1958]; Haas [1958/2004]). Different authors give somewhat various definitions to the concept of spillover.

Within the framework of neofunctionalism, the concept was firstly used by Haas to describe situations in which the original goal can be attained only by taking further steps, which create a further condition and a need for more measures, and so forth. According to the theory, the phenomenon of spillover (or the expansive logic of sector integration) causes internal tensions (disequilibria), which finally ensure the dynamics of the integration.[8] Lindberg [1963] uses the expression of inherently expansive tasks. In his formulation *"the initial task and grant of power to the central institutions creates a situation or series of situations that can be dealt with only by further expanding the task and the grant of power"* (Lindberg [1963]: p. 10). Schmitter [1969] interprets spillover as *"[t]he process whereby members of an integration scheme – agreed on some collective goals for a variety of motives but unequally satisfied with their attainment of these goals – attempt to resolve their dissatisfaction either by resorting to collaboration in another, related sector (expanding the scope of the mutual commitment) or by intensifying their commitment to the original sector (increasing the level of mutual commitment) or both"* (Schmitter [1969]: p. 162). Simply speaking, the spillover effect lead to the deepening of the integration, which increase interdependence among the member states. This cumulative process has in principle two main consequences. First, ever-increasing interdependence may contribute to the maintenance of peace within the region. This is because economic, political and social interconnectedness increases the expected costs of (economic and political) nationalism for all members. Second, in line with the logic of spillover, the deepening may improve the efficiency of the community's functioning. Paradoxically, the series of disequilibria compel the integration to deepen.

From another perspective, spillover can be evaluated as a potential outcome of conflict or crisis resolution. Haas [1961] makes a difference between three modes of conflict resolution. The first type is the conflict settlement based on the principle of *minimum common denominator*. This practically means international bargaining where the result is always depends on the preferences of the least cooperative bargaining partner. Classical diplomatic negotiations take place in this framework. Accommodation by

[8] It has to be underlined that paralell to the spillover process, economic and political interdependence also strengthen among the member states.

splitting the difference already shows some features of integration. Here, some kind of intergovernmental mediatory body (e.g. an ad hoc international expert group) may be admitted by the partners in order to facilitate the negotiation. As a result, the outcome will be somewhere the final bargaining positions. This mode of compromise is prevalent in the case of international organizations. The third type of conflict resolution – *upgrading the common interests* – is often identified with the phenomenon what we call integration. In this scheme, conflicts are redefined at a higher level, and resolved with the participation of an institutionalized mediator who possesses autonomous range of powers. The result of the negotiation process is the spillover, i.e. the expansion of task and/or mandate. This combination can be observed in the operation of supranational organizations (Haas [1961]). *Table 5* summarizes the main features of conflict resolution modes.

Table 5: Types and outcomes of conflict resolution

	Mode of resolution	**Result of resolution**	**Example**	
Minimum common denominator	international bargaining	least cooperative partner	classic diplomatic negotiations	↓
Splitting the difference	intergovernmental mediatory body (actor)	between final bargaining positions	international organizations	
Upgrading common interests	conflict resolution at a higher level + institutionalized mediator with autonomous range of powers	task/mandate expansion (spillover)	supranational organizations	

Source: Own table based on Haas [1961]

In their article, Haas and Schmitter [1964] pose the question whether economic integration automatically lead to political unity.[9] They argue that linkages between economic integration and its political consequences have functional features. In relation to this, political actors seek to resolve their problems in order to upgrade common interests. During this process, they transfer more and more authority to the center, so the spillover appears as an intervening variable between economic and political union. Methodologically, Haas and Schmitter try to capture the process of integration using different variables (in their words, pattern variables). The authors divide these variables into three categories: 1) variables, which exist before the act of

[9] The authors refer to political union as an arrangement under which existing countries cease to act as autonomous decision-making entities with respect to a significant range of policies (Haas and Schmitter [1964]).

union (background conditions), 2) variables existing at the time of economic union, 3) and variables existing after the establishment of the union (process conditions). The category of *background conditions* contains the following variables: size and power of units, rate of transactions, pluralism and the elite complementarity. Size of unit refers to the relative (economic) power of the states in a functional context of the integration. Put differently, what matters here, is functional similarity or difference. Another important variable is the rate of transactions before economic liberalization. For instance, in line with the transactionalist theory, international trade, labor and capital mobility are all significant elements. The category of pluralism incorporates the structure of the societies and describes the prevalent mode of group conduct. Lastly, elite complementarity shows whether corresponding elite groups think in the same way or not. The second set of variables (*conditions at the time of economic union*) involves two major factors. Possible governmental purposes refers to the convergence of aims based on different combinations of economic objectives and political commitment. Accordingly, Haas and Schmitter identify the following four possibilities: 1) identical economic objectives with strong political commitment; 2) converging economic objectives with strong political commitment; 3) identical economic objectives with weak political commitment; and 4) converging economic objectives with weak political commitment. The second variable (powers and functions of new region-level institutions) means the power of regional (supranational) institutions. If an independent institution possesses the power to initiate, support and make significant policies, then automatic integration is likely to take place. By contrast, in the absence of a strong, i.e. centralized, institutional structure, critical steps must be negotiated from time to time based on unanimity voting. The third cluster of variables (*process conditions*) consist of three key pattern variables. Decision-making style refers to the mode of implementation of the economic integration when actors confront one another continuously. Another important factor is the change in the rate of transactions compared to the inception of the integration. Finally, the adaptability of governmental and private players also matters since it is relevant whether actors are able to transcend difficulties and disappointments by increasing the centralization level. The model assigns a qualitative value or probability (high, mixed or low) to each variable and then evaluates the three clusters. Based on the total judgments, the model gives the chance of automatic politization (Haas and Schmitter [1964]).

Table 6 represents the Haas–Schmitter model.

Table 6: The Haas–Schmitter model of neofunctionalism

Background conditions	Conditions at the time of economic union	Process conditions
• size of unit • rate of transactions • pluralism • elite complementarity	• possible governmental purposes • powers and functions of new region-level institutions	• decision-making style • rate of growth of transactions • adaptability of governmental/private actors
Total judgment	**Total judgment**	**Total judgment**
CHANCES OF AUTOMATIC POLITIZATION		

Source: Own table based on Haas and Schmitter [1964] and Rosamond [2000]

In this part, we have presented the formation phase of neofunctionalism, i.e. the ontology and the original methodological design of the school. In the wake of the works of the founding fathers, we can encapsulate the major points (elements) of the neofunctionalist thinking.

The original theory consists of five basic assumptions, which summarize and explain the driving force of the integration. Firstly, neofunctionalists see the integration as a *process* that evolves over time and has its own dynamics. Secondly, integration is characterized by *multiple, diverse and changing actors* who may create transnational coalitions. Thirdly, the theory assumes that actors who make decisions are *rational players*, which practically means that they have the ability to learn from their experiences. Regarding decision-making process, neofunctionalism assumes that integration evolves through *incremental decision-making* (marginal adjustments or *spillovers*) instead of grand designs. Finally, the cooperation of actors is often better characterized by *positive-sum games*, in other words, by a win-win situation (Niemann and Ioannou [2015]).

In spite of the differences, Haas and Lindberg established a comprehensive theory, the aim of which was to describe, explain, predict and prescribe the process of the 'European project' (Tranholm-Mikkelsen [1991]). In the first period of the European integration, the expansion of the cooperation – i.e. the establishment of the EEC and the Euratom – was the evidence of the existence of spillover. In summary, due to the initial success of the ECSC and the EEC, neofunctionalism became the dominant theory in the early periods of integration theorizing (Leuffen et al. [2013]).

Despite the early success, the events of the 1960s and the 1970s weakened the explanatory power of neofunctionalism. As Lindberg [1965] notes, in spite of the optimistic tone and spectacular success of the first period, the hardest steps and measures remained to be taken and needed strong political will (Lindberg [1965]). These events led to the withdrawal and transformation phase.

2.2.3. The withdrawal and transformation phase

In the mid-1960s, due to the so-called 'De Gaulle phenomenon', the positive linear development of the integration stopped. In 1965, President De Gaulle took a significant turn when he boycotted functioning and decision-making system of the Council for months, because he did not agree with the financial proposals regarding agricultural policy. This step became known in the EU studies as the '*empty-chair policy*'. The member states were able to resolve this crisis by the '*Luxembourg Compromise*' in the beginning of 1966. Nevertheless, the compromise significantly slowed down decision-making, because issues involving a fundamental national interest of a member state required unanimous decisions (Arató and Koller [2019]; Horváth [2011]).

De Gaulle, in addition, hindered the territorial extension (enlargement) of the European Community since, for fear of the influence of the United States, he vetoed the application for accession of the United Kingdom in 1961 and 1967. As a result, it became obvious that the first enlargement of the Community was possible after the resignation of Charles De Gaulle.

However, the 'De Gaulle phenomenon' was only one of the reasons for the stagnation of the European integration. The rising protectionism (economic nationalism) caused by the oil crises in the 1970s, and the subsequent recessions also hampered cooperation within the European Community as all member states sought to protect their own economies (Kollárik [2019a]). The only positive event of this period was the establishment of The Hague Declaration in 1969 and the Werner Plan in 1970, which laid down the implementation plan of the monetary union. However, the first oil crisis and the collapse of the international monetary system, i.e. the Bretton Woods system, made it impossible to deepen the integration.

Due to the crisis and stagnation of the mid-1960s, a new integration theory appeared in the scholarly literature. The theory, based on the works of Stanley Hoffmann [1964; 1966], was very similar to the conventional realist theory of International Relations.

This new, state-centered school (*Classical Intergovernmentalism*) became and remained the dominant integration theory until the adoption of the Single European Act (SEA) in 1986.

Hoffmann [1964], in his article, examines the interactions of the European integration and the Atlantic alliance. He argues that the nation-states are still alive, and they are the primary actor of the interstate relations. These entities compete for power and influence in an international system where hierarchy exists between the strong and the weak. Hoffmann also points to three major problems and difficulties of the spillover process. First, in some sectors (e.g. energy policy) the member states failed to establish a common policy. Second, agreement on negative integration, i.e. liberalization, is much easier than on positive integration. Third, in the words of Hoffmann, spillover process is a fiduciary operation (Hoffmann [1964]). Put differently, "*[t]he more the Communities progress, the more difficult agreement tends to become"* (Hoffmann [1964: p. 88]).

Hoffmann [1966] offers a threefold distinction, which may help us to analyze the interaction of the nation-states and the international system. In his categorization, *national consciousness* is a feeling, a sense of cohesion and distinctiveness. By contrast, *national situation* is a more complex category comprising of two elements, internal and external features. Internal elements are, for instance, domestic political system, or social structure whereas external components represent the state's position in the world. According to Hoffmann, statesmen must take national situation into account when defining and shaping the country's foreign policy. However, he acknowledges that national situation may facilitate integration, even if national consciousness is strong. The third category is *nationalism* representing a doctrine or an ideology that gives to the nation-state absolute value and priority. Hoffmann argues that (Western) Europe in the postwar period can be characterized by three features, which are the temporary termination of nationalism, the political collapse of Europe, and the nuclear stalemate between the superpowers (Hoffmann [1966]). The study concludes that *"[t]he most visible aspect is the survival of the nations. To be sure, they survive transformed […]* and *[…] the transnational linkages of businessmen and farmers are part of the transformation"* (Hoffmann [1966: p. 889]).

In spite of the similarities with the realist tradition, Hoffmann [1995] emphasizes that his original intention was to advance a deeper notion of 'interests'. In his view, ideas, precedents, experiences, domestic forces and rulers all matter and play a role in the integration process (Hoffmann [1995], cited by Rosamond [2000]).

Hansen [1969], in his critique, alleges that (early) neofunctionalist scholars made three theoretical errors. First, they deny the cleavage between 'low' politics and 'high' politics. This is important because member states managed to propel integration only in the fields of welfare. Consequently, spillover from the economic sector towards the political sector is not automatic. Second, despite the fact that exogenous factors do matter, neofunctionalism did not take the international environment into account. Finally, economic gains can be reached without the existence of supranational institutions, purely on an intergovernmental basis (Hansen [1969]).

It should be noted briefly that besides intergovernmentalism, another theoretical framework (*interdependence theory*) also emerged in the 1970s. While interdependence theory and neofunctionalism have many common assumptions, they differ in some significant factors. First, interdependence theory is not a teleological approach. Second, it does not necessarily imply regional integration. Possible integrative consequences are the result of political acts, but they are not 'coded' in the theory. Lastly, according to the interdependence approach, the phenomenon of interdependence is a condition, not a process (Tranholm-Mikkelsen [1991]).

The political and economic stagnation of the European Communities made scholars in the 'neofunctionalist camp' to respond to these negative events and the attack of Classical Intergovernmentalism.

Haas [1967], in his study, makes the first major revision of neofunctionalism. First, he revises the theory and tries to apply it to the Latin American Free Trade Association (LAFTA). Second, he shows the differences between the European and Latin American cases. In the first part of the article, Haas notes that *"[...] the tension between the visions of Jean Monnet and Charles de Gaulle goes far beyond personal ideology and differences on desirable policy: the tension suggests that integration and disintegration as two rival social processes are simultaneously at work. In 1967 we know that the social scientist has not yet completely understood them"* (Haas [1967:

p. 315]). This quotation can be evaluated as a criticism, which suggests that integration is not necessarily a one-way process.

However, Haas stresses that France should be seen as the ‘deviant case’ meanwhile many elite groups continues to support the integration process. He identifies three *structural homogeneities* in Western Europe. First, all the countries in Western Europe have pluralistic social structure. Second, countries are internally fragmented due to the pluralist structure, but each group or class has its counterpart in the other states. Simply speaking, domestic (internal) heterogeneity and regional homogeneity coexist. Haas refers to this phenomenon as ‘symmetrical heterogeneity’. Third, the bureaucratization of decision-making is very similar to each other in the member states. These structural attributes altogether have the capacity to explain the success of the economic integration, i.e. the ‘expansive logic of functionalism’.

According to Haas, if certain modifications are made, neofunctionalism remains a valid and useful approach in explaining regional integrations. First of all, a statesman, like De Gaulle or Otto von Bismarck, who can integrate disparate publics with force or power, is always more effective than an indirect process fueled by economic expectations. However, in the absence of a strong statesman, as was in the case in Europe in the early 1950s, the only alternative is gradualism and functionalism. Haas distinguishes four types of decision-making style leading to different outcomes. When political leaders and non-governmental elites have dramatic-political aims, then integration is either a smooth and direct process or impossible. The ‘opposite’ case happens if both group of players have incremental-economic objectives. This combination means the convergence of aims and leads to a gradual but automatic integration. Problems with automatic progress, however, may arise if statesmen and elites have different types of goals. In these cases, integration is erratic and reversible (Haas [1967]). *Table 7* represents these combinations in a matrix form.

Table 7: Decision-making styles and integration outcomes

		Aims of Non-Governmental Elites	
		Dramatic-Political	*Incremental-Economic*
Aims of Statesmen	*Dramatic-Political*	Integration either direct and smooth; or impossible	Integration erratic and reversible
	Incremental-Economic	Integration erratic and reversible	Integration gradual but automatic

Source: Own table based on Haas [1967]

As the integration structure becomes more complex, the propensity for conflict increases. Nevertheless, if integration has gone very far before national situation improves, the probability of disintegration converges to zero. As Haas notes, despite the setbacks of the 1960s, integration went further in Europe than anywhere else in the world (Haas [1967]).

Schmitter [1969] attempt to improve the Haas–Schmitter model by conceptualizing and operationalizing linkages that relate the initial and subsequent stages of the integration process. He describes three process hypotheses, the *spillover hypothesis,* the *externalization hypothesis* and the *politicization hypothesis*. The first one is an explicit statement while the others are subsidiary propositions of the first. In the words of Schmitter, *"[s]pillover [...] refers to the process whereby members of an integration scheme – agreed on some collective goals for a variety of motives but unequally satisfied with their attainment of these goals – attempt to resolve their dissatisfaction either by resorting to collaboration in another, related sector (expanding the scope of the mutual commitment) or by intensifying their commitment to the original sector (increasing the level of mutual commitment) or both"* (Schmitter [1969: p. 162]). Schmitter underlines that initial scope and level, by themselves, cannot extrapolate future performance. Consequently, the concept of automaticity refers to the high probability that spillover, externalization and politicization will take place. Unfortunately, functional pressure, in itself, is not enough. It must be perceived, interpreted and translated into feasible decision-making styles. The progress of integration, in all probability, discriminate third countries, which, in turn, will respond to this negative impact. As a result, in line with the externalization hypothesis, member states will be forced to elaborate a collective external position. Lastly, politicization happens when controversiality of joint decision-making increases and the interested and active clientele widens. The probable outcome of this process is the redefinition of the original mutual objectives (Schmitter [1969]).

Nye [1968] draws the attention to significant differences experienced in the conceptualization and measurement of integration. In order to improve operationalization, he distinguishes economic, social and political integration. Each category can be divided into further subtypes with a clear measurement (Nye [1968]).

In his later work, Nye [1970] acknowledges that neofunctionalism has several virtues. Nevertheless, in spite of the amendments and refinements, it still contains numerous faults. Nye offers a refined neofunctional approach by applying some modifications in four factors. First, considering the fact that the concept of dependent variable is arbitrary reflecting values and preferences, it should be identified more carefully and less ambiguously. Second, by adding more political actors, the neofunctionalist model becomes more complex and its applicability improves. According to Nye, different styles of politics dominate the integration system at different times. In this context, in the wake of Haas [1967], he stresses the importance of actors with 'dramatic-political' objectives. In addition, Nye argues that negatively or neutrally affected players should be taken into consideration. This is indispensable, because actors can promote or hinder the process of integration. Furthermore, the role of mass opinion leaders is also a significant factor, which has to be incorporated into the model. Besides positive and negative responses, there is a third possibility, the maintenance of the status quo. According to Nye, this scenario (inertia) is the 'normal' reaction when process forces are not too strong. Third, this model offers other process mechanisms that exist after the creation of a regional economic integration. Nye concludes that process mechanisms may have negative consequences on the integration process.[10] Fourth, this modified framework ignores the categorization of the Haas–Schmitter model and distinguishes structural and perceptual conditions. Structural conditions are variables considered to be relatively stable during the integration process. By contrast, perceptual conditions are volatile variables determined mostly by factors other than the integration process itself (Nye [1970]).

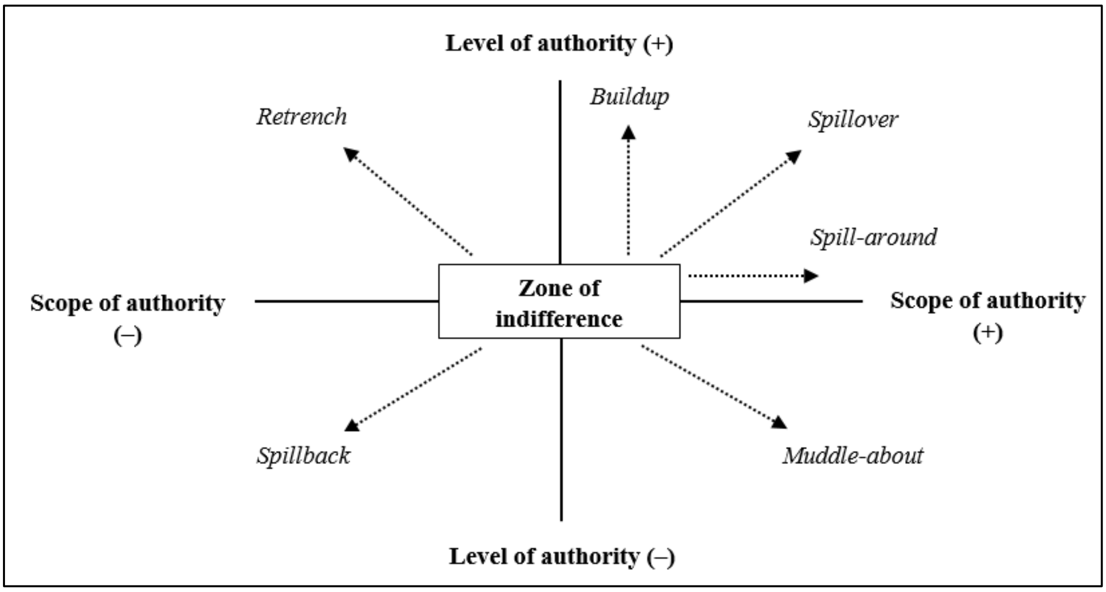
Haas [1970] concentrates on the 'dependent variable' problem. He argues that an indispensable precondition of elaborating an integrated theory of regional integration is the clarification of what we would like to explain and/or predict. He suggests different ways of defining the dependent variable. The early neofunctionalist framework was teleological and worked with the idea of a political community or a political union. Haas underlines that these categories (ideal types) are not suitable dependent variables because they cannot be observed in the real life. Another possibility may be if we set up one or more dimensions (scales) and measure the

[10] These process forces are rising transactions, functional linkages, deliberate linkage and coalition, regional group formation, elite socialization, ideological-identitive appeal and external factors.

progress of the integration along these scales. Finally, it is also possible to identify multiple dependent variables. Haas suggests three (heuristic) dependent variable; regional sate, regional community and asymmetrical regional overlap. These should be seen as possible temporary results (provisional points) of the integration process. Regional state refers to a hierarchically ordered structure where political authority is transferred to a center. Regional commune is a less centralized system where interdependence exist among the participating units, but there is no a single center of authority. Asymmetrical regional overlap is a complex architecture, which is characterized by asymmetrical interdependence and several centers (Haas [1970]).

Philippe C. Schmitter [1970] makes a very significant refinement by introducing several alternative actor strategies. In line with Nye [1970], he hypothesizes that maintaining of the status quo is the most probable outcome in the integration process. In one of his macrohypotheses, Schmitter states that *"[a]ll integration processes will tend toward a state of rest or stagnation – unless disturbed by exceptional (i.e., unpredictable) or exogenous conditions not present in the original convergence or in the institutions themselves"* (Schmitter [1970: p. 847]). *Figure 5* represents the model of Schmitter.

Figure 5: Alternative actor strategies



Source: Own figure based on Schmitter [1970]

Vertical axis measures the level of decisional authority of regional institutions while the horizontal axis shows the extension of issue areas (scope). The status quo is represented by the so-called *zone of indifference*. As long as the actors remain within this area, nothing happens and thus, no new costs arise. The strategy of *encapsulation*, thus, indicates the self-maintenance whereby member states react on a crisis by marginal changes within the zone of indifference. By contrast, leaving the zone involve costs. Moving in the negative directions, i.e. the decrease of scope and/or authority, means that member states forgo some established benefits of cooperation and face the sunk costs of the previous efforts. On the other hand, an increase of scope and/or authority also entails costs deriving from greater uncertainty and the upsetting of crystallized distributional patterns. According to this revised model, *spillover* takes place when there is an increase in both dimensions, i.e. the scope and authority increases simultaneously. *Spill-around* describes the extension of issue areas (scope) while the degree of authority remains constant. *Buildup* refers to the increase of the level of authority without extending the scope. The three positive strategies, i.e. spill-around, buildup and spillover shows a shift towards a political community. The combination of greater decisional authority and less coverage of issue areas is called the strategy of *retrench*. It is also possible that regional bureaucrats debate on a wider variety of issues while decreasing the level of authority (*muddle-about*). Finally, *spillback* refers to the contraction of the integration in both dimensions (disintegration). As it was mentioned above, encapsulation is the most probable strategy since actors will prefer to remain within the zone of indifference (Schmitter [1970]). *Table 8* summarizes the major revisions and refinements of neofunctionalism.

Table 8: Major revisions and refinements of neofunctionalism

Author and date	Title of work	Main refinements
Haas [1967]	The Uniting of Europe and the Uniting of Latin America	• structural homogeneities (pluralistic social structure, symmetrical heterogeneity, bureaucratization) • actors with dramatic-political aims
Nye [1968]	Comparative Regional Integration: Concept and Measurement	• better conceptualization and measurement of integration
Schmitter [1969]	Three Neo-Functional Hypotheses about International Integration	• spillover hypothesis • externalization hypothesis • politicization hypothesis
Nye [1970]	Comparing Common Markets: A Revised Neo-Functionalist Model	• Four major modifications (dependent variable, list of political actors, new process mechanisms, integration conditions)
Haas [1970]	The Study of Regional Integration: reflections on the	• dependent variable problem • ideal types, scales, multiple dependent variables

	Joy and Anguish of Pretheorizing	(regional state, regional commune, asymmetrical regional overlap)
Schmitter [1970]	A Revised Theory of Regional Integration	• alternative actor strategies
Lindberg and Scheingold [1970]	Europe's Would-Be Polity	• revision of neofunctionalism • permissive consensus
Haas [1976]	Turbulent Fields and the Theory of Regional Integration	• theories of regional integration are becoming obsolete

Source: Own compilation and table

In spite of many efforts were made to amend and refine the original version of the theory, Haas [1976] declared neofunctionalism obsolete in the mid-1970s. Haas argues that the explanatory power of the core assumptions of regional integration theories is weakening. He also stresses that *"[t]he phenomenon of externalization may well increase in importance beyond anything previously imagined"* (Haas [1976: p. 176]). Therefore, the framework of regional activity should be questioned and reexamined (Haas [1976]).

In summary, in the withdrawal and transformation period of the European integration, neofunctionalism underwent several revisions and modifications. However, the theory did not manage to regain its dominance in explaining the integration processes. Furthermore, in the mid-1970s, the founding father of the school, Ernst Haas, himself declared the theory obsolete. As Daniel Wincott [1995] states, neofunctionalism collapsed as a focus for regional integration research (Wincott [1995]).

2.2.4. Rebirth of neofunctionalism: the recovery phase

The year 1985 was a turning point in the history of European Communities when the European Commission published its White Paper on the Single (or Internal) Market (*Completing the Internal Market*). In the next year, in 1986, the proposal was incorporated into the Single European Act (SEA)[11], which laid down the plan for establishing the Single Market by the end of 1992. In relation to this, it soon became obvious that a well-functioning internal market needs tighter economic and monetary cooperation as well. As a result, on the Hannover Summit in 1988, the member states decided (again) on the creation of the Economic and Monetary Union. The implementation plan of the EMU was based on the Delors Report[12], which was adopted

[11] The Single European Act came into force in 1987.
[12] Jacques Delors was the President of the European Commission between 1985 and 1995.

in 1989. The plan was finally given legal form by the Maastrich Treaty in 1992[13]. These events gave a significant momentum to the integration and to neofunctionalism, respectively (Kollárik [2019a]).

Tranholm-Mikkelsen [1991], in his article, intends to re-open the debate on neofunctionalism by returning to the original formulations of the school. He scrutinizes the empirical developments of the European Communities since 1985 and concludes that each type of spillover, i.e. the functional, political and cultivated, can be detected. Regarding the EMU, functional spillover is the following. The free movement of capital is likely to increase the exchange rate volatility that imposes additional costs on trade (Tranholm-Mikkelsen [1991]). These costs, in turn, will affect international trade negatively. The negative correlation between exchange rate volatility and trade volume is known in the scholarly literature as the 'Rose-effect' (see e.g. Frankel and Rose [2000]). According to Tranholm-Mikkelsen, political spillover can be discovered in the case of governmental and non-governmental elites concomitantly. With respect to the former, he mentions commissioners and MEPs while the latter consists of different interest groups (Tranholm-Mikkelsen [1991]). Pelkmans and Robson [1987] emphasize that *"[s]upport for the 'completion' of the Internal Market has also been forthcoming from a wide range spectrum of pressure groups in European society"*. In this context, they refer to the positive role of European business community, consumer organizations and labor unions (Pelkmans and Robson [1987: p. 184]). Finally, the active role of the European Commission in supporting functional and political pressures is the evidence of cultivated spillover. In summary, the horizontal and vertical shift of the European Union is the clear demonstration of the explanatory power of neofunctionalism. Nevertheless, as Tranholm-Mikkelsen puts it, integration should be seen as a 'dialectical process' determined by two opposite forces, the 'logic of integration' and the 'logic of disintegration' (Tranholm-Mikkelsen [1991]).

The new achievements of the integration from the mid-1980s onwards generated an optimistic political environment (mood) that persisted until the beginning of the 2000s.[14]

[13] Following the cumbersome ratification process, the Treaty on European Union (Maastricht Treaty) came into force on 1 November 1993.

[14] Despite the problems and stumbling blocks of the 1990s, such as the crisis of the European Monetary System (EMS) in 1993 or the difficulty of the ratification process of the Maastricht Treaty, this era was one of the EU's most dynamic and successful periods. The general optimistic mood ended with the

From theoretical point of view, the following years were extremely important. With respect to neofunctionalism, two major developments must be mentioned. The first is the establishment of a new (integration) theory, *Liberal Intergovernmentalism (LI)*, which soon became the main rival approach to neofunctionalism. The second development is the further refinements of the neofunctionalist framework. One of these is labelled as *supranational governance* or *supranational institutionalization*.

Liberal intergovernmentalist school was elaborated by the works of Andrew Moravcsik [1993; 1995] in the first half of the 1990s. He built his theory on other state-centered approaches of the 1980s, such as *regime theory*, *domestic politics approach* and *two-level games* (Moravcsik [1993]).

In the wake of the crisis of the Hegemon Stability Theory (HST), regime theory[15] became a central research topic of International Political Economy (IPE) at the turn of the 1970s and 1980s. The concept of regime refers to a kind of cooperation system among independent national states. The approach of *neoliberal institutionalism* is tightly intertwined with the regime theory and stresses the role of international institutions in inter-state cooperation (Vigvári [2012]).

Domestic politics approach emphasizes the importance of national governments in European Community policy-making. As Bulmer [1983] notes, *"[…] the supranationalism-versus-intergovernmentalism debate overshadowed some of the equally important findings concerning policy-making in the member states"* (Bulmer [1983: p. 349]).

Putnam [1988] accepts this view and stresses that one should take both national and international level into account when studying the politics of international negotiations. Putnam argues that these negotiations can usefully be seen as two-level games but neither of the two levels can be ignored. At the national level, domestic players pressurize their governments to adopt favorable policies while at the

fiasco of the 'Constitution Treaty' and the eruption of the global financial and economic crisis of 2008-2009. Nevertheless, it is worth to note that, on the other hand, the Lisbon Treaty was signed in 2007 (and came into force in 2009), which, in our opinion, refines a bit the big picture.

[15] The term 'regime' was intoduced to IPE by John Ruggie in 1975. According to Ruggie, *"[t]he term regime […] refers to a set of mutual expectations, rules and regulations, plans, organizational energies and financial commitments, which have been accepted by a group of states"* (Ruggie [1975: p. 570]).

international level, national governments seek to satisfy these demands (Putnam [1988]).

Drawing on these approaches, Moravcsik [1993] asserts that the European Community is not more than a successful international regime (international institution) designed to manage economic interdependence. Consequently, studying the European integration does not require a *sui generis* theory (Moravcsik [1993]).

Liberal Intergovernmentalism assumes rational state behavior and delivers a three-level explanation of international cooperation (integration) by amalgamating the liberal theory of national preference formation, intergovernmentalism and neoliberal institutionalism. *Table 9* represents the framework of LI.

Table 9: The liberal intergovernmentalist framework

	Level	Features
3	Institutional choice (neoliberal institutionalism)	• compliance enforcement • function and sovereignty delegation to international institutions
2	International bargaining (intergovermentalism)	• international bargaining • relative power • asymmetric interdependences • supranational elites does not matter • states act (bargain) as unitary actors • convergence or divergence of national preferences
1	National preference formation (liberal theory)	• integration does not shape preferences • aggregation of preferences • articulation of preferences • state-society relations • cost-benefit analysis of economic interdependence • dominance of economic interests

Source: Own table based on Benczes [2018a] and Moravcsik [1993]

The *first level* represents the national preference formation. Here, economic interests matter in the first place, and various domestic interest groups articulate their preferences based on cost-benefit analysis. It is noteworthy that the integration does not shape preferences. States, as unitary players, aggregate preferences and bargain with each other on the international stage (*second level*). Supranational elites does not take part in this process, the outcome is based on the relative power of countries. On the *third level*, states transfer sovereignty to institutions because they can facilitate cooperation and enforce compliance with common rules (Benczes [2018a]; Moravcsik [1993; 1995; 1998]; Moravcsik and Schimmelfennig [2019]). Shortly after the appearance of LI, the theory was criticized by several scholars for various reasons.[16]

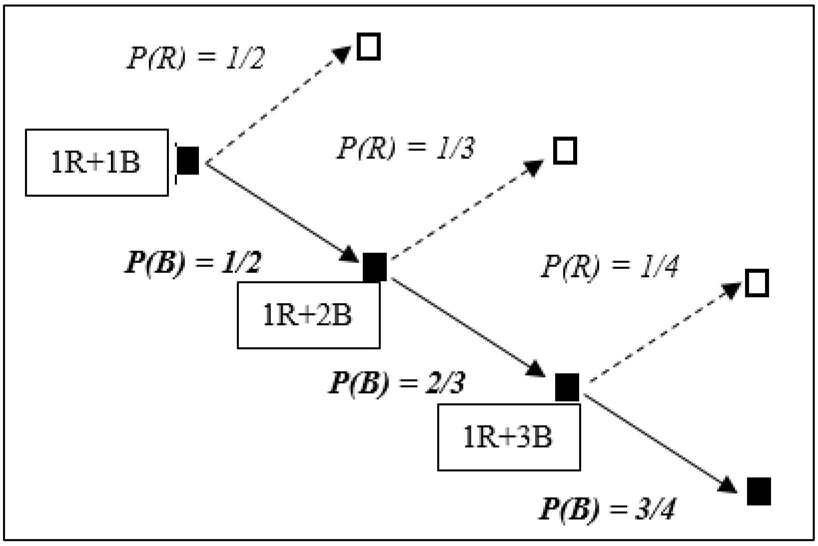
From the 1980s onwards, another research field ('new institutionalism') appeared (more precisely re-emerged) in response to the behavioralist revolution of the 1950s and 1960s. This family of theories illuminates and stresses the role of institutions in political outcomes. 'New institutionalism' consists of three theories, historical institutionalism (HI), rational choice institutionalism and sociological institutionalism. (Hall and Taylor [1996]).

Of the three branches, we deal briefly with historical institutionalism because this approach played an important role in the rebirth of neofunctionalism. It has to be clarified that historical institutionalists define institutions *"[a]s the formal or informal procedures, routines, norms and conventions embedded in the organizational structure of the polity or political economy"* (Hall and Taylor [1996: p. 6]). The central assumption of HI is that social processes must be seen as historical phenomena (Pierson [1996]). In relation to this, the concept of *path dependence* is a fundamental building block of the theory. However, as Pierson [2000] notes, one cannot find a clear definition. Instead, there is a broader and a narrower definition. In the former sense, path dependence refers only to the cliché that 'history matters' because temporal sequence has an impact on outcomes. The narrower approach proves to be more useful since it tells something about the costs and probabilities as well (Pierson [2000]). According to Levi [1997], *"[p]ath dependence has to mean […] that once a country or region has started down a track, the costs of reversal are very high. There will be other choice points, but the entrenchments of certain institutional arrangements obstruct an easy reversal of the initial choice"* (Levi [1997], cited by Pierson [2000: p. 252]). This interpretation is also known as increasing returns process (IRP), self-reinforcing process or positive feedback process. Mathematically, the IRP follows a so-called *Polya-process*, which can be characterized by the following four features. *Unpredictability* means that initial events are random and have large effects with many possible outcomes. *Inflexibility* refers to the rising costs of reversal, which makes it

[16] For instance, Benczes [2018a] provides a very good summary on the major criticisms of LI.

more difficult and unlikely to shift from one path to another (‘lock-in’ process or inertia). In addition, path dependence is a non-ergodic process, i.e. early events have an impact on future choices (*non-ergodicity*). Finally, in the long run, the outcome that becomes locked in may turn out to be inefficient (*potential path inefficiency*) (Pierson [2000]). *Figure 6* represents a simple model to illustrate the phenomenon of path-dependence mathematically.

Figure 6: Path dependence and the Polya-process



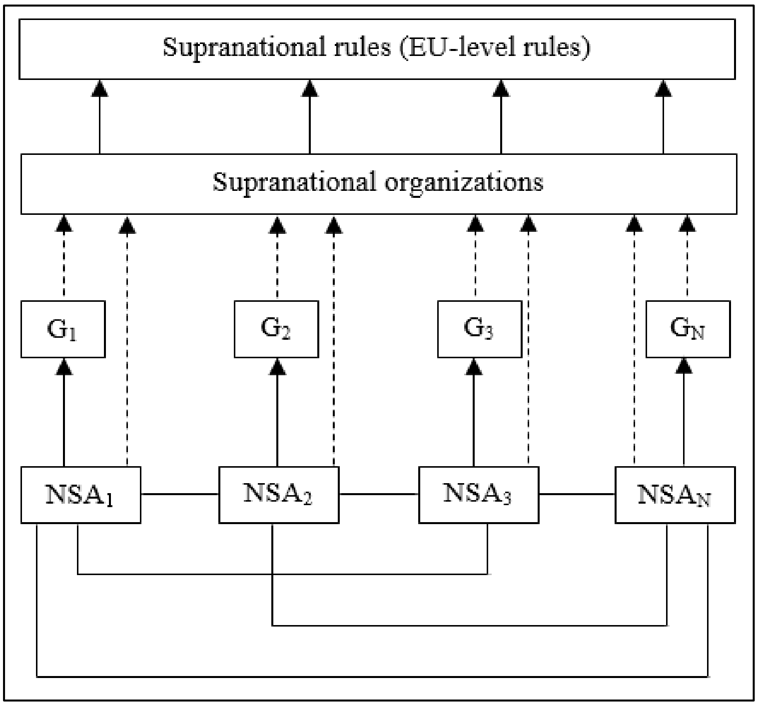
Source: Own compilation and figure based on Pierson [2000]
Note: The model represents a simple Polya urn process.
The urn is filled with two balls. Let *R* denote the red ball and *B* the black one.
Let us suppose that in the first round we remove the black ball and return it accompanied by an additional black ball. It means that the probability (*P*) of drawing a black ball again increases to 2/3. If we remove a black ball in the second round, the probability of the same ‘path’ further increases (*P* = 3/4) since the number of black balls increases to three, and so on.

Capoccia and Kelemen [2007] present a ‘dual model’ of institutional development. In their framework, the evolution of institutions can be divided into critical junctures and institutional stability. Accordingly, critical junctures are relatively short periods when rapid and radical changes (may) happen in the institutional system. Put differently, the probability of institutional change increases significantly. By contrast, institutional stability refers to a relatively long period characterized by institutional reproduction and inertia. As the authors note, critical junctures are rare events, the normal state of an institutional system is stability or adaptive change (Capoccia and Kelemen [2007]). Inertia shows extraordinary similarity to the concept of encapsulation, which refers to marginal changes within the zone of indifference (Schmitter [1970]).

It can be seen that historical institutionalism shows significant affinities with neofunctionalism. Therefore, it is not surprising that newer refinements of the theory draw on several arguments of HI. Pierson [1996], for instance, analyzes the European integration process in a historical institutionalist framework (Pierson [1996]). Pollack [2019] highlights that most historical institutionalist analyses of the European integration have stressed positive feedbacks. This mechanism can be assessed as the counterpart of functional spillover (Pollack [2019]).

Stone Sweet and Sandholtz [1997; 1998] propose a transaction-based theory called Supranational Governance (SG) (or Supranational Institutionalization). Their contribution is the result of a four-year collaborative research project (supranational governance is sometimes labelled as 'Laguna Beach approach') (Stone Sweet and Sandholtz [1998]; Verdun [2002]). The authors depart from the argument that previous theories, i.e. neofunctionalism and (liberal) intergovernmentalism have been unable to explain the uneven development of the European integration. While supranational governance shows significant similarities to neofunctionalism, it focuses on supranational governance and institutionalization. Accordingly, the mode of governance is treated as the dependent variable. Stone Sweet and Sandholtz define integration as *"[t]he process by which the horizontal and vertical linkages between social, economic, and political actors emerge and evolve"* (Stone Sweet and Sandholtz [1997: p. 304]). In this definition, horizontal linkages refer to the stable relationships between actors of the member states while vertical linkages mean the stable relationships between EU-level and state-level actors. SG consists of the following three interrelated elements: transnational society (especially non-governmental players), European Community (EC) organizations and EC rules. In order to measure the increasing influence of these factors, Stone Sweet and Sandholtz offer a scale that stretches between intergovernmental politics and supranational politics. Accordingly, different policy sectors may be located at different points on the scale. In short, SG intends to explain why movement occurs along the scale from intergovernmental politics toward supranational politics. Furthermore, it tries to explain why different policy areas move faster and farther than others. The interaction of the three factors and the phenomenon of the modified spillover can be summarized as follows. As the point of departure, the approach assumes that international (economic) transactions between non-state actors (NSAs) exist. As the number and intensity of these transactions start to increase, the maintenance of different domestic rules and legal regimes in the member states is becoming more and more costly. Not surprisingly, NSAs (such as transnational corporations, businesses, etc.), in turn, require supranational (i.e. EU-level) regulations that lower transaction costs and facilitate cross-border transactions. Accordingly, NSAs exert pro-integration pressure on their own governments. The need for supranational rule-making is in line with the concept of functional spillover. However, governments may try to protect their interests and autonomy by hindering the integration process. In this case, non-governmental players may turn directly to supranational institutions to voice their demands (similarly to the phenomenon of political spillover). In the last step, according to the cultivated spillover, supranational (EU-level) institutions use their autonomy to make new EU-level rules to satisfy the demands of NSAs. Thus, as Stone Sweet and Sandholtz argue, collective transnational utility increases. The movement along the scale has its own dynamic (*institutionalization*) due to positive feedbacks that result in new rules (Stone Sweet and Sandholtz [1997; 1998]; Leuffen et al. [2013]). *Figure 7* shows the schematic framework of SG.

Figure 7: The schematic model of supranational governance



Source: Own figure based on Stone Sweet and Sandholtz [1997]

As Sandholtz and Stone Sweet [2014] claim, SG is related to the Haasian version of neofunctionalism but it also shows some differences. First, drawing on the results of historical institutionalism, SG incorporates the concept of institutionalization and path dependence (positive feedback). Second, as it was mentioned, the outcome (dependent variable) to be explained is the expansion of supranational governance (or institutionalization). Finally, SG does not assume that loyalties and identities of actors shift inevitably to supranational level as the integration proceeds. Put simply, supranational governance (institutionalization) without loyalty transfer is possible (Sandholtz and Stone Sweet [2014]).

In spite of the fact that SG was probably the most significant modification of neofunctionalist thinking, other amendments and revisions were also made during the recovery phase.

Niemann [1998] studies the emergence of the PHARE program (*PHARE – Poland and Hungary Assistance for the Restructuring of the Economy*) in neofunctionalist approach. The aim of his article is twofold. First, he intends to upgrade underestimated neofunctionalist assumptions. In this context, he stresses the importance of externalization and '*engrenage*'. Second, he extends the theory by incorporating the mediating role of the Council Presidency and the presence of *epistemic communities*. In his view, both can be attached to the category of cultivated (institutional) spillover. Niemann concludes that Moravcsik was wrong because both levels of the 'game' are influenced by supranational and transnational actors. Consequently, he criticizes the liberal intergovernmentalist approach (Niemann [1998]).

Haas [2001] argues that neofunctionalism can be seen as a forerunner and 'subset' of constructivism since the latter also draws on pluralism and peace theory. Despite their differences, neofuncionalism and constructivism show important similarities, with special respect to value-driven preferences (interests) (Haas [2001]).

Schmitter [2004] and Rosamond [2005] acknowledge that the conceptual toolkit of neofunctionalism is still relevant in studying the EU and, in a broader sense, comparative regionalism. However, in order to distinguish the modified versions of the theory from its original framework, Schmitter uses the term *'neo-neofunctionalism'* (Schmitter [2004]; Rosamond [2005]).

Niemann [2006], in his chapter, provides a very detailed model of the revised neofunctionalist theory. While retaining many assumptions of the original neofunctionalist framework, Niemann makes some relevant and important modifications. His central argument is that integration occurs only when spillover pressures are stronger than countervailing forces. Regarding this, he identifies three clusters of countervailing forces. These are sovereignty-consciousness, domestic constraints and diversities, and negative integrative climate.[17] With respect to the spillover process, Niemann distinguishes five types. In addition to functional, political and cultivated spillover, he introduces the concept of *social spillover* covering the interconnectedness of governmental elites. Put differently, social spillover tries to capture the phenomenon of *engrenage* in structured form. It is important because elite socialization and learning may facilitate (supranational) problem-solving process. Finally, Niemann draws the attention to the fact that external (global) environment also influence and shape the preferences of domestic and EU-level actors. Unfortunately, as he notes, the original version of neofunctioalism underestimated global events and treated the Community as an isolated entity.[18] Accordingly, Niemann extends the model with the notion of *exogenous spillover*. International (economic) competition, globalization, migration, environmental problems or international terrorism, are all examples of external impacts (Niemann [2006]).

In addition to the modifications mentioned above, another research direction also appeared. Risse [2005] concentrates on the relationship between neofunctionalism and collective identitites. The issue of identity and loyalty transfer is a relatively under-explored part of the Haasian definition of integration. In the words of Risse (Risse [2005: p. 295]), *“[s]hifting loyalties as a defining feature of political integration was largely lost as an object of study”*. He also stresses the phenomenon and presence of ‘multiple loyalties’. Accordingly, it is false to treat European identity as a zero-sum game that implies the decrease one’s loyalty to national entities (Risse [2005]).

In the beginning of the 2000s, there were attempts to mix various integration theories. Verdun [2002] argues that an *eclectic theory* has the capacity to take all relevant factors of different theories into account. In order to achieve this, the author clusters various

[17] Sovereignty-consciousness refers to the phenomenon that crucial actors are reluctant to delegate further competences to the supranational level. This type of (negative) force has to do with national traditions and identities. Domestic constraints and diversities includes factors (interest groups, opposition parties, media, public pressure, structural factors, etc.) that narrow down the governments’ autonomy. Finally, negative integrative climate refers to general pessimistic attitudes towards integration.
[18] As Niemann remarks, Schmitter [1969] was the first who dealt with exogenous factors in his ’externalization hypothesis’.

approaches into two groups. The so-called ‘neofunctionalist family’ contains the following schools: neofunctionalism, historical institutionalism, constructivism, epistemic community approach, advocacy-coalition approach, policy networks approach, Laguna Beach approach, fusion-thesis and multi-level governance (MLG). By contrast, domestic politics approach, two-level games, liberal intergovernmentalism and (realist) intergovernmentalism can be attached to the so-called ‘intergovernmentalist’ family. Verdun focuses on two important factors that make the main difference between the two clusters. While the ‘neofunctionalist cluster’ see non-state actors to be the decisive players in the integration process, the ‘intergovernmentalist’ camp stresses the importance of the role of national states (governments). Furthermore, the ‘neofunctionalist’ family assumes the presence of some automaticity due to the spillover mechanism, the ‘intergovernmentalist’ cluster focuses on national interests and bargaining. According to Verdun, integration theories complement each other since integration is happening continuously at various levels with different actors. Thus, the relative significance of different actors and mechanisms depends on the given situation (Verdun [2002]).

In this subsection, we have provided an overview on the re-emergence of neofunctionalism and its newer revisions. In addition, we presented Liberal Intergovernmentalism, which became the main contending theory in the 1990s and 2000s. Finally, we outlined some new research directions such as the eclectic theory of integration or the study of collective identities. In our categorization, with the economic crises in the end of the 2000s, the ‘recovery phase’ ended as well. At the same time, a turbulent period began, which opened up channels for heated debates and new approaches. The next subsection summarizes shortly these developments.

2.2.5. Crisis of theories: the uncertainty phase

The global financial and economic crisis of 2008-2009, and the subsequent sovereign debt crisis can be assessed as a ‘critical juncture’. The dichotomy of ‘less Europe’ or ‘more Europe’ became, again, the major debate among the member states. Moreover, unusual solutions of the crisis management (e.g. tighter cooperation on an intergovernmental basis) made Economic Governance even more complex. Consequently, it became a real question whether the crisis is rather beneficial or detrimental (Lefkofridi and Schmitter [2015]). This cleavage and the dilemmas of the crisis management influenced the field of Integration Theory because the theoretical explanation of the crisis became disputed (Ioannou et al. [2015]; Nicoli [2019]). As a result, alternative theories and approaches appeared in the literature with the aim of explaining new developments in the EU. These theories are *postfunctionalism*, *New Supranationalism*, *New Intergovernmentalism* and *New Parliamentarism*.

Negative experiences of the integration from the 2000s gave rise to a new research program called postfunctionalism. Postfunctionalism intended to explain the new developments of the EU in a somewhat new framework. Hooghe and Marks [2009] state that *"[...] neofunctionalism and intergovernmentalism have become less useful guides for research on the European Union"* (Hooghe and Marks [2009: p. 3]. Their approach draws on multi-level governance and places the EU into a wider context. Postfunctionalism assumes that, since the adoption of the Maastricht Treaty, domestic and European politics have been tightly intertwined. As a result, mass politics became a new factor in the European integration that shape potential outcomes. The line of thinking is as follows. As the authority of the EU reaches core areas influencing sovereignty, national identity, and economic welfare, public opinion turns against the EU. In the next step, Eurosceptic parties realize and exploit this sentiment during elections and referendums. In summary, according to the postfunctionalist approach, politicization is rather a negative process leading to a 'constraining dissensus'. Consequently, the expected outcome of the crises is stagnation or disintegration (Schimmelfennig [2017]).

Postfunctionalism was (heavily) criticized through the following years. Schimmelfennig [2014] argues that neofunctionalism provide a good explanation for the developments of EU during the Eurozone crisis. In his view, national governments managed to contain the 'constraining dissensus' in three ways, i.e. by Euro-compatible government formation, avoiding referendums and supranational delegation (Schimmelfennig [2014]).

Of course, neofunctionalist arguments did not evaporate during the crisis. For instance, Ioannou et al. [2015], and Niemann and Ioannou [2015] conclude that neofunctionalism provide a good framework to explain the developments of the crisis management (Ioannou et al. [2015]; Niemann and Ioannou [2015]). Nonetheless, other scholars claim that it is hard to find any evidence of functional and political spillovers in terms of delegation of new competences (Vilpisauskas [2013]).

Jones et al. [2015] bring eclectic view back into the debate by claiming that both neofunctionalism and intergovernmentalism offer a good explanation. More precisely, they argue that while intergovernmentalism may be a suitable framework in the short-term, neofunctionalist approach has the capacity to interpret long-term developments of the crisis. The authors use the term of 'failing forward' to refer to this interesting puzzle (Jones et al. [2015]).

In this theoretical debate, a new 'cluster' of theories appeared, which focuses exclusively on the role of the EU institutions. This new cluster is known as *New EU Governence* and consists of three different approaches, New Intergovernmentalism, New Supranationalism and New Parliamentarism. As Schmidt [2016] notes, all these approaches have to be taken into account when analyzing the EU governance. Put differently, the actions and interactions of various EU actors represented by these theories make up the New EU Governance. However, Schmidt admits that there is a common flaw of these schools because all of them ignores the national level (Schmidt [2016]). We totally agree with this statement since the EU is a *complex adaptive system*[19] of national, transnational and EU actors. Thus, when analyzing the integration, all players and all levels have to be taken into account.

New Intergovernmentalism focuses on the role of intergovernmental institutions. According to this theory, the Council and the European Council play the key role in shaping integration outcomes. Nevertheless, they do it in a consensus-seeking way, which (significantly) differs from the 'old' intergovernmentalist thinking. Furthermore, the creation of so-called *de novo* bodies such as the European External Action Service (EEAS), the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) is also an important element of the approach. As Bickerton et al. [2015] remark, *de novo* bodies are not traditional supranational institutions, some of them are created within the framework of the EU treaties while others outside of them. In addition, these bodies have relatively simple and issue-specific tasks (Bickerton et al. [2015]; Schmidt [2016]).

[19] In our terminology, adaptivivity refers to the phenomenon that the EU is changing in time due to external and internal impacts and the learning process of the actors.

New Supranationalism states that the crisis management appears to be more complex than new intergovernmentalist explanations suggest. This theory emphasizes that, in spite of the negative integration climate, supranational institutions have been significant actors in the post-crisis period. According to Dehousse [2015], supranational players, especially the European Commission and the European Central Bank, managed to increase their powers in key (strategic) policy areas, even if this increase was the result of a series of irksome meetings and decisions. (Dehousse [2015]). It is noteworthy that this kind of incrementalism does not contradicts neofunctionalist argumentation at all.[20] It is true, however, that unusual institutional solutions were introduced and final decisions were made in an intergovernmental way in some cases. To some extent, New Supranationalism criticizes New Intergovernmentalism for downgrading the role of supranational institutions.

Apart from the above-mentioned differences, New Intergovernmentalism and New Supranationalism should be seen as complementary approaches. Unfortunately, both theories leave out the function of the European Parliament when explaining the integration (Schmidt [2016]). New Parliamentarism fills this gap by emphasizing the growing significance of the institution, primarily in excercising oversight to intergovernmental and supranational actors. In addition, it should not be forgotten that the European Parliament also plays a key role in the so-called ordinary legislative procedure (co-decision procedure) (Schmidt [2016]). As it is well-known, since the adoption of the Lisbon Treaty, this mode of decision-making has been the dominant one in the EU.

In summary, the uncertainty phase of neofunctionalism suggests that it seems very difficult to find the proper theoretical framework to explain the developments of the crisis management. Nevertheless, we argue that neofunctionalism can provide a suitable explanatory framework. In the next subsection, we elaborate our own model.

2.3. The applied analytical (methodological) framework

So far we have presented the ontology and evolution of neofunctionalism. We have seen that the theory underwent a series of modifications and refinements from the late

[20] Let us remember that neofuncionalism stresses the importance of incrementalism instead of ’grand designs’ and big leaps.

1960s. As a result, different scholars elaborated different methodological and conceptual toolkits. In *Table 10*, we summarize and categorize the evolution of the Neofunctionalist Research Program.

Table 10: The evolution of the Neofunctionalist Research Program

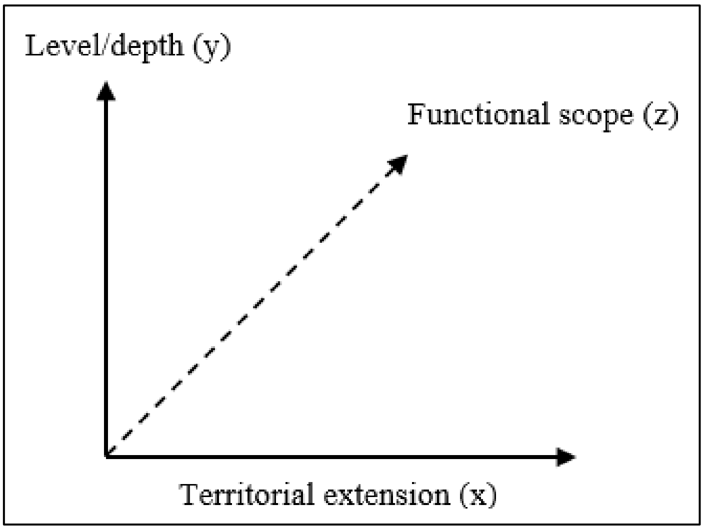
	Name of phase	Period	Main features/themes	Major works
1	Formation	1958 – 1964	• Initial success of the European integration • The birth of neofunctionalism and Integration Theory	• Haas [1958/2004; 1961; 1964] • Lindberg [1963] • Haas and Schmitter [1964]
2	Withdrawal and transformation	1965 – 1984	• The "De Gaulle phenomenon" • Oil crises and protectionism • Failure of the Werner Plan • 'Eurosclerosis' • Classical Intergovernmentalism • Interdependence theory • Declaring neofunctionalism obsolete • Transformation of neofunctionalism	• Hoffmann [1964; 1966] • Hansen [1969] • Haas [1967; 1970;1976] • Lindberg [1965] • Lindberg and Scheingold [1970] • Nye [1968; 1970] • Schmitter [1969; 1970]
3	Recovery	1985/1986 – 2008/2010	• Adoption of the Single European Act • The Delors Plan • Adoption of the Maastricht Treaty • Single Market • Economic and Monetary Union • Rebirth of neofunctionalism • Liberal Intergovernmentalism • Supranational governance • Failure of the Constitutional Treaty	• Tranholm-Mikkelsen [1991] • Bulmer [1983] • Putnam [1988] • Moravcsik [1993; 1995; 1998] • Pierson [1996; 2000] • Stone Sweet and Sandholtz [1997; 2014] • Verdun [2002]
4	Uncertainty	2008/2010 –	• Global financial and economic crisis • Eurozone crisis • Migration and refugee crisis • The Covid-19 crisis • Integration or disintegration? • New theories (e.g. postfunctionalism)	• Hooghe and Marks [2009] • Dehousse [2015] • Bickerton et al. [2015] • Schmidt [2016] • Schimmelfennig [2014]

Source: Own table and categorization

In this section, we establish our own analytical framework. The model is based on the previous versions of the theory but it also contains some conceptual and methodological amendments. As we have stressed in the Introduction, the objective of our analytical framework is to elaborate a parsimonious version of neofunctionalism that amalgamates the fundamental features of the previous versions of the theory but at the same time, contains some modifications which makes neofunctionalism applicable in a broader sense. Three amendments are made. First, our model put a greater emphasis on the external environment of the EU by incorporating exogenous triggers into the model. Second, we see the spillover a complex mechanism and divide it into triggers and institutional outcomes. Third, we increase the number of the potential political actors ('elites') by adding relatively new non-governmental players to the category of political triggers.

In order to clarify the basic dimensions of the integration, we depart from the following model. *Figure 8* shows a three-dimensional coordinate system, which represents the '*integration space*'. Let *Ω* denote the integration space, which is the function of three variables (dimensions), *x*, *y*, and *z*, where *x* represents the territorial extension of the integration, *y* denotes the centralization level (depth), and *z* is the scope of cooperation.

Figure 8: The three-dimensional integration space



Source: own figure based on Leuffen et al. [2013]

Accordingly, the structure of an integration scheme can be written in a mathematical form as follows:

$$\Omega = \Omega\,(x, y, z), \qquad \text{where}$$

x = x (territorial extension)

y = y (level/depth)

z = z (functional scope).

Territorial extension (dimension x) depends on the number of the participating countries in a certain integration scheme. In this respect, the accession of one or more states means the increase in the number of member states. We can also refer to this phenomenon as geographical integration or geographical spillover. Holding other dimensions constant (*ceteris paribus*), geographical spillover, in itself, does not mean a qualitative change, or in other words, a tighter and more efficient cooperation among the members.

The degree of depth (dimension y) refers to the centralization level of the integration and this is what we call vertical integration. Here we face two fundamental and interrelated questions. The first has to do with the so-called dependent variable problem. In order to manage this problem, we do not assume a clear end-point. Instead, in line with Haas [1970], it may be useful to see the integration process as a scale on which we can move towards a higher degree of cooperation (or supranationalism) compared to a previous point in time (Haas [1970]). On the scale it is possible to identify multiple dependent variables (critical milestones) without referring to an end state. This mode of thinking is also in line with the concept of incrementalism, which is one of the major characteristics of the neofunctionalist theory. Accepting this view, we do not see the European integration a teleological process, however, we accept implicitly that some kind of end state may arise in the very long run.

Balassa [1961], in his famous book, elaborated a five-stage model that represents the deepening of regional economic integrations. He distinguishes the following levels of integrations: Free Trade Area, Customs Union, Common Market, Economic Union and Full Economic Integration (Balassa [1961]). During the following decades, based on Balassa's original model, other typologies have also been made in order to describe the development of the European integration more exactly. Szijártó [2018] provides a good overview and comparison of these variations. Building on these typologies, we propose the following stages: Free Trade Area, Customs Union, Common Market, Single Market, Economic and Monetary Union, Full (Complete) Economic and Monetary Union, and Political Union. According to this, the achievement of a complete EMU can be assessed as a kind of dependent variable, a critical milestone. In this context, the major goal of our framework is to explore and explain the gradual deepening. *Table 11* shows the comparison of the different typologies.

Table 11: The stages of regional economic integrations

Typology of Balassa		Early EU typology		Typology of Crowley		New EU typology	
				0	Regional autarky		
1	Free Trade Area	1	Free Trade Area	1	Free Trade Area	1	Free Trade Area
2	Customs Union	2	Customs Union	2	Customs Union	2	Customs Union
3	Common Market	3	Common Market	3	Common Market	3	Common Market
4	Economic Union	4	Single Market	4	Economic Union	4	Single Market
5	Full Economic Integration	5	Economic and Monetary Union	5	Monetary Union	5	Economic and Monetary Union
		6	Political Union	6	Fiscal Union*	6	Economic Governance and Banking Union
				7	Political Union*	7	Fiscal Union
						8	Political Union

Own typology	
1	Free Trade Area
2	Customs Union
3	Common Market
4	Single Market
5	Economic and Monetary Union
6	Full Economic and Monetary Union** or Economic Federalism
7	Political Union***

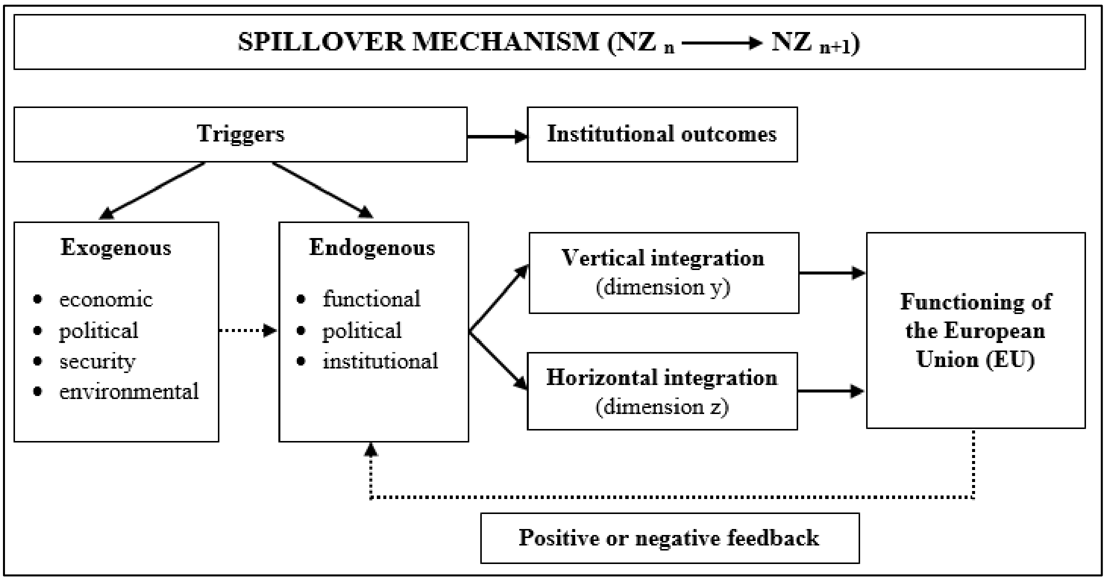
Source: Own table based on Szijártó [2018] with modification
* The order of Fiscal Union and Political Union is interchangeable
** Full (Complete) Economic and Monetary Union means the strong Economic Governance including the Fiscal Union and the Banking Union
*** The formation and the exact content of a Political Union is uncertain, however, it is a possible outcome in the very long run.

The scope of integration (dimension z) represents policy areas where the member countries cooperate to some extent. We call this dimension horizontal integration. Taking into account that in the EU almost all policy areas are integrated to some extent (Stone Sweet and Sandholtz [1997]), this dimension has reached its (quasi) maximum value. To indicate this, we can rewrite the equation of the integration space in the following form:

$$\Omega = \Omega\ (x, y, z_{max}).$$

Figure 9 represents our analytical framework in a schematic form.

Figure 9: The modified neofunctionalist framework



Source: Own figure and model

As in the previous versions of neofunctionalism, the central methodological concept of our model is the spillover, however, we give a somewhat different meaning to it. By spillover we mean the process (mechanism) which shifts the integration from an initial equilibrium (E_n) (neutrality zone, NZ_n) to a new one (E_{n+1} or NZ_{n+1}). As long as the initial equilibrium exists, the integration is in the so-called neutrality zone. The spillover mechanism should be seen as a complex system. Accordingly, we divide it into two stages, triggers and (institutional) outcomes.

Spillover triggers can be defined as factors that make the initial equilibrium state unstable. It practically means that these factors put pressure on the member states to shift the integration away from the neutrality zone. Furthermore, we can distinguish two types of triggers, exogenous and endogenous triggers.

Exogenous triggers are factors coming from outside the integration. These may be economic, political, security or environmental of nature. It has to be emphasized that exogenous triggers have to be strong enough to induce endogenous triggers. Put differently, external impacts have to be strong enough to affect the integration fundamentally and make the member countries to react.

Nevertheless, endogenous triggers may arise without the presence of exogenous ones. This is the case when tensions emerge due to internal problems and malfunctions or when member states and/or supranational players agree on horizontal and/or vertical integration. Thus, based on Tranholm-Mikkelsen [1991], we discriminate functional, political and institutional endogenous triggers.

Functional triggers arise if the integration works inefficiently for certain reasons in one or more policy areas. Here we underline again that this inefficiency has to be powerful enough to cause critical disturbance in the functioning of the integration that makes the initial equilibrium unstable. A functional trigger, in itself, indicates only that something has to be made in order to manage the existing critical malfunction. Therefore, this type of trigger must be accompanied by the decision and action of the 'elites'. In other words, political and/or institutional triggers are also indispensable.

Accepting the framework of Niemann and Ioannou [2015], functional triggers can be operationalized by testing the following elements ('indicators'): (1) the salience of the original objective(s), (2) the existence of functional interdependencies between the original and other issue area(s), (3) the availability of alternative functional solutions, (4) and the perception of relevant actors. Put simply, a functional trigger can be detected if these four factors exist simultaneously. The first factor refers to one or more significant and/or urgent original policy objective(s), which can only be reached by further integration. Functional interdependencies represent the interconnectedness between different issue areas (Niemann and Ioannou [2015]). However, compared to the framework of Niemann and Ioannou [2015], we interpret this element in a slightly different way. In line with our own neofunctionalist model, we distinguish two types of functional interdependence: horizontal and vertical interdependencies. By horizontal interdependence, we mean the situation when the original issue (policy area) is in connection with another policy area. For instance, this was the case between the Single Market and the Economic and Monetary Union. Accordingly, horizontal interdependence extrapolates horizontal integration as an institutional outcome. By contrast, vertical interdependence exists when the original policy area is incomplete, and, as a result, works inefficiently. In principle, this type of relation should lead to vertical integration. With respect to the third element, functional triggers are considered to be strong if alternative functional solutions are not available, or these solutions are too costly. Finally, it is an important precondition that functional triggers have to be perceived by relevant actors. This is the case if political discourse is shaped by these functional arguments (Niemann and Ioannou [2015]). Nevertheless, it has to be noted that this element, to some extent, is intertwined with the concept of political trigger.

In our conceptual framework, the category of political trigger is used in a broad sense. We define political trigger as the integrative role of political actors who perceive that supranational solutions, i.e. horizontal and/or vertical integration, are beneficial and/or indispensable for the member states. However, by political actors, we mean all the agents (or interest groups) who have an impact, directly or indirectly, on the European politics. In this context, those players are relevant who articulate their positions in favor of further integration. Here we can mention a wide range of actors, such as political parties, politicians, governmental and non-governmental organizations, interest groups, financial institutions (financial markets[21] in a broader sense), domestic companies, transnational or multinational corporations (TNCs/MNCs) and the public opinion.

Political triggers can be operationalized by scrutinizing two factors: (1) the extent to which supranational solutions are perceived advantageous by relevant actors, and (2) the degree to which these actors represent and articulate their positions in a coordinated way transnationally, rather than nationally (Niemann and Ioannou [2015]).

Finally, institutional trigger refers to the (potentially) pro-integration activity of the supranational institutions, i.e. the European Commission (EC), the European Parliament (EP), the European Court of Justice (ECJ) and the European Central Bank (ECB). It should be emphasized, however, that pro-integration activity can be induced either by functional dissonances or by the intent of supranational institutions to extend the limits of their power and competences. Of course, it seems reasonable that functional triggers may create the opportunity for this process.

Exogenous and/or endogenous spillover triggers may lead to various institutional outcomes. In accordance with our three-dimensional model, triggers may result in two possible outcomes, horizontal and/or vertical integration. Accepting that horizontal

[21] As Niemann and Ioannou [2015] note, it might be problematic to treat financial market like unitary actors but their actions seemed unitary during the crisis. This perception was the result of high uncetrainty and herd like behavior (Niemanna and Ioannou [2015]).

integration (dimension z) has already reached its maximum (z_{max}), spillover outcome is relevant only in the vertical direction (dimension y). As it was mentioned earlier, the horizontal movement can be measured by the change in the number of policy areas where member states cooperate within the framework of integration.

Vertical integration refers to the delegation of new or already existing competences or policies to the level of integration. This process must entail the involvement of supranational actors (institutions) in decision-making. Based on Börzel [2005], we offer a three-level scale for the operationalization of the centralization level. The first level is the *intergovernmental cooperation* that can be characterized by a limited supranational involvement. In this case, the Council plays the key role since the dominant decision-making rule is unanimity. However, the supranational institutions have a very circumscribed decision-making power. The second level means the so-called *joint decision-making method* whereby the Council and the European Parliament, based upon the proposal of the European Commission, bargain over the final legislative outcome. In practice, the Council may decide either by unanimity or by qualified majority voting (QMV).[22] The third level is the *supranational centralization*, which refers to the decision-making method where supranational institutions take unilateral actions (Börzel [2005]). Vertical integration may also be detected if new actors, institutions, mechanisms emerge with partly of fully supranationalized competence. From another point of view, it can be seen as a horizontal integration within a certain policy area.

Horizontal and/or vertical integration have an impact on the functioning of the integration, which in turn, may result in a certain type of feedback. In principle, we can discriminate three cases. *Positive feedback* occurs when the institutional outcome improves the functioning of the EU. However, positive feedback can be divided into two further subtypes, simple and dynamic positive feedbacks. Simple positive feedback refers to the phenomenon when the initial triggers cease to exist without generating new triggers. In this case, a stable equilibrium (neutrality zone) sets in. Practically, it means that the original problem is resolved by the institutional response (horizontal and/or vertical integration) and this response does not induce new

[22] With the entry into force of the Lisbon Treaty in 2009, QMV and the co-decision procedure became the dominant rule in the decision-making system. According to the Article 294 of the Treaty on the Functioning of the European Union (TFEU), this is the ordinary legislative procedure.

problems. By contrast, it is also possible that the positive feedback leads to an unstable equilibrium and results in new endogenous triggers. Accordingly, member states decide to take further steps that yield new institutional outcomes. These triggers may be the subsequent modification or fine-tuning of the previous outcome. This means that a dynamic feedback has a kind of multiplier effect on the functioning of the integration. The dynamic process (feedback) stops if a certain outcome leads to a stable equilibrium. In principle, *negative feedback* may present if an institutional outcome finally turns out to be harmful or inefficient. If the member states give a 'wrong answer' to the triggers, or if they are unable to work together efficiently in the new neutrality zone, then the initial problems (triggers) continue to exist.

Let us summarize the major points of our modified neofunctionalist model. The central concept of the framework is the spillover, however, we see it as a complex, multi-level mechanism. By spillover we mean the process which shifts the EU from an initial neutrality zone to another one. Exogenous and endogenous triggers are critical factors that, eventually, result in different institutional outcomes, horizontal and/or vertical integration. These outcomes have an impact on the functioning of the EU and generate either positive or negative feedback.

In this section, we have provided an extensive description and analysis on the Neofunctionalist Research Program. Based on the historical review, we have also shown that the theory was able to explain the long-run development of the European integration project. Nevertheless, we have to admit that in the period between 1965 and 1985, neofunctionalism lost its explanatory power. Moreover, it should be highlighted that the theory has changed over the last decades and numerous versions have been elaborated. These variations modified the conceptual and methodological toolkit in many ways, but the school has maintained its core presumptions and elements. Applying the approach of Imre Lakatos (Lakatos [1997]), the Neofunctionalist Research Program managed to preserve the '*hard core*' of the theory while the '*protective belt*' underwent a series of amendments.

Neofunctionalism, however, arrived to a critical juncture again in the second half of the 2000s. After the introduction of the single currency, and especially following the rejection of the ratification of the Constitutional Treaty by France and the Netherlands, the optimistic attitude of the member states has changed significantly. In addition, the increasing economic and political problems were further exacerbated when the global financial and economic crisis and the sovereign debt crisis hit. Currently, one can ask the question whether the reforms of the EMU, and the strengthening of the European Economic Governance lead to a wider and/or a tighter cooperation within the Eurozone (and also in the EU). Put differently, does neofunctionalism have the capacity to renew again? The next section deals with the Eurozone crisis and the reforms of the Economic Governance.

3. EUROZONE CRISIS AND THE STRENGTHENING OF EUROPEAN ECONOMIC GOVERNANCE

In the previous section, we have presented the developmental trajectory of neofunctionalism. Furthermore, in the last subsection, we have elaborated our own analytical framework. Now, we turn to the issue of the Eurozone crisis (sovereign debt crisis). In subsection 3.1, we depart from the theoretical fundamentals of the Economic and Monetary Union. Accordingly, this part provides a short theoretical summary and gives an overview on the original structure (design) of the EMU. Subsection 3.2 encapsulates the anatomy and the chronology of the crisis by focusing on the fragility (incompleteness) of the EMU. Finally, subsection 3.3 deals with the reforms of the European Economic Governance.

3.1. The original architecture of the Economic and Monetary Union

3.1.1. The theories of Optimum Currency Areas

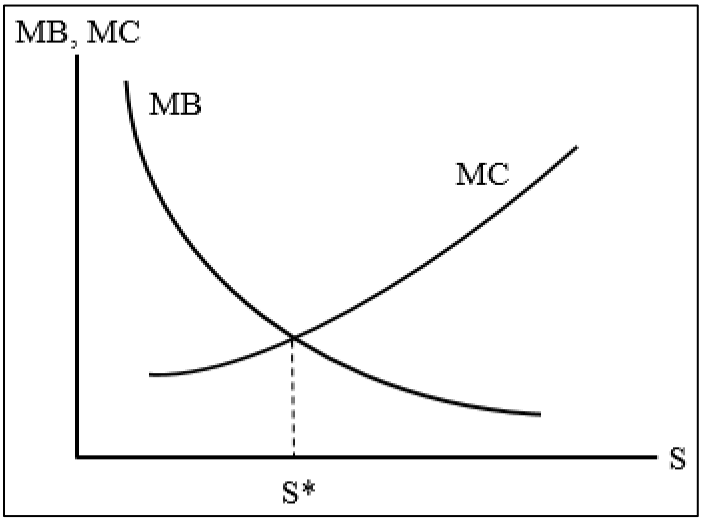
The establishment of the Economic and Monetary Union means the introduction of a fixed exchange rate mechanism among participating countries. However, it has to be noted that the EMU is a very special version of the fixed exchange rate systems because the exchange rates are *irrevocably* fixed. Therefore, the key question is as follows: under which conditions is it advantageous for a region to establish a monetary union and introduce a single currency.[23]

Before answering this question, it is important to determine the optimal size (S^*) of a currency union. In order to do this, we have to compare the marginal benefit (*MB*) and marginal cost (*MC*) of the zone. In this case, *MB* measures the additional benefit of increasing the area by one country. Since the advantage grows with the size of the union, *MB* is always positive, however, it is decreasing. Unfortunately, the enlargement of a currency area has costs too. These costs derive from greater economic diversity. Thus, *MC* is represented by an upward-sloping curve and measures the additional cost of a new member state. As long as marginal benefit exceeds marginal

[23] A monetary union, in general, can be defined as a region where countries use a fixed exchange rate regime. In addition, as a technical step, participating states may decide on the introduction of a single currency. In the German-language literature, the phrase of *'Krönungstheorie'* refers to the phenomenon that the adoption of a common currency completes, i.e. 'crowns' the process (Ferkelt [2020]).

cost ($MB > MC$), it is worth to enlarge the union by one more country. By contrast, if marginal cost is larger than the marginal benefit ($MB < MC$), the net benefit (NB) of the currency area tends to decrease. Consequently, the optimal size can be found in the point (S^*), where marginal benefit equals marginal cost ($MB = MC$). Put differently, S^* represents the size of the area, where NB reaches its maximum (NB_{max}) (Baldwin and Wyplosz [2020]). Figure 10 shows this situation in a graphic way.

Figure 10: The optimal size of a currency area



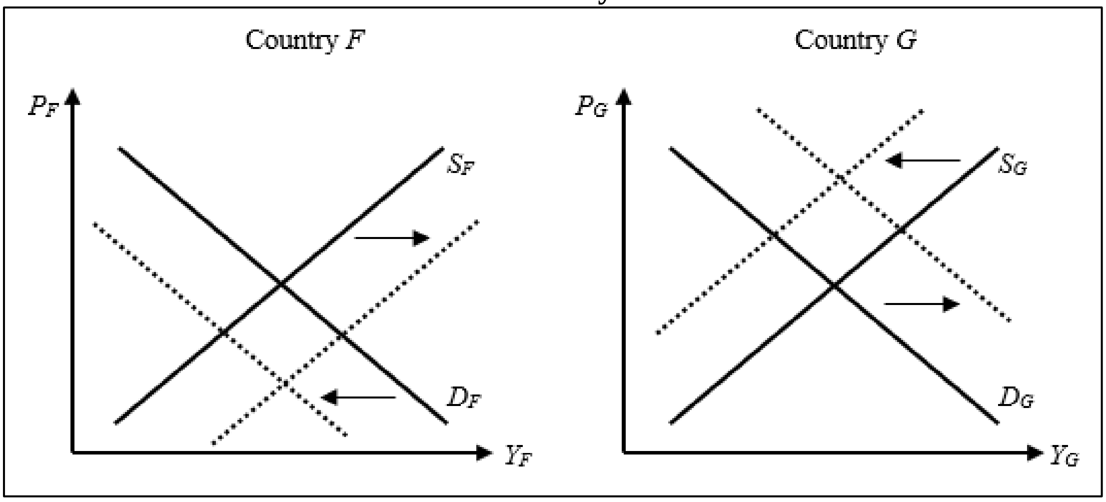
Source: Own figure based on Baldwin and Wyplosz [2020]

The Theory of Optimum Currency Areas (OCA-theory), which provides the theoretical basis of monetary integration (Halmai [2017]), was elaborated by Robert A. Mundell [1961], who departed from studying the balance-of-payments crises (Lőrincné [2007]).[24] Mundell presents a simple two-country model to illustrate adjustment problems after a demand shock. Let us assume that only two countries exist, say, *G* and *F*, which form a monetary union. Practically, it means that they have a common central bank (*CB*) and use a common currency.[25] Let us suppose now that consumers change their preferences and start to prefer the products of country *G* to the products of country *F*. This change leads to a negative demand shock in *F* and a positive demand shock in *G*.[26] Accordingly, output declines and unemployment increases in *F* while the opposite occurs in *G*.[27] Simply speaking, both countries will face an adjustment problem. The demand shock is depicted in *Figure 11*. In country

[24] Robert Mundell was awarded the Nobel Prize in 1999.
[25] The model assumes that initially both countries are characterized by full-employment and balance-of-payments equilibrium.
[26] Let us suppose that the demand shock is permanent.
[27] Positive demand shock is also problematic because it results in higher inflation rates in country *G*.

F, the aggregate demand curve (D_F) shifts to the left (and D_G to the right in country *G*). Fortunately, at least in principle, there are two automatic equilibration mechanisms (wage flexibility and labor mobility), with which countries may overcome the demand shock. If *wages are flexible*, they will decrease in country *F* and increase in country *G* following the shock. Due to the change in the wage rates, aggregate supply curves in both countries will shift (S_F to the right and S_G to the left) (see *Figure 11*). Lower prices in *F* improve the competitiveness of the country's products while the products of *G* become less competitive. This process finally leads to a new equilibrium. Besides wage flexibility, *international factor mobility* (especially mobility of labor) may also help countries to reach a new equilibrium. As unemployment raises in country *F*, unemployed workers can move to country *G* to get a job. As a result, unemployment decreases (or eliminates) in *F* and so does inflationary wage pressure in *G*. Thus, the movement of production factors (labor) can solve the adjustment problem in both countries without changes in the wages. In summary, flexible wages and/or labor mobility lead automatically to a new equilibrium (Mundell [1961]; De Grauwe [2018]).

Figure 11: Demand shock and the automatic adjustment process in case of wage flexibility



Source: Own figure based on De Grauwe [2018]

In the 1960s, further criteria were added to the OCA-theory.[28] McKinnon [1963] focuses on the degree of *economic openness*. This factor is important because exchange rate fluctuations impose additional costs on economic players and negatively

[28] In this section, we focus only on the major elements of the OCA-theory. For instance, Mongelli [2002; 2008] and Szijártó [2014; 2017; 2018] provide an exhaustive overview on the phases, evolution and criticisms of the theory.

affect the international trade. Consequently, choosing a fixed exchange rate system may be advantageous (Szijártó [2014]).

Kenen [1969] emphasizes the significance of *production* (and consumption) *diversification*. He argues that high degree of diversification (i.e. the absence of specialization) can alleviate the negative impacts of (asymmetric) shocks. Kenen also draws the attention to another important factor that should be an indispensable element of a monetary union. This criterion is the need for a (permanent) *fiscal transfer mechanism* (or insurance system), which has to do with redistribution in case of an asymmetric shock. Through this system, countries can compensate each other either automatically or discretionally. Such equilibration mechanisms exist within different federal countries, for example in Germany or Switzerland (Baldwin and Wyplosz [2020]; Szijártó [2014]).

In the so-called 'reconciliation phase', during the 1970s, the main objective of scholars (e.g. Corden [1972], Ishiyama [1975], Tower and Willet [1976]) was to *synthetize* and jointly interpret the diverse OCA-criteria (Mongelli [2002]). In addition, Mundell completely revised his theory in the early 1970s. The Mundellian revision was the result of two main developments. First, the free movement of capital was becoming dominant in that period, which directed attention to the importance of destabilizing speculative capital movements. Second, by the 1970s, monetarism became the mainstream economic theory. In short, Mundell started to focus on financial integration instead of production factor mobility (Szijártó [2017]).

From the 1990s onwards, new OCA-theories have appeared in the scholarly literature. Here, we mention two of them, *endogenous* and *exogeneous* (or *reverse*) *OCA-theories*. The endogenous approach see monetary integration as a dynamic process and claims that it does not matter whether countries comply with the OCA-criteria in advance. According to endogeneity, monetary union will lead to the synchronization of business cycles among the member states. As a result, due to the positive effects of the integration, countries will finally meet the criteria. Simply speaking, as time goes by, a former suboptimal currency area is becoming an optimal one. However, this process of accommodation may be unsuccessful or very slow. Therefore, as the exogenous approach recommends, under these circumstances optimality can be attained through various institutions (Szijártó [2017; 2018]).

3.1.2. The original design of Economic and Monetary Union

Since the international monetary system (i.e. the Bretton Woods system) provided a (relatively) stable background for economic processes in the end of the 1950s, the Rome Treaties did not contain any provision on the creation of a monetary union. However, this positive environment changed significantly by the end of the next decade. In the second half of the 1960s, serious problems of the Bretton Woods system became evident. Furthermore, the implementation of the customs union revealed that German-made products were more competitive than French-made goods. This difference led to intense exchange rate fluctuations between the German Mark (DEM) and the French Franc (FRF), and negatively affected international economic relations within the Community.

The first major step towards monetary integration was the *Hague Summit* in 1969 when the six member states decided to establish a monetary union. By the next year, the *Werner Plan*[29] laid down the schedule of the implementation. Unfortunately, the crises of the 1970s (the collapse of the Bretton Woods regime and the first oil shock) undermined the accomplishment of the program. Thus, the issue of monetary union was removed from the political agenda for a long time.

Despite the failure of the Werner Plan, there were also positive developments in this policy area. In 1979, member countries launched the *European Monetary System* (EMS) in order to mitigate exchange rate fluctuations. The EMS was based on three pillars. The European Currency Unit (ECU) was a currency basket and a unit of account. The second pillar, *Exchange Rate Mechanism* (ERM), determined the margin within which the exchange rates were allowed to fluctuate. Finally, the third pillar (*credit facilities*) provided short-term ECU loans for interventions.

Following the adoption of the Single European Act, it became obvious that the single market would not work efficiently without supranational monetary policy (since there is a trade-off between the intensity of exchange rate fluctuations and the volume of trade). Realizing the necessity of monetary integration, the Delors Plan outlined the schedule of EMU in 1989.

[29] The Werner Plan was named after Pierre Werner (prime minister and finance minister of Luxembourg), who led the expert group.

The *first stage* of the implementation (from 1990 to 1993) aimed at liberalizing the capital movements and strengthening of the independence of central banks. In 1992, member states signed the Maastricht Treaty, which transformed the Delors Plan into a legal form (Pelle and Végh [2019]). In addition, according to the German proposal (Rácz [2007], the Treaty defined the so-called *convergence criteria*, which have to be met by the candidate countries before joining the Eurozone. These are as follows (De Grauwe [2018]):

1) *inflation rate convergence* (HICP): the inflation rate (HICP – Harmonized Index of Consumer Prices) should not be more than 1.5 percentage point higher than the average (arithmetic mean) of the three lowest rates among the EU member states;
2) *interest rate convergence*: long-term interest rate should not be more than 2 percentage point higher than the average rate of the three countries with the lowest inflation rates;
3) *budget deficit ceiling*: the budget deficit/GDP ratio should not exceed 3 percent;
4) *government debt ceiling*: the gross government debt/GDP ratio should not exceed 60 percent (or, if it is more than 60 percent, it has to show a sufficiently decreasing tendency and approach the reference value);
5) *ERM-2 membership*: the candidate country is not allowed to manipulate (devalue) its exchange rate during the two years before joining the Eurozone. According to the Treaty, exchange rates should be maintained within the band of fluctuation (without changing the band) in this period.[30]

It has to be noted that the reference values of the criteria are, to some extent, arbitrary. However, budgetary values can be derived from the relationship of 'debt dynamics' as well. Assuming that the annual (real) economic growth rate is 3 percent and the annual inflation rate is 2 percent, the government debt/GDP ratio will be stabilized at the level of 60 percent as long as the budget deficit/GDP ratio does not exceed the level of 3 percent (Benczes and Kutasi [2010]). Formally, we can write the following equation:

$$d = (g + \pi) \times b$$

where

d is the budget deficit/GDP ratio;

[30] Prior to August 1993, the fluctuation band had been +/- 2.25 percent. As a result of the ERM crisis, member states modified it to +/- 15 percent.

g is the annual real economic growth rate;

π is the annual inflation rate;

b is the government debt/GDP ratio.

Besides the above-mentioned entry conditions, other macroeconomic and legal factors (e.g. independence of the central banks) may be assessed during the accession phase.

In the *second stage* (1994–1998), member countries set up the institutional framework of the EMU. The European Monetary Institute (EMI), which was the predecessor of the European Central Bank (ECB), began to operate in 1994.[31] Three years later, in 1997, the Stability and Growth Pact (SGP) was signed with the aim of supervising the fulfilment of the budgetary criteria. In case of non-compliance with the criteria, member states could be penalized within the framework of the Excessive Deficit Procedure (EDP).[32]

The *third stage* started in January 1999 when eleven countries introduced the single currency in dematerialized form. Since Greece was unable to satisfy the convergence criteria, it joined the Eurozone only in 2001. Thus, twelve EU members could adopt the euro in cash form in 2002.

From economic point of view, the EMU is based on a three-pillar system (*impossible trinity*). The three pillars are the fixed exchange rate regime, the free movement of capital and the centralized (supranational) monetary policy. The (Mundellian) trilemma of these factors (Mundell [1968]) is well known from textbooks and handbooks dealing with International Economics (see e.g. Benczes et al. [2009]; Krugman and Obstfeld [2003]).

According to the Maastricht Treaty, the Eurozone have been characterized by the so-called triple denial (or *trinity of denial*), i.e. (1) no exit, (2) no bail-out, and (3) no default. In accordance with the first (implicit) denial, the Treaties do not contain any provision on the possibility of leaving the EMU. Moreover, none of the countries can be expelled by other Eurozone members. This is because a potential exit would enhance uncertainty and would negatively affect the credibility of the EMU. The 'no

[31] Sándor Lámfalussy (1929–2015), the Hungarian-born economist was the president of EMI. He is also known as the 'Father of the euro'. The EMI operated until the establishment of the ECB and the ESCB in 1998.
[32] Since the sanctions were not automatic and were based on political decisisions, the efficiency of the SGP was controversial. Furthermore, the Pact was 'softened' in 2005 (Rácz [2007]).

exit' property means that it is impossible for the member countries to manage competitiveness problems through devaluation. The only possible scenario is the exit from the EU (Benczes [2013]; Losoncz [2014].

In order to avoid (financial) contagion and moral hazard, the so-called no bail-out clause prohibits both the Union and the member states to bail-out any sovereign, authority or public undertaking in trouble (Benczes [2013]). According to Article 123 (1) of the Treaty on the Functioning of the European Union (TFEU), "*[o]verdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States […] in favor of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments"* (TFEU [2012]). Furthermore, according to Article 125 (1) *"[t]he Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State […] A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State […]"* (TFEU [2012]). On the other hand, due to the no bail-out clause, the ECB cannot be a lender of last resort (LLR).

The denial of default is a principle, not a legal act. The principle comes from the assumption that as long as the member states follow the rules, the default can be prevented. However, tremendous costs of default (for instance in the form of contagion) may lead to moral hazard and opportunistic behavior (Benczes [2013]; Losoncz [2014]).

Finally, as Halmai [2020a] notes, the *OCA-endogeneity* was an implicit assumption of the original structure of the EMU (or EMU 1.0). Simply speaking, the dominant view was that monetary integration would accomplish the OCA criteria subsequently (Halmai [2017; 2020a]).

The *European Central Bank* (ECB), together with national central banks of the Eurozone-countries, is responsible for the implementation of monetary policy within the EMU. The primary monetary objective of the ECB is price stability. Initially, the ECB applied the mixture of monetary and inflation targeting in order to keep annual inflation rate (HICP) below 2 percent. Since this complex ‘policy mix’ was difficult to follow, the ECB revised its monetary strategy in 2003 and dropped monetary targeting out of the mix (Ferkelt [2020]).

Based on Baldwin and Wyplosz [2020], Benczes [2013] and Halmai [2017; 2020a], *Table 12* summarizes the major elements and features of the Eurozone’s original design.

Table 12: The original design of the EMU

	Elements	Features
1	Maastricht convergence criteria	• inflation rate (HICP) convergence • interest rate convergence • budget deficit ceiling • government debt ceiling • ERM-2 membership
2	Assumption of OCA-endogeneity	• OCA will be accomplished subsequently
3	Stability and Growth Pact (SGP)*	• Excessive Deficit Procedure (EDP)
4	Impossible trinity	• fixed exchange rate regime • free movement of capital • centralized (supranational) monetary policy
5	Trinity of denial	• denial of exit • denial of bail-out • denial of default
6	Eurosystem**	• European Central Bank (ECB) + national central banks of Eurozone members • Primary monetary objective: price stability

Source: Own table and typology based on Baldwin and Wyplosz [2020], Benczes [2013], and Halmai [2020a]

* The Stability and Growth Pact is binding for all EU members. However, non-EMU countries are subject to different sanctions.

** It should be emphasized that the central banks of non-EMU countries are part of the European System of Central Banks (ESCB) but do not ‘participate’ in the Eurosystem.

The first decade of the single currency (and the EMU) can be assessed through various indicators. Between 1999 and 2008, the HICP (with the exception of one year) remained below 2 percent. However, the ECB followed a rather restrictive monetary policy and kept the interest rates relatively high in order to reach price stability. The international role of the single currency started strengthening after 2001, and the euro became one of the most significant reserve and traded currencies (Ferkelt [2020]).

3.2. The anatomy of the Eurozone crisis

3.2.1. The global financial and economic crisis

The global financial and economic crisis of 2008-2009 was a significant turning point in the history of the world economy. Despite the fact that first signs of the crisis could be seen in the United States in 2007, the collapse of Lehman Brothers[33] in September 2008 is considered to be the starting point of the global depression. The direct trigger of the crisis was the bubble on the real estate market. House prices in the US started falling in 2007, which led to the worsening of the macroeconomic situation (Romer [2012]).

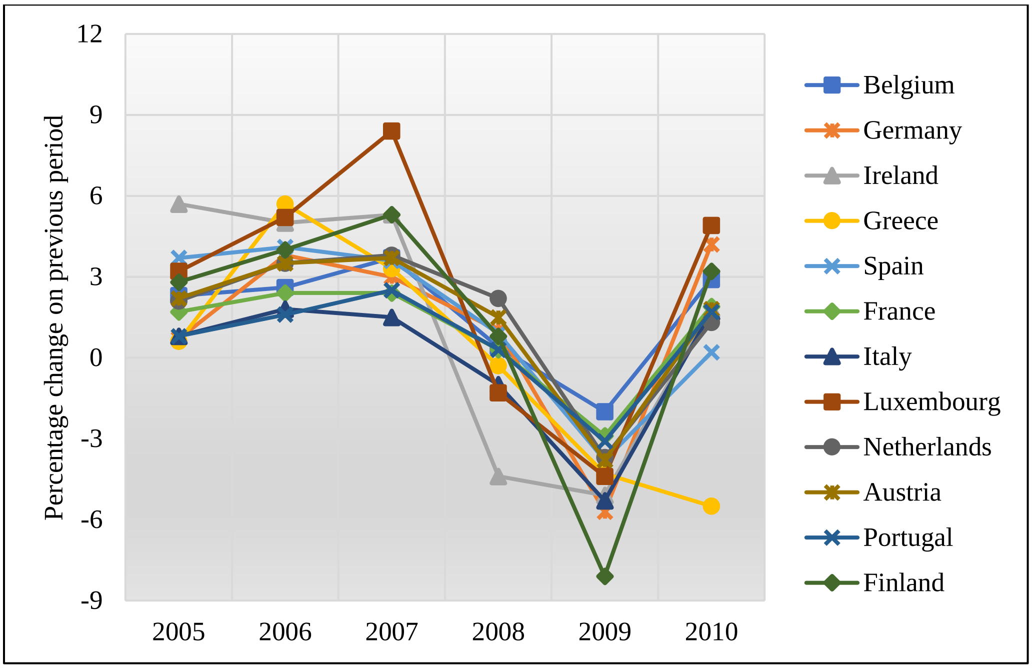
Of course, it should not be forgotten that the real estate bubble was just the culmination of several indirect causes connected to financial liberalization (globalization), and inadequate economic and monetary policy measures. The root of this issue stretches back to the first half of the 20th century. Following the 'Great Depression' of 1929-1933, the so-called Glass-Steagall Act (1933) separated commercial banking and investment banking. The main purpose of the Act was to reduce speculative risks by regulating the banking system. Unfortunately, the Gramm-Leach-Bliley Act (1999) repealed the provisions of the Glass-Steagall Act, which gave considerable momentum to the process of financial deregulation. In addition to this, the Community Reinvestment Act (1995) signed by President Clinton obliged banks to provide loans for low-income consumers too. These measures, in all probability, contributed to the increase of demand for loans (Gál [2010]).

The monetary policy of the Federal Reserve (FED) also played a crucial role in the outbreak of the crisis. From 2001, low interest rates fueled speculative demand on the real estate market, which led to a sharp increase of house prices. After 2004, inflationary pressures started growing, which resulted in monetary restrictions in the US. When the FED raised the interest rates anew, many households were unable to service their debt. As a result, banks and other financial institutions went bankrupt. Because of information asymmetry, interbank lending market froze, which culminated in a 'distrust crisis' (Benczes and Kutasi [2010]).

[33] Lehman Brothers was one of the major investment banks in the United States.

The contagion soon spread to Europe and the European Union as well. In the next year, almost all member states suffered from a real economic recession and negative GDP-growth rates. *Figure 12* shows the GDP-growth rates of the twelve Eurozone countries (EZ-12) (Eurostat [Web]).

Figure 12: GDP-growth rates in the EZ-12 (2005-2010)



Source: Own figure based on Eurostat data (Eurostat [Web])

Although the graph represents the data of the EZ-12, the same tendency was true also in the case of the entire EU.[34] As it can be seen, prior to 2008, all countries of the EZ-12 group were characterized by positive economic growth. When the financial crisis spread to the real economy, all the EZ-12 members faced negative growth rates. The average rate was around -4.5 percent in 2009.

Countries, in turn, responded to the crisis by (conventional) Keynesian counter-cyclical fiscal expansion, which considerably increased budget deficits (or decreased surpluses) (*Table 13*) (Eurostat [Web1]). The average deficit/GDP rates were between 7 and 8 percent in 2009 and 2010. This was a significant worsening compared to the previous years, when the average deficit rates were far below the Maastricht criterion of 3 percent. Of the twelve countries, only Luxembourg and Finland were able to satisfy this criterion in 2009 and 2010.

[34] Poland was the only member state with a positive growth rate in 2009.

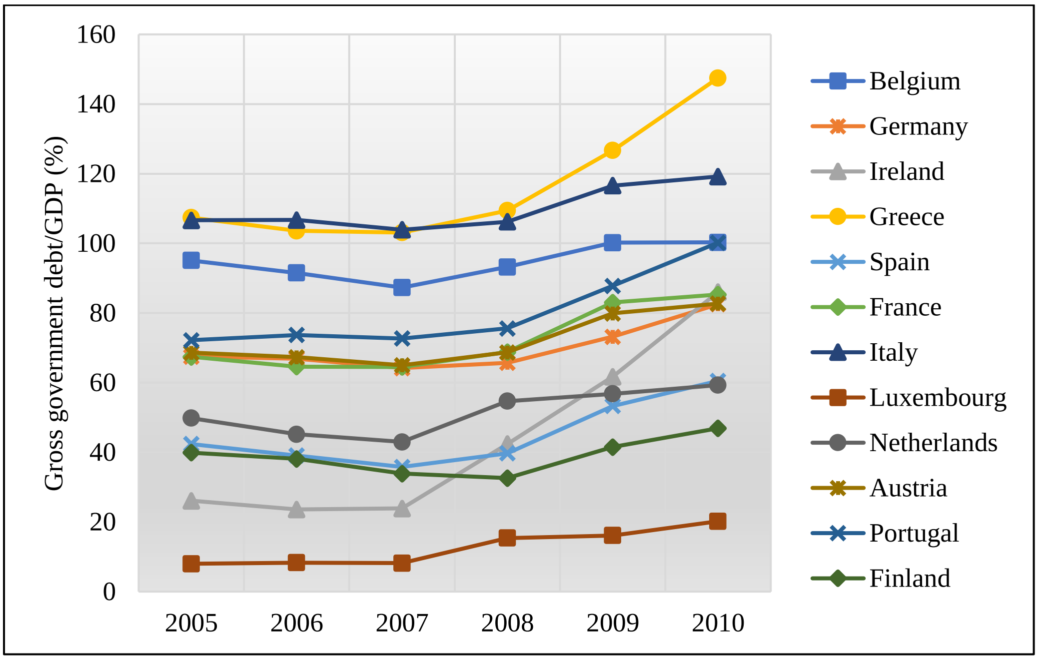
Table 13: Budget deficit/surplus in the EZ-12 (2005-2010) (as a percentage of GDP)

	2005	2006	2007	2008	2009	2010
Belgium	-2.7	0.2	0.1	-1.1	-5.4	-4.1
Germany	-3.3	-1.7	0.3	-0.1	-3.2	4.4
Ireland	1.6	2.8	0.3	-7.0	-13.9	-32.1
Greece	-6.2	-5.9	-6.7	-10.2	-15.1	-11.3
Spain	1.2	2.1	1.9	-4.6	-11.3	-9.5
France	-3.4	-2.4	-2.6	-3.3	-7.2	-6.9
Italy	-4.1	-3.6	-1.3	-2.6	-5.1	-4.2
Luxembourg	-0.2	1.9	4.4	3.5	-0.2	-0.3
Netherlands	-0.5	0.0	-0.2	0.1	-5.2	-5.3
Austria	-2.5	-2.5	-1.4	-1.5	-5.3	-4.4
Portugal	-6.1	-4.2	-2.9	-3.7	-9.9	-11.4
Finland	2.7	4.0	5.1	4.2	-2.5	-2.5
Mean*	***-2.0***	***-0.8***	***-0.3***	***-2.2***	***-7.0***	***-8.0***

Source: Own table based on Eurostat data (Eurostat [Web1]
*Own computation (rounded data)
Note: Negative values refer to budget deficit while positive values represent budget surplus

Of course, fiscal expansion, declining GDP and accumulating budget deficits together caused an increase of public debt/GDP rates in all countries of the EZ-12 (*Figure 13*).

Figure 13: Gross government debt in the EZ-12 (2005-2010) (as a percentage of GDP)



Source: Own figure based on Eurostat data (Eurostat [Web2])

The average ratio of the EZ-12 increased by around 18 percentage points from 2008 to 2010. The average debt/GDP rate of the EZ-12 was 83 percent in 2010. However, it is noteworthy that the data show a large dispersion (this trend was similar in the whole EU). By 2010, only three countries (Luxembourg, Netherlands and Finland) were able to satisfy the limit of 60 percent. Furthermore, Spain was in a relatively good position with its debt/GDP ratio of 60.5 percent in 2010.

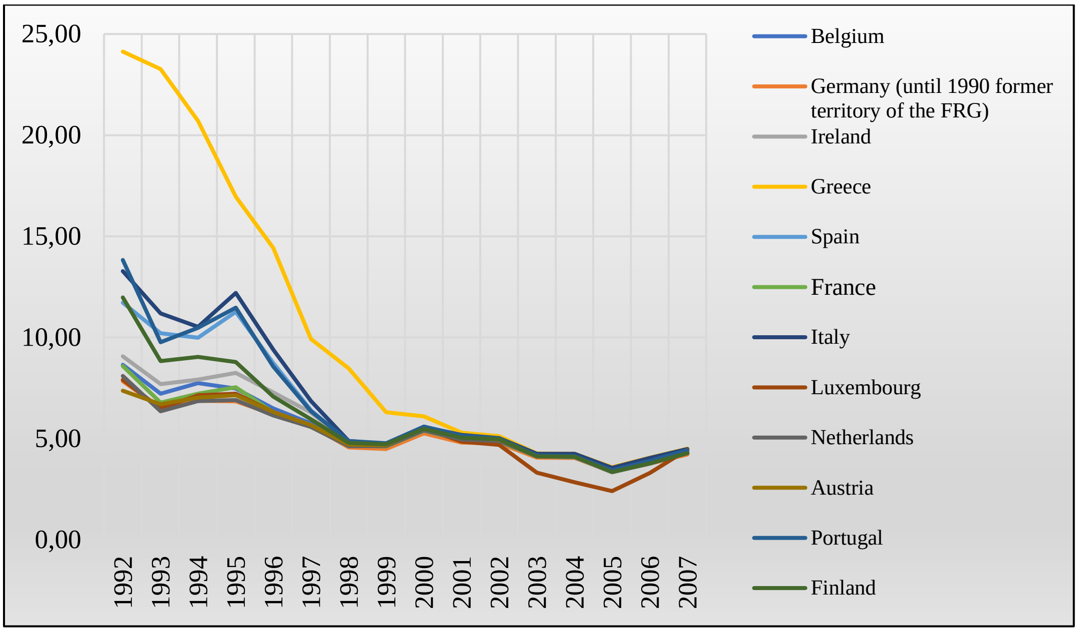
Paradoxically, counter-cyclical fiscal policy resulted in a second depression in the Eurozone. When the economy of the United States started growing from 2010, the EMU had to face the so-called 'sovereign debt crisis'. This is because the above-mentioned Keynesian measures led to increasing deficits and public debt rates, which worked efficiently, but also strengthened the worry of financial markets about the sustainability of public finances. Finally, this uncertainty resulted in a second recession in the Eurozone (Baldwin and Wyplosz [2020]).

3.2.2. The Eurozone crisis: causes and consequences

The starting point of the Eurozone crisis (sovereign debt crisis) was the Greek general election in October 2009, when the Panhellenic Socialist Movement (*PASOK – Panellinio Sosialistiko Kinima*) returned to power and George Papandreou became the new Prime Minister of the country (Dinas [2010]). In the ECOFIN meeting of December, the newly elected government announced that Greece's budgetary situation was much worse than official statistics had stated previously (Featherstone and Papadimitriou [2017]; Győrffy [2017]; Losoncz [2014]). The finance minister, George Papakonstantinou, revealed that the country's budget deficit was around 13 percent of GDP instead of 6 percent. In addition, this number was further revised subsequently to 15.9 percent (Featherstone and Papadimitriou [2017]). The unsustainability of the Greek budget deficit (and public debt) led to a deterioration of trust on the financial markets, because investors questioned the budgetary stability of other member states as well. The loss of confidence caused a series of debt crises in the periphery of the European Union.

There are several causes of the Eurozone crisis. The original design of the EMU incorporated many underlying problems, which contributed significantly to the emergence and the eruption of the sovereign debt crisis in early 2010. Following the entry into force of the Maastricht Treaty, interest rates of the member states started converging in the EMU (*Figure 14*). This convergence was fueled by the positive expectations regarding the implementation of the monetary union. Consequently, risk premiums evaporated as markets believed the stability of the EMU and the single currency (Baldwin and Giavazzi [2015]; Győrffy [2018]).

Figure 14: Interest rate convergence in the EZ-12 (1992-2007)
(long-term government bond yields, annual data, %)



Source: Own figure based on Eurostat data (Eurostat [Web3])

Unfortunately, this process was interpreted as a sign of real convergence between the ‘core countries’ and the ‘periphery’.[35] In case of regional economic integrations, real convergence is as essential as nominal convergence. This is because significant heterogeneity may cause serious problems. In spite of this, the Maastricht Treaty specified nominal criteria only. Therefore, the monitoring of real convergence is indispensable for non-EMU member states (Kollárik [2020a])[36].

As interest rates were decreasing and converging to the German rate, member countries were able to access to financial markets at very low yields after the introduction of the single currency in 1999. Thus, cheaper credit encouraged

[35] The scholarly literature uses the terms ‘North’ and ‘South’, ‘core’ and ‘periphery’ interchangeably to refer to the gap between developed and less developed member states. In the thesis, we also use these expressions. However, it is important to emphasize that these terms have absolutely nothing to do with Marxism, dependence theory or other ‘New Left’ approaches.
[36] The publication is the outcome of the project “From Talent to Young Researcher project aimed at activities supporting the research career model in higher education”, identifier EFOP-3.6.3-VEKOP-16-2017-00007 co-supported by the European Union, Hungary and the European Social Fund.

borrowing in the EMU and played a role in setting up pre-crisis imbalances. In addition, overinvestment and under-savings amplified the imbalances of the current accounts of 'Southern' member states. Furthermore, the vast majority of investments went to non-traded sectors (e.g. government consumption and housing), and did not contribute to the building up of export capacities. Export competitiveness, on the other hand, decreased due to rising wages and costs (Baldwin and Giavazzi [2015]).

Private and public debt accumulation was also an important factor on the road towards the crisis. In relation to this, the cross-border lending activity of banks exacerbated the problems of the EMU. This is because banks from the 'Northern' states accumulated a large amount of debt from the 'Southern' countries (Baldwin and Giavazzi [2015]).

Besides the above-mentioned economic processes, structural (institutional) problems, and the shortcomings of European Economic Governance played also a crucial role in the crisis (and crisis management) (Jones et al. [2015]). This is what we call the incompleteness of EMU (we will return to this issue soon). *Table 14* summarizes the major causes, features and consequences of the Eurozone crisis.

Table 14: Major causes of the Eurozone crisis

	Cause	Features and consequences
1	Intra-EZ capital flows	• positive expectations about the EMU • converging interest rates (decreasing risk premiums) • significant capital flows from EZ core countries to EZ periphery states • bad structure of investments • overinvestments and under-savings in the periphery • imbalances of current accounts • decreasing export competitiveness
2	Private and public debt buildup	• too much debt accumulation in several member states between 1999 and 2007
3	Banks' cross-border lending	• banks from the core countries bought very large amounts of debt from the peripheral nations • 'doom loop' between banks and sovereigns
4	Incompleteness of EMU	• inconsequent sanctions based on political decision • absence of crisis management tools • 'doom loop' between banks and sovereigns • asymmetric integration structure
5	Global financial and economic crisis of 2008	• exogenous trigger • recession and counter-cyclical fiscal policies • realizing Eurozone's underlying problems • Greek announcement as an 'internal trigger'

Source: Own table and compilation based on Baldwin and Giavazzi [2015]

As we have seen, the major problems had already existed before the outbreak of the sovereign debt crises. Nevertheless, as Baldwin and Giavazzi [2015] note, *"[i]t is, ex post, surprising that the building fragilities went unnoticed. […] Till 2007, the Eurozone was widely judged as somewhere between a good thing and a great thing"* (Baldwin and Giavazzi [2015: p. 36]). Interestingly, when the global crisis hit in 2008, member states started to realize the systemic shortcomings of the EMU. In the words of Baldwin and Giavazzi [2015], *"[t]he rose-garden feeling, however, started to disintegrate with the fall of Lehman Brothers […]"* (Baldwin and Giavazzi [2015: p. 36]). Lefkofridi and Schmitter [2015] agree with this diagnosis. From neofunctionalist perspective, they argue that the timing of Eurozone crisis was triggered by the financial collapse in the United States (Lefkofridi and Schmitter [2015]). Jones et al. [2015] share this view by stressing that subprime lending crisis in the US should be seen as an exogenous trigger, which caused trouble for cross-border banks in the EMU (Jones et al. [2015]). Finally, as Hooghe and Marks [2019] state, the Eurocrisis was induced by the meltdown of confidence in the financial sector of the United States in 2008 (Hooghe and Marks [2019]).

These observations and events are in line with our first hypothesis (H1), according to which the global financial and economic crisis of 2008-2009 can be assessed as a critical exogenous economic spillover trigger. It was *critical* because it played a crucial role in realizing underlying malfunctions of the EMU's original design. Moreover, the negative impacts of the crisis were strong enough to induce enormous systemic risks for the Eurozone. The trigger was *exogenous* since the pressure came from outside the European integration. Furthermore, it was also *economic* by nature because the pressure arose in the realm of economy.

It is true, however, that the exogenous trigger was amplified by the Greek announcement in December 2009, which finally led to the Eurozone crisis and functional pressures. In the words of Dyson [2017], *"[…] [f]rom the summer and autumn of 2010 onwards, the crisis was being redefined as a eurozone crisis"* (Dyson [2017: p. 56]). *Table 15* encapsulates the major building blocks, which induced endogenous functional triggers in general.

Table 15: The route towards functional triggers

Underlying malfunctions	Exogenous trigger	Greek crisis	Eurozone crisis	Endogenous functional triggers
→				
• Intra-EZ capital flows • Debt buildup • Banks' cross-border lending • Incompleteness of EMU	• Global financial and economic crisis • Subprime lending crisis • Meltdown of confidence • Realizing systemic problems	• Announcement of the new finance minister in 2009 • Outbreak of the Greek crisis	• Loss of trust • The crisis spreads to the periphery of the Eurozone • Exogenous triggers are amplified	• Huge systemic risks • Critical juncture • Moving out of the neutrality zone

Source: Own table

Following the eruption of the Greek crisis, the country got its first financial assistance package (*Greek Loan Facility*) from the Eurozone and the International Monetary Fund (IMF) in May 2010. The credit facility, which amounted to 110 billion euros, required serious fiscal austerity measures from Greece (Szijártó [2018]). Since risk premiums and interest rates skyrocketed, external financing became inevitable for Greece.

Unfortunately, fiscal consolidation turned out to be inappropriate and insufficient since the Greek government focused primarily on the revenue side of the budget. In other words, tax increases were not accompanied by the significant decrease of government expenditures. This policy-mix, in turn, had a negative impact on the business environment of the country. In addition, policy-makers failed to implement structural reform measures concerning a series of fields such as public administration, labor market, wages, pension system, healthcare system etc. (Győrffy [2017]; Visvizi [2012]). Because of the failure of the adjustment program, the country received a second rescue package of 130 billion euros in March 2012 (Pagoulatos [2018]).

As the 'confidence crisis' spread to the peripheral region of the EU, Ireland became the second program country. Compared to the Greek case, the Irish crisis was even more surprising, because the country had achieved spectacular economic performance and convergence during the 1990s (Honohan and Walsh [2002]). The main problem of the Irish economy was the devastating boom-and-bust cycle on the real estate market. Since the property boom was financed through aggressive lending by the banking sector, the collapse in construction activity together with declining real estate prices led to considerable losses in the banking system (Lane [2011]). In order to consolidate the banking system, Ireland received financial assistance of 85 billion euros (Szijártó [2018]).

Portugal was the next country, which received external assistance from the so-called 'Troika' of the IMF, the European Commission, and the ECB in 2011. During 2010, Portugal's 10-year bond yields increased from 3.9 percent to 5.0 percent. In addition, public spending also rose significantly due to automatic stabilizers and the implementation of a former campaign promise of increasing public wages. As part of the rescue package, three of the four largest banks were finally recapitalized with public funds (Reis [2013]).

The Eurozone crisis peaked during the summer of 2012 when the (confidence) crisis spread to the two largest peripheral countries of the currency union, Spain and Italy. Given the size of these member states, their potential collapse was particularly worrying. While Italy suffered 'only' from a balance-of-payments crisis, Spain experienced a balance-of-payments crisis and a banking crisis simultaneously.[37] Finally, the Spanish government requested external financial assistance from the Eurozone in June 2012. Fortunately, this was not the case in Italy (Quaglia and Royo [2015]).

With the escalation of the sovereign debt crisis, the sustainability of the EMU and the single currency became uncertain. Thus, it was necessary to restore the confidence of markets. This measure eventually took the form of verbal intervention by the President of the European Central Bank in July 2012. In his speech at the Global Investment Conference in London, Mario Draghi emphasized that the ECB would safeguard the euro at any price: *"[w]ithin our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough"* (Draghi [2012: p. 2]). The verbal intervention was followed soon by concrete measures when the ECB announced its Outright Monetary Transactions (OMTs) program in September (Szijártó [2018]).

Furthermore, the speech of Herman van Rompuy on 26 June 2012 gave momentum to the launch of systemic reforms. The report emphasized the point of no return, i.e. the

[37] Quaglia and Royo [2015] offer a very detailed comparison of the sovereign debt crisis in Italy and Spain.

EMU cannot operate efficiently with an asymmetric architecture (Benczes [2020]; Rompuy [2012a]). This was the point when member states started focusing on large-scale and long-term reforms instead of ‘ad hoc’ measures.

In spite of these efforts, the Eurozone crisis was not easy to contain. During the summer of 2012, the crisis spread further to the Republic of Cyprus.[38] [39] As Zenios [2013] notes, in this case, we can talk about a complex (or ‘perfect’) crisis characterized by the amalgamation of sovereign debt and banking crisis with considerable indebtedness of business and households and a fall of competitiveness (Zenios [2013]). Nevertheless, the most important underlying factor of the Cypriot crisis was probably the tight economic and financial link between Cyprus and Greece. Since the Cypriot banks were exposed to the Greek sovereign debt to a large extent, the Cypriot banking sector and economy became infected (Oehler-Sincai [2013]). Since the Russian financial assistance was unable to solve the problems (Szijártó [2018]), the country applied to the Troika for a rescue package in June 2012. After lengthy and cumbersome negotiations, the parties finally reached an agreement on 25 March 2013. According to the agreement, the Troika provided for Cyprus a bailout of 10 billion euros (Amini [2015]; Oehler-Sincai [2013]; Zenios [2013]).

In spite of the Cypriot crisis and the existing problems, the short period between 2013 and 2014 was characterized by the moderate tranquility of international financial markets. Following the *‘whatever it takes’* speech of Mario Draghi (Draghi [2012]), bond spreads of the member states in the periphery started declining very fast. However, the credit ratings of these states did not reflect this improvement. De Vries and De Haan [2016], based on their econometric models, provide two explanations for this divergence of credit ratings and yield spreads. According to the first explanation, the impact of credit ratings on yield spreads has changed and these two variables are no longer in line with each other. In addition, the second result (explanation) suggests that credit rating agencies changed their assessment and became more conservative in

[38] For the sake of completeness we note that Cyprus has been divided since 1974 when Turkey invaded the northern region of the island. Taking into account that Northern Cyprus is not recognized by the United Nations as an independent state, this ’country’ (or region, more precisely) is not a member of the European Union. Consequently, when talking about Cyprus, we always refer to the Republic of Cyprus.

[39] It should be noticed, however, that Cyprus faced the first major problems already in September 2011 when its access to the international bond market was blocked by prohibitive bond yields. In the end of the year, the country obtained a loan of 2.5 billion euros from the Russian Federation (Oehler-Sincai [2013]).

order to regain their reputation (De Vries and De Haan [2016]). Apart from the fall of bond yields, Greece was showing the signs of its economic recovery in all respects. Major economic factors such as consumption, investment, exports, consumer confidence, and employment appeared to improve. Due to these positive developments, the country managed to access to bond markets anew in 2014 (Pagoulatos [2018]).

Promising tendencies were interrupted in January 2015 when the radical left-wing party, SYRIZA, came to power. The rejection of fiscal restrictions and the suspension of the second adjustment program's implementation indicated a significant populist shift in the country. As a result, this chicken game led to a brinkmanship, which caused a capital flight from the country. Moreover, in April 2015, the Greek government was unable to meet its loan repayment obligations. In order to manage the situation, the anti-austerity government led by Alexis Tsipras initiated new negotiations with the EU on a third rescue package. During this period, the idea of the Greek exit ('*Grexit'*) became a potential scenario again. Since the negotiating parties failed to reach an agreement, Alexis Tsipras announced a referendum on the potential bailout package. In spite of the fact that 61.3 percent of the voters voted down the deal, the SYRIZA was unable to reach a better negotiation outcome. A few days later, the government approved the third rescue package of 86 billion euros in exchange for further reforms (Featherstone and Papadimitriou [2017]; Pagoulatos [2018]; Szijártó [2018]). *Table 16* summarizes the stages and major events of the sovereign debt crisis.

Table 16: Phases and major events of the Eurozone crisis

Phase	Date or period and events
Stage 1: Outbreak	• October 2009: The PASOK wins the elections in Greece • December 2009: Greek finance minister reveals that statistics has been falsified • May 2010: The First Greek Loan Facility (GLF I) (110 bn euros)
Stage 2: Contagion	• November 2010: Ireland receives a financial assistance (85 bn euros) • May 2011: Portugal receives a financial assistance (78 bn euros) • March 2012: The Second Greek Loan Facility (GLF II) (130 bn euros) • July 2012: Spain receives a financial assistance (100 bn euros) and the potential collapse of Italy • 26 July 2012: The *'whatever it takes'* speech of Mario Draghi • September 2012: ECB announces the OMTs program • April 2013: Cyprus receives a financial assistance (10 bn euros) • 2013-2014: Moderate tranquility and promising tendencies • January 2015: SYRIZA wins the elections in Greece (suspension of austerity) • July 2015: Referendum on a third bailout package • July 2015: The Third Greek Loan Facility (GLF III) (86 bn euros)

Source: Own table and categorization based on Baldwin and Wyplosz [2020] and Szijártó [2018]

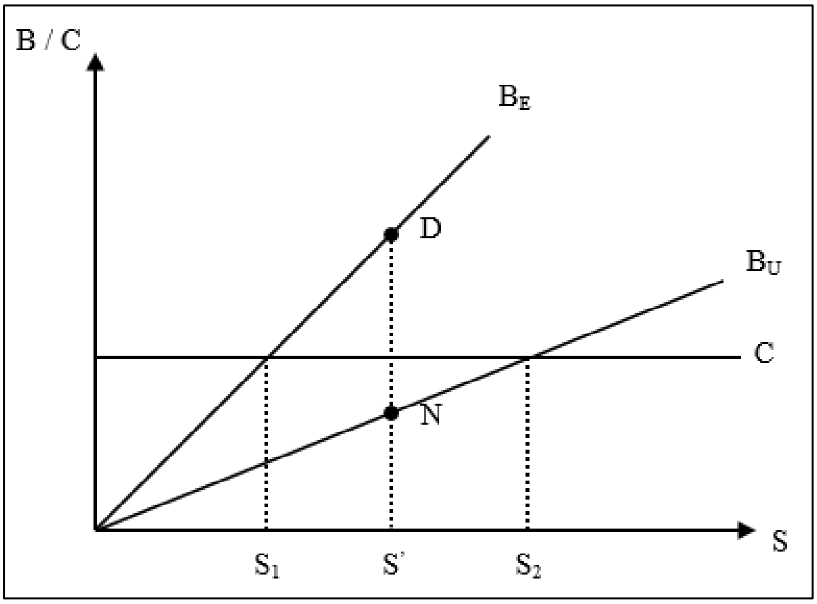
In summary, exogenous trigger combined with the pressures of the Eurozone crisis made decision-makers throughout the EMU to respond to these tensions. Simply speaking, the EMU arrived at a critical juncture where the accumulated problems had to be managed.

3.2.3. The incompleteness of the EMU

As it was mentioned earlier, the incompleteness of the EMU was one of the major factors that contributed to the Eurozone crisis. When talking about incompleteness, we think of the institutional shortcomings and asymmetric integration structure of the Eurozone. The main asymmetry (incompleteness) comes from the fact that fiscal policy remained in the hand of member states. Practically it means that EMU-countries have their independent national authorities that control the budget and issue debt denominated in the single currency. This asymmetric architecture may have serious implications in case of a solvency shock.

The following model (*Figure 15*) represents the benefits, costs, and equilibria of such a shock. Let us suppose that a Eurozone-member faces a solvency crisis because of decreasing revenues (and increasing expenditures) due to a recession. Furthermore, it has to be stressed that there is a positive correlation between the magnitude of the shock and the loss of solvency (De Grauwe [2018]).

Figure 15: Solvency shock in case of an incomplete monetary union



Source: Own figure based on De Grauwe [2018] with slight modification

As it can be seen, horizontal axis shows the magnitude of the shock (*S*), while the vertical axis represents the benefits (*B*) and costs (*C*) of defaulting on the debt. For the sake of simplicity, by default we mean that the government is willing to repay only 50 percent of its debt (De Grauwe [2018]).

Let us have a look at the benefits. Since a default decreases the interest burden on the debt (and the debt itself), the government does not have to take the political risk (cost) of a potential austerity measure. According to *Figure 15*, we can distinguish two different benefit curves, B_U and B_E. B_U represents the benefit of a default that is unexpected by investors (financial markets), while B_E is the benefit of a default that is expected by those players. Since the magnitude of the solvency shock is in positive correlation with the benefits of a default, B_U and B_E are both upward-sloping functions. This positive relationship is obvious, because costs of austerity measures increase considerably when the solvency shock is large (for the sake of simplicity, on *Figure 15* we draw linear functions). In addition, we can see that the B_E curve runs above the B_U curve. This difference can be explained by the phenomenon that in the case of expected default investors will sell government bonds. This tension, in turn, leads to the increase of interest rate, which have a negative impact on the budget deficit. As a result, higher budget deficit implies a more intense austerity program (higher political risk), which makes the default more attractive (De Grauwe [2018]).

Of course, as *Figure 15* shows, a default has a significant cost (*C*) too. The major source of this cost is the fact that the government faces a loss of reputation when it rejects to repay its outstanding debt. Consequently, it will be more difficult (and costly) for the country to borrow in the future. In order to simplify the model, the cost of a default is considered to be a fixed cost, i.e. a constant function (De Grauwe [2018]).

Given the three functions, i.e. the two benefit curves (B_U and B_E) and the cost curve (*C*), it is possible now to identify and analyze the equilibrium states of the model. In line with *Figure 15*, we can study three different scenarios. The first scenario represents a small solvency shock when $S < S_1$. In this case, the cost of a (potential) default is larger than the benefits (both B_U and B_E), which means that the government will be reluctant to default. In addition, assuming rational expectations, investors will not anticipate a default. The behavior of governments and financial markets together leads to the no-default outcome (equilibrium). The second scenario is a large solvency shock, which takes place when $S > S_2$. Since a large shock significantly increases the benefits (both B_U and B_E) of a potential default, the government will intend to choose this option. Accordingly, rational players of the financial markets will also expect the same choice, which finally results in a true default. The third case (scenario) is the intermediate solvency shock ($S_1 < S < S_2$) when we get two possible equilibria, *D* and *N*. Put differently, the outcome of the shock, say *S'*, depends on what is anticipated by the investors. Equilibrium *D* (or 'bad equilibrium') is represented by the point on the B_E curve, which means that rational investors expect the default. This negative expectation, in turn, makes the benefit larger than the cost. Consequently, the government will default. By contrast, equilibrium *N* (or 'good' equilibrium) leads to the opposite situation. Since point *N* is located on the B_U curve, financial markets do not anticipate a default, and thus, the cost of a potential default exceeds its benefit. In line with the expectations, the government will not default (De Grauwe [2018]). *Table 17* summarizes the features and outcomes of the three scenarios.

Table 17: Equilibria in case of different solvency shocks

Scenario (type of shock)	Features	Outcome
Small shock ($S < S_1$)	• $C > B_U$ and B_E • government will not default • rational investors do not expect default	No default
Large shock ($S > S_2$)	• $C < B_U$ and B_E • government will want to default • rational investors will anticipate this	Default
Intermediate shock ($S_1 < S < S_2$)	• equilibrium *D* ('bad equilibrium') • B_E > C • *D* is located on B_E • investors expect a default • the government will want to default	Default
	• equilibrium *N* ('good equilibrium') • $B_U < C$ • *N* is located on B_U • investors do not expect default • government will not default	No default

Source: Own table and compilation based on De Grauwe [2018]

In spite of the high-level abstraction applied in the model, one can conclude that market sentiments are of primary importance and may lead to different outcomes in case of a fiscal problem. In other words, the expectations of financial markets may significantly influence the behavior of governments. Nevertheless, the existence of multiple equilibria is rooted in the so-called *'liquidity constraint dilemma'*, which is a major attribute of the EMU's incompleteness. The dilemma lies in that in the absence of the lender of last resort function, the central bank does not have the right to provide the necessary liquidity to pay out the bondholders. As a result, financial markets may force the government to default in case of negative expectations. This is the reason why the two benefit curves, B_U and B_E, do not coincide (De Grauwe [2018]).

Now we can see that the asymmetric integration structure makes the monetary union, i.e. the EMU more vulnerable when a solvency crisis hits. According to De Grauwe [2018], this type of fragility can be reduced in three different ways: (1) by increasing the cost of a default; (2) by entrusting the role of lender of last resort to the central bank, i.e. the ECB; or (3) by establishing a budgetary union (De Grauwe [2018].

In principle, the possibility of the EMU's disintegration could increase the potential cost of a default. The term disintegration may refer to the exit of one or more countries, or the break-up of the Eurozone.[40] In the first case, 'weak' member states might decide to leave the EMU to regain their monetary independence. However, the consequences (costs) of this scenario would probably be considerable. In the second case, with the collapse of the monetary union, economic, social and political outcomes would be catastrophic (Belke [2011]; Vigvári [2014]). The second way of reducing fragility is the elimination of the above-mentioned liquidity constraint dilemma. If the central bank of the monetary union has the right to provide additional liquidity for the economy, financial markets do not have to worry about insolvency. Finally, it is also possible to consolidate (centralize) national budgets and debt by creating a budgetary (fiscal) union (we will discuss it exhaustively in the second case study).

Apart from the asymmetric architecture of the EMU, we can mention other elements of incompleteness as well. Regarding the Stability and Growth Pact (SGP), sanctions had been based on political decisions (Rácz [2007]). This mode of application made it impossible to use the SGP efficiently in case of excessive deficit problems. As Schuknecht et al. [2011: p. 3] note, *"[w]hen it came to implementing the Stability and Growth Pact in a rigorous manner, the first test was failed"*. Following the collusion of Germany and France to block the Excessive Deficit Procedure, SGP underwent an important reform in 2005, which introduced greater discretion, leniency and political control into the system (Schuknecht et al. [2011]).

[40] It is worth to note that the Treaties do not make it possible for a member state to abandon the Eurozone (as it was mentioned earlier, this is the so-called 'denial of exit'). In spite of this prohibition, the scenario of exit was integral part of academic and public debates during the crisis.

Furthermore, in the absence of crisis management tools, it was more difficult and problematic for the member countries to alleviate the negative impacts of the crash. Last but not least, the interconnectedness between banks and sovereigns, i.e. the phenomenon of doom-loop was also a significant element, which amplified the negative consequences of the Eurozone crisis.

3.3. European Economic Governance and its reforms

Following the eruption of the sovereign debt crisis, the EMU-states had to take immediate measures in order to safeguard the single currency and the Eurozone. However, in line with the neofunctionalist reasoning, it became evident that underlying problems and systemic shortcomings could be managed only by the strengthening of European Economic Governance. Endogenous triggers were strong enough to make the initial equilibrium unstable. Consequently, member states should have responded to the incompleteness of the EMU by deepening the integration. This process, at least in principle, became part of the long-run strategy of the Eurozone.

Unfortunately, there is no a single definition to EEG. For instance, Heise [2008] provides a relatively good identification of the concept. He distinguishes the terms of European government and European governance. In his view, European government is *"[t]he establishment of a potent, supranational actor who is able to control financial resources and establish rules […],* while European governance refers to *"[t]he establishment of a system of multilateral negotiating or networking in order to coordinate national policies that are prone to externalities and free-riding behavior […]"* (Heise [2008: p. 4]).

Alternatively, the concept of EEG can be captured by the enumeration of different elements and institutions. Regarding the original design of EMU, the system of EEG may contain the following elements:

- Maastricht convergence criteria;
- multilateral surveillance procedure;
- no bail-out clause;
- Stability and Growth Pact (SGP) and the Excessive Deficit Procedure (EDP);
- European Central Bank (ECB) and the Eurosystem.

These building blocks can be supplemented with financial markets (market forces), who are monitoring countries continuously and punish them when necessary.

Szijártó [2018] offers another categorization of EEG. According to his typology, macroeconomic governance was a four-pillar system before the Eurozone crisis (*Table 18*) (Szijártó [2018]). Nevertheless, it was an asymmetric architecture since the four pillars significantly differed with respect to efficiency. The most efficient pillar was the monetary policy since the European Central Bank had been given supranational competence to implement monetary policy within the EMU. Regarding pillar 2, member states have not established a supranational fiscal policy. This shortcoming was a Pareto-inferior solution, which incorporated important functional pressures. Instead of establishing a true fiscal union, the Amsterdam Treaty, as a second-best solution, created the Stability and Growth Pact (SGP) with the aim of controlling public finances of the countries. Furthermore, the fiscal pillar was supplemented by different elements of 'soft' economic governance (pillar 4). These elements facilitated economic cooperation through harmonization and exchange of information. Finally, regulation of the financial system (pillar 3), similarly to fiscal policy, remained in the hands of nation-states, which resulted in latent functional pressures. This area was characterized by various soft instruments (initiatives), and external regulations (Basel I and II).

Table 18: The system of European Economic Governance before the crisis

	Pillar 1: Monetary policy	**Pillar 2: Fiscal policy**	**Pillar 3: Financial regulation**	**Pillar 4: Soft economic governance**
Objectives	Price stability	Sustainability of public finances	Financial stability	Harmonization and exchange of information
Instruments	• Conventional instruments of the European Central Bank (ECB)	• **No efficient instruments** • Stability and Growth Pact (SGP) • Modified Stability and Growth Pact (SGP)	• **No efficient instruments** • 'Soft' instruments: (Financial Services Action Plan; Lámfalussy Process) • External instruments: (Basel I and Basel II regulations)	• Broad Economic Policy Guidelines (BEPGs) • Employment policy guidelines • Macroeconomic dialogue • Social dialogue • Open method of coordination (in relevant policy areas)

Source: Own table based on Szijártó [2018] with slight modification

After the outbreak of the Euro crisis, new elements were added to the repertory of EEG in order to overcome the shortcomings of the original structure of the Eurozone and foster tighter economic cooperation among the members. In the short run, member states introduced different crisis management tools (short-term responses) in order to avoid the collapse of the Eurozone or the entire integration. As a second step, during the following years, member countries initiated systemic reforms (long-term responses), which resulted in the strengthening of EEG. In relation to this, Carstensen and Schmidt [2018] distinguish between fast- and slow-burning phases of the sovereign debt crisis. Their categorization reflects the difference between these two stages very well. The fast-burning phase, during 2010 to 2012, refers to the first period of the crisis when the situation required immediate responses from the states. According to Carstensen and Schmidt, this period was mostly characterized by intergovernmental actors and solutions. However, in the slow-burning phase, between 2012 and 2015, decision-makers had more time to elaborate systemic solutions. As the authors argue, supranational actors also played an important role in this phase of the crisis (Carstensen and Schmidt [2018]). Put differently, in accordance with the neofunctionalist approach, slow-burning phase created favorable circumstances to work on optimal (long-run) solutions that (might) lead to the deepening of the EMU.

In the very beginning of the sovereign debt crisis, member states were trying to alleviate the short-term impacts of the shock. In the absence of crisis management tools, it became necessary to prevent the collapse of the financial system in the Eurozone. This primary objective was reached by setting up a so-called ‘firewall system’. The first pillar of this system was the establishment of the *European Financial Stability Mechanism* (EFSM) in May 2010, immediately after the first support package for Greece. During the next month, in June, the *European Financial Stability Facility* (EFSF) was also established. The major function of these instruments was to provide assistance for countries, which were unable to finance themselves from the markets because of the severe loss of confidence (Győrffy [2018]; Sibert [2010]). Nevertheless, it has to be highlighted that these two instruments differed in some respects. The lending capacity of the EFSM was ‘only’ 60 billion euros, and this sum was financed by the EU budget. By contrast, the EFSF possessed a lending capacity of 440 billion euros through bond issuance (Szijártó [2018]). Unfortunately, these temporary instruments proved to be insufficient in preventing the escalation of the crisis. Varoufakis [2013], for instance, goes further and claims that the EFSF contributed to the contagion because of the toxic structure of the funds (Varoufakis [2013]).

In order to manage the contagion, it was indispensable to 'restructure' the above-mentioned emergency funds. Therefore, member countries decided to create the *European Stability Mechanism* (ESM), a permanent rescue facility with a lending capacity of 700 billion euros. The new mechanism started to operate in October 2012, earlier than it had originally been planned. With the start of the ESM, the EFSF, *de facto,* merged into the new mechanism (Gros and Mayer [2017]). Furthermore, it is important to emphasize that the ESM was established on an intergovernmental basis. The *Treaty Establishing the European Stability Mechanism* (TESM) was signed by the then 17 EMU-members in March 2011, and came into power after the ratification process in October 2012 (Szijártó [2018]). In sum, the creation of the ESM (and previously the EFSF/EFSM) was a considerable step on the road of strengthening the European Economic Governance, because, as Győrffy [2018: p. 34] notes: *"[t]hese emergency funds […] made the bailing out of troubled countries possible in an orderly manner"*. Since the ESM became a permanent tool, it should be regarded as a significant part of the long-run (systemic) fiscal reforms of the EEG.

In the meantime, the European Central Bank also intervened on the markets with the aim of mitigating the negative impacts of the crisis. These new, *non-conventional monetary policies of the ECB* were introduced, because conventional measures had (temporarily) lost their effectiveness (Gifuni [2017]). These non-conventional measures were the Security Market Program (SMP), the Outright Monetary Transactions (OMT), the Long-Term Refinancing Operations (LTROs) and the Quantitative Easing (QE).

The introduction of the *Securities Market Program* (SMP) was announced by Jean-Claude Trichet in May 2010. Under the program, the ECB directly purchased government bonds of countries in trouble. The SMP operated between May 2010 and February 2012, but it was unable to impede the crisis in the peripheral member states. As a result, in parallel to the launch of the *Outright Monetary Transactions* (OMT), the SMP was officially terminated in September 2012. In the framework of the OMT, the ECB had the opportunity to buy government bonds on the secondary markets without quantitative limits. However, in case of applying for the OMT, countries had to undertake considerable fiscal adjustments. Although, it is essential to note that no bonds have been purchased under the program. In December 2011 and February 2012, additional liquidity support was provided to European banks, mostly in the periphery. These *Long-Term Refinancing Operations* (LTROs) were 3-year long operations whereby financial institutions, against collateral, got credit at a very low interest rate. Nevertheless, in spite of optimistic expectations, the LTROs were unable to increase the volume of lending, thus the impact on the real economy was quite moderate. Due to significant deflationary pressures, on 22 January 2015, the ECB announced its so-called *Quantitative Easing* (QE) program. The program started in March 2015 and meant the purchase of bonds and securities from banks, European institutions and national agencies. By doing so, the ECB injected additional liquidity into the banking system and boosted the real economy (Brunnermeier et al. [2016]; Claeys et al. [2015]; Győrffy [2018]; Krishnamurthy et al. [2017]; Szijártó [2018]).

Whereas the above-mentioned elements could be assessed as emergency reactions in order to safeguard the Eurozone, long-term (or systemic) responses focused mostly on the institutional reforms of the EEG's fiscal pillar. In this respect, we can highlight the following elements: the ESM, the European Semester, the Six Pack, the Two Pack, and the Fiscal Compact.

The major task of the ESM, as it was mentioned above, is to provide loans to Eurozone member states facing financial hardship. The main decision-making body of the institution is the Board of Governors (BoG) consisting of the Eurozone's finance ministers (practically, the members of the Eurogroup). Decisions within the BoG are taken by unanimity, but it has to be stressed that Germany, France, and Italy received a *de facto* veto. As a result, they can block individually any decision. Since the ESM became a permanent crisis management instrument, it was also necessary to revise and modify Article 136 of the TFEU. Until now, the ESM has provided financial assistance to Greece, Spain, and Cyprus (Tesche [2020]; Zoppé and Dias [2019]).

With the abatement of the crisis, the ESM entered into a less active period. As a result, academic and political debates on the future and the possible new roles of the mechanism intensified. In 2015, the Five Presidents' Report initiated the integration of the ESM in the EU law framework by 2025. The European Parliament, in its contributions, emphasized the need for establishing a European Monetary Fund (EMF) with adequate lending capacity and a clearly defined mandate (Zoppé and Dias [2019]). In principle, this step would be a radical milestone in the evolution of the EEG. According to Sapir and Schoenmaker [2017], *"[t]he proposed transformation of the ESM into an EMF should be viewed as part of a wider institutional reform of the fiscal dimension of the euro area"* (Sapir and Schoenmaker [2017: p. 1]). The idea of creating such an institution was supported also by the European Commission in its document published in December 2017. The roadmap of the Commission on the deepening of the EMU contained, *inter alia*, a legal proposal for a Council Regulation establishing a European Monetary Fund. According to the proposal, the EMF would have been a Union body integrated in the EU legal framework based on the so-called 'flexibility clause' (Article 352 of the TFEU). A year later, in December 2018, the Eurogroup agreed on significant amendments of the ESM Treaty (Term Sheet on the ESM Reform) without referring to the Council Regulation on the proposed EMF. On 14 December 2018, at the Euro Summit, the heads of state or government of the Eurozone member states supported all the elements of the Eurogroup report. A few months later, on 14 June 2019, the draft text of the revised ESM Treaty and its annexes was accepted by the Eurogroup. On 21 June 2019, the Euro Summit welcomed the progress and the agreement of the document. The signature of the treaty had to be postponed due to the outbreak of the Covid-19 crisis, thus, the member countries signed it on 27 January 2021.[41] As a result, the ratification process has begun in the member states (Aerts and Bizarro [2020]; Zoppé and Dias [2019]).[42]

Since 2011, based on the EU Regulation 1175/2011, the economic governance tools have been integrated in the so-called *European Semester*. The European Semester provides a framework to support economic policy coordination in the EU by increasing (time) consistency (Hagelstam et al. [2019]; Hallerberg et al. [2012]). From a practical point of view, the framework has two basic objectives: (1) to harmonize (coordinate) EU-level goals and state-level priorities, and (2) to promote employment and sustainable competitiveness of the member states (Losoncz [2014]).

[41] Due to domestic political reasons (change of government), Estonia signed the revised ESM Treaty only on 8 February 2021.
[42] For instance, Aerts and Bizarro [2020] provide a very good description on the reform of the ESM.

The European Semester starts in late autumn when the European Commission presents its Annual Growth Survey (AGS), which contains the EC's key reform priorities for the coming year. In parallel with the AGS, the Commission reviews macroeconomic processes of the member states in the framework of the Alert Mechanism Report (AMR).[43] The EC also proposes draft Council recommendation with respect to the economic policy of the Eurozone (EA recommendations). The so-called 'autumn package' contains the Joint Employment Report as well. During January and February, the Council of the European Union and the European Parliament discuss the AGS and the AMR, respectively. The Council also approves the EA recommendations while the EC publishes detailed Country Reports (CRs), including an evaluation of macroeconomic imbalances and an assessment of the progress (implementation) of Country-Specific Recommendations (CSRs). CSRs consist of a wide range of policy fields such as education, health care or wage determination. As the next step, the European Council gives its policy orientations (strategic guidance and priorities) for the EU in March. Before submitting their National Reform Programs (NRPs) and Stability or Convergence Programs in April, member states are expected to take into account the EU-level priorities and the findings of the Country Reports.[44] Next, the Commission assesses these programs and proposes updated CSRs in May. Finally, in June and July, the Council and the European Council endorse and adopt the final version of the recommendations. The remaining six months, from July to the end of the year, is the implementation phase or 'national semester'.[45] At the end of the year, member states adopt their national budgets and the cycle starts again (European Council [Web1]; Hagelstam [2019]; Verdun and Zeitlin [2018]).

From an integration theory viewpoint, one can raise the question whether the architecture of the European Semester should be assessed as primarily supranational or intergovernmental. However, it is not easy to answer this question. With respect to this, Verdun and Zeitlin [2018] stress that various approaches can be found in the scholarly literature. Some scholars (e.g. Bickerton et al. [2015]) argue that New

[43] If necessary, based on the AMR, individual EU member countries receive (country-specific) recommendations (CSRs) to correct existing macroeconomic imbalances.
[44] Stability and Convergence Programs contain medium-term budgetary strategies while National Reform Programs (NRPs) outline structural reform plans regarding economic growth and employment. Furthermore, it is important to note that Convergence Programs are submitted by non-Eurozone member countries whereas EMU-members prepare Sability Programs.
[45] In the implementation phase, Eurozone members submit their Draft Budgetary Plans (DBPs) by mid-October.

Intergovernmentalism is the suitable theory to explain the European Semester. At the same time, others, such as Dehousse [2016], take the approach of New Supranationalism. Finally, a third group of authors point to the shift of governance competences from parliaments to technocrats (Verdun and Zeitlin [2018]). In our opinion, the European Semester should be assessed as a significant step towards a potential and efficient fiscal union. However, in its present form, it falls somewhere between Pillar 2 (fiscal policy) and Pillar 4 (soft economic governance) in the framework (system) of the European Economic Governance (see Table 18).

Table 19 summarizes the cycle of the European Semester in schematic form.

Table 19: The schematic framework of the European Semester

I: Preparatory Phase	
November and December	The 'Autumn Package' • Annual Growth Survey (AGS): EU-level priorities for the coming year • Alert Mechanism Report (AMR): review of country-level macroeconomic processes • Recommendations on the economic policy of the EA (EA Recommendations) • Joint Employment Report: review of social issues
II: The First Semester	
January and February	• The Council and the EP discuss the AGS and the AMR • The Council approves EA Recommendations • EC publishes detailed Country Reports (CRs)
March	• The European Council presents its policy orientations (strategic priorities)
April	• Member states submit their National Reform Programs (NRPs) and Stability or Convergence Programs
May	• The EC evaluates NRPs and Stability/Convergence Programs, and proposes updated Country-Specific Recommendations (CSRs)
June and July	• The European Council and the Council endorse and adopt the final version of the recommendations
III: The Second (National) Semester	
From July to December	Implementation phase • October: Eurozone member states submit their Draft Budgetary Plans (DBPs) for the next year • At the end of the year, member states adopt their national budgets

Source: Own table and compilation based on European Council [Web1]; Hagelstam [2019]; and Verdun and Zeitlin [2018]

In order to supplement the Stability and Growth Pact (SGP) and the Europe 2020 strategy, the Eurogroup adopted the *Euro Plus Pact* in the beginning of 2011. Although the agreement is open for all EU members, four countries have not signed it until now.[46] The Pact focuses on four major areas, which are as follows: (1) the strengthening of competitiveness, (2) the promotion of employment, (3) the improvement of the fiscal policy's sustainability, and (4) the strengthening of financial stability. In spite of the importance of these policy areas, the Pact is a political declaration based on a loose economic coordination. The objectives adopted by the members are integrated into the framework of the European Semester through the National Reform Programs (Halmai [2020b]; Marján [2013]).

As it was already mentioned, the Stability and Growth Pact, mostly due to political reasons, was unable to prevent fiscal problems in the member states. The SGP was based on two major pillars (arms), but neither of them worked efficiently. While the preventive arm operated through political pressures, the corrective arm could never sanction the members (Valle-Flor [2018]).

Following the eruption of the sovereign debt crisis in Greece, the European Commission was requested by the European Council to submit proposals in order to strengthen the European Economic Governance. At the same time, a Task Force (*VRTF – Herman van Rompuy Task Force*) was set up within the European Council (Chang [2013]). By the end of September 2010, a month before the VRTF Report, the EC prepared and presented six legislative proposals, which subsequently became known as the *Six-Pack*. A year later, on 28 September 2011, the European Parliament approved the Six-Pack, and the new mechanism entered into force on 13 December 2011 (De Prest et al. [2012]; Valle-Flor [2018]).

The Six-Pack consists of five regulations and one directive.[47] The legislative package focuses on two main areas. On the one hand, it modifies (strengthens) the framework of the SGP, and, on the other hand, introduces the so-called *Macroeconomic Imbalance Procedure* (MIP). The latter aims at preventing serious macroeconomic imbalances in all member states based on a scoreboard performance. According to EU Regulation No. 1174/2011, the Excessive Imbalance Procedure (EIP) was attached to the MIP including sanctions for the Eurozone countries (Losoncz [2014]; Bénassy-Quéré and Wolff [2020]).

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[46] Hungary, the Czech Republic, Sweden, the United Kingdom and Croatia have not joined the Euro Plus Pact. Of course, with the exit of the UK, four countries remained by now.
[47] EU Regulation No. 1175/2011, EU Regulation No. 1177/2011, EU Regulation No. 1173/2011, EU Directive No. 2011/85, EU Regulation No. 1176/2011, and EU Regulation No. 1174/2011.

Nevertheless, with the escalation of the Eurozone crisis in some member states, further measures became necessary. As a result, the European Parliament and the Council adopted two other regulations at the end of 2011 to supplement the Six-Pack. This legislative package[48], the so-called *Two-Pack*, reinforces further fiscal surveillance in the EMU (the Two-Pack is applied only for the EMU-members). The first regulation (EU Regulation No. 472/2013) focuses on the strengthening of economic and budgetary surveillance of Eurozone countries experiencing or threatened with serious difficulties regarding financial stability. The second regulation (EU Regulation No. 473/2013) contains provisions for monitoring and assessing Draft Budgetary Plans and ensuring the correction of excessive deficits (Bouwen [2013]).

Beyond the above-mentioned elements of the EEG, another intergovernmental agreement, the *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union* (TSCG or Fiscal Compact), was signed by 25 member states on 2 March 2012.[49] As Smeets and Beach [2020] note, negotiations on the TSCG were initiated by a Franco-German letter to the President of the European Council in August 2011, and the Fiscal Compact itself was the result of a German dictate (Smeets and Beach [2020]). According to the main element of the TSCG, government budgets of the EMU-countries have to be balanced or in surplus. In line with this, annual structural deficits may not exceed 0.5 percent of nominal GDP, and this criterion has to be incorporated into national legal systems (Chang [2013]; Smeets and Beach [2020]). Finally, it is worth noting that the ratification of the TSCG is a mandatory precondition of getting financial assistance from the ESM (Losoncz [2014]).

In this chapter, we have introduced briefly the OCA-theories that serve as theoretical basis for monetary unions. Next, we presented the original architecture of the EMU, and assessed the Eurozone's first decade. Subsection 3.2 focused on the anatomy of the crisis and the incompleteness of the EMU. Lastly, in subsection 3.3, we scrutinized the major reforms of the European Economic Governance.

In sum, we can make some important statements. First, we can conclude that the Eurozone crisis led to the strengthening of fiscal and economic cooperation in the

[48] EU Regulation No. 473/2013 and No. 472/2013. The Two-Pack entered into force in May 2013.
[49] The United Kingdom and the Czech Republic refused to sign the Fiscal Compact. The TSCG, which is open to all EU members, entered into force in 2013.

EMU (and in the EU).[50] Second, new elements of the EEG were established mostly on intergovernmental basis, however, supranational institutions played an important role in some cases. Consequently, this kind of 'dichotomy' may be best explained by recent approaches such as New Intergovernmentalism and New Supranationalism. At the same time, it should be underlined that these new mechanisms (or some of them) might be a springboard towards a deeper integration in the future. In sum, despite the fact that numerous new mechanisms and rules were introduced during the crisis, neither of the above-discussed solutions led to vertical institutional outcomes. In other words, neither of them was able to support neofunctionalist logic. The Four Presidents' Report (Rompuy [2012a]), by contrast, laid down a more ambitious package of proposals that anticipated the deepening of the EMU.

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[50] Nevertheless, it has to be stressed that this new architecture of the EEG became extremely complicated.

4. EUROZONE CRISIS MANAGEMENT IN NEOFUNCTIONALIST APPROACH: EXPLORATORY CASE STUDIES

In the previous chapter, we have presented the global financial and economic crisis and the Eurozone crisis (sovereign debt crisis). We showed that the depression of 2008-2009 can be assessed as an exogenous spillover trigger, which brought underlying systemic risks of the EMU to the surface. The loss of confidence together with increasing macroeconomic imbalances resulted in the Greek crisis and the sovereign debt crises of the Eurozone. Since the collapse of the EMU and the single currency became a potential scenario, member states decided to strengthen European Economic Governance in order to make the integration more efficient and resilient.

According to the approach of our theoretical framework, the Eurozone arrived at a critical juncture, which made the existing equilibrium (neutrality zone) unstable. The exogenous trigger, through the sovereign debt crisis, led to endogenous spillover triggers in general. The response of member countries suggests that triggers were strong enough and the EMU moved out from the neutrality zone.

In this chapter, we test our hypotheses and methodological framework through the elaboration of two exploratory case studies. In other words, this hypothesis testing means also the testing of the explanatory power of neofunctionalism in the case of Eurozone crisis management. Based on our theoretical model, the aim of the case studies is twofold. First, we intend to explore and identify endogenous functional, political and institutional triggers, which are responsible for moving out of the neutrality zone. Second, we want to map whether institutional outcomes promoted vertical integration. Put differently, we want to identify the positive movement in dimension *y*. In section 4.1, we elaborate the case of European Banking Union while section 4.2 deals with European Fiscal Union.

4.1. The European Banking Union

The first attempt to harmonize financial activity within the territory of the European Community dates back to 1977. However, only the adoption of the directive no. 89/646/EEC provided legal basis for cross-border banking activity (Benczes [2020;

De Rynck [2016]). In spite of liberalization (negative integration), regulation and supervision of financial institutions remained in the hands of member states.[51] In other words, banks operated on the Single Market in the absence of single regulation (Benczes [2019]). It is true, however, that the idea of a 'banking union' emerged in the end of the 1980s.[52] According to the first proposal, the central bank, i.e. the European Central Bank, would have overall powers regarding supervison and regulation. Unfortunately, the German Bundesbank rejected this idea in the beginning of the 1990s (Brunnermeier et al. [2016]).

At that time, consensual view was that banks' liabilities were approximately risk-free for three reasons. First, banks are generally perceived as businesses following a well-diversified model. Accordingly, they hold large amounts of domestic sovereign debt. Second, depositors are insured by the governments with the aim of preventing panic and bank runs. Third, due to different banking regulations, banks are, at least in principle, adequately capitalized (Acharya and Steffen [2017]).

After the introduction of the single currency, several observers warned that the lack of financial integration would increase the vulnerability of the EMU. Therefore, member countries responded to this incompleteness by the launch of the so-called Lamfalussy process. However, in the absence of decision-making powers, the mechanism remained a platform for exchange of information (Angeloni [2015]).

The global crisis of 2008 was first and foremost a banking crisis, thus many post-crisis reforms focused on banks. Since the banking sector is internationalized to a large extent, this field is very exposed to negative externalities concerning financial stability (Quaglia and Spendzharova [2017]). Donnelly [2014] defines financial stability as *"[…] [t]he on-going capacity of banks to meet the demands of their depositors and other creditors"* (Donnelly [2014: p. 982]). In relation to this, illiquidity, insolvency, zombie banks, the collapse of interbank loans, and the coexistence of state and private debt are the major symptoms of financial instability. Following the international crisis, restoration of financial stability became the primary objective of the EU. Financial

[51] Mügge [2013], for example, offers a slightly different approach and distinguishes two waves of EU financial integration. According to his categorization, the first wave began with the plan of the Single Market in the 1980s while the second wave started a decade later in the mid-1990s.
[52] The expression 'banking union' first appeared in 2011 (Véron [2015]).

stability is a precondition of a well-functioning financial system, and thus, it is a common interest of the member states (Mérő and Piroska [2013]).

Since the absence of a single financial regulatory environment in the EU led to serious problems after the outbreak of the crisis in the United States, the need for tighter cooperation in this policy area became necessary in the European integration. Taking into account that the immediate impact of the crisis was the meltdown of the interbank market, the financial system of the EMU (and the EU) was put under considerable functional pressures. It became instantly obvious that the traditional thinking based on the existence of efficient markets was false. Furthermore, when the crisis spread to Europe, member countries realized that the single currency was unable to prevent contagion coming from abroad (Sarcinelli [2013]). Consequently, policy-makers were motivated to learn from regulatory failures and make the financial system more efficient (Hennessy [2014]).

In line with our modified neofunctionalist model, it means that the crisis, which came from outside the EU (exogenous trigger), generated endogenous functional triggers that were strong enough to make policy-makers to react. While underlying functional pressures had not been managed until the eruption and spread of the global financial crisis, the serious negative consequences made the status quo, i.e. the neutrality zone, unstable. When the Eurozone crisis hit, and especially when it escalated in 2012, member states launched systemic reforms in the realm of banking regulation. The incompleteness of the Economic and Monetary Union in the financial sector can be detected through the underlying functional pressures. With respect to these triggers, we can mention the following five factors: (1) the above-mentioned financial stability as a common interest (public good), (2) the absence of macro-prudential regulations, (3) the moral hazard problem, (4) the absence of supervision, deposit insurance and bank resolution, and (5) the connection between banks and states (sovereigns). The last factor is also known under different names such as ‘doom loop’, ‘diabolic loop’, ‘deadly embrace’, or ‘vicious circle’.

As we have already emphasized, the stability of the banking sector is indispensable for a well-functioning financial system. Thus, *financial stability* should be seen as a common interest (public good), which makes the EMU a more symmetric integration system. As a result, it may improve the functioning of the entire EMU. However, this stability has different preconditions.

The first lesson we have learnt from the financial crisis has to do with systemic (macro-prudential) risks (Hennessy [2014]). The ‘international banking crisis’ revealed that micro-prudential regulations are unable to prevent those risks that may jeopardize the functioning of the financial system. It is particularly important because systemic risks go with considerable social costs. As Mérő [2012] notes, in times of crises, these costs may exceed 10-30 percent of the GDP. Consequently, micro-prudential regulations must be supplemented with *macro-prudential rules* (Mérő [2012]).

Moral hazard also played a significant role in the build-up of the banking crisis. Since the principle of ‘too big to fail’ had been the prevalent view, large banks were inclined to take much higher risks than smaller financial institutions. In addition, the same expectation characterized the financial markets as well. As a result, large banks were able to involve new capital more cheaply. This combination of ‘security’ and ‘cheap money’ made systemically important banks more competitive, which increased the profitability of these institutions (Mérő [2012]).

Furthermore, *banking supervision*, *single deposit insurance* and *single bank resolution* had been ignored by decision-makers until the eruption of the Eurozone crisis (Frankel [2015]). In the absence of such regulations, the risk of moral hazard became even more significant.

In the absence of a bail-out system (resolution fund), banks in trouble had to be recapitalized by sovereigns. However, these actions resulted in the downgrading of government bonds by credit rating agencies. This, in turn, negatively affected the situation of banks since their portfolios contained large amount of government bonds. Thus, governments (sovereigns) had to inject more and more capital into the banking system anew. This mutual negative feedback (*doom loop*) made banks and states vulnerable within the EU (Benczes [2019]).

Instability and vulnerability coming from these functional pressures were realized due to the global crisis. As a result, member states (and other economic players) started to focus on the shortcomings of the regulation of the financial system. As Mérő and Piroska [2017] highlight, the crisis legitimated the shift from the laissez faire ‘regulation’ towards a rule-based regulation (Mérő and Piroska [2017]). Nevertheless, it is important to emphasize that member states were reluctant to carry out (truly) systemic reforms in this area until the escalation of the Eurozone crisis.

In 2009, an expert group chaired by Jacques de Larosiére, former IMF managing director, was established. Based on the proposal of the Larosiére Report, a new, two-pillar supervisory structure was introduced in 2010 (*Table 19*). This reform was the first attempt to strengthen macro-prudential regulation within the European integration. The first pillar of the *European System of Financial Supervision* (ESFS) is responsible for micro-prudential supervision and refers to the so-called European Supervisory Authorities (ESAs). By ESAs we mean the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authorities (ESMA). The European Systemic Risk Board (ESRB), which became the second pillar of the new architecture, is responsible for macro-prudential oversight of the entire financial sector. The structure of the ESFS is supplemented by the activity of National Competent Authorities (NCAs) (Brunnermeier et al. [2016]; Mérő and Piroska [2017]).

Table 20: The structure of the European System of Financial Supervision

<table>
<tr><th colspan="4">EUROPEAN SYSTEM OF FINANCIAL SUPERVISION (ESFS)</th></tr>
<tr><th colspan="3">Pillar 1: Micro-prudential supervision</th><th>Pillar 2: Macro-prudential supervision</th></tr>
<tr><td colspan="3">European Supervisory Authorities (ESAs)</td><td rowspan="2">European Systemic Risk Board (ESRB)</td></tr>
<tr><td>European Banking Authority (EBA)</td><td>European Insurance and Occupational Pensions Authority (EIOPA)</td><td>European Securities Markets Authority (ESMA)</td></tr>
<tr><td colspan="4">National Competent Authorities (NCAs)</td></tr>
</table>

Source: Own table (European Council [Web])

Despite the positive results, the ESFS, in itself, was insufficient to manage all the underlying functional pressures of the policy area in question. The need for tighter cooperation was realized and stressed by non-governmental actors as well. For instance, Philippe de Buck, the then Director General of Business Europe, in his public letter pointed to the importance of financial stability. According to the letter, *"[b]uilding counter-cyclical buffers in the financial sector, developing credible bank resolution frameworks and orderly restructuring conditions in a crisis situation are all fundamental elements to mitigate risk and better protect taxpayer's money in the future. The EU's financial sector reforms must be a priority"* (Business Europe [2011:

p. 2]). In the same year, another non-state actor, the Bruegel Institute, also highlighted the need for a 'banking federalism' (Véron [2011]). It can be seen that non-governmental political actors have been active in supporting the idea of the banking union. Thus, political triggers can be detected.

With the escalation of the Eurozone crisis in 2012, policy-makers finally decided to launch large-scale (systemic) reforms. The first major step towards these changes was the '*Four Presidents' Report*'[53] (Rompuy [2012a]), which outlined, *inter alia*, the plan of a multi-pillar structure, which later became known as the European Banking Union. The Report was followed by the Euro Area Summit Statement a few days later. According to the document, *[...] [i]t is imperative to break the vicious circle between banks and sovereigns"* (Euro Area Summit Statement [2012: p. 1]). Rompuy [2012b] shares this view by emphasizing that the highly integrated nature of the EMU combined with different national regulations amplifies the negative impacts of the diabolic loop (Rompuy [2012b].

The European Council requested the European Commission to make a proposal on a single supervisory mechanism. Article 127 of the TFEU made it possible to delegate supervisory tasks to the European Central Bank without the amendment of the Founding Treaties (Benczes [2020]). The Commission in its proposal argued in favor of a supranational solution: *"[t]he objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore be better achieved by the EU. Recent events have clearly demonstrated that only supervision at the European level can ensure appropriate oversight of an integrated banking sector and a high level of financial stability in the EU and the Euro Area in particular"*(European Commission [2012a: p. 3]).

Besides the European Commission, European Central Bank also played a crucial role in promoting supranational solutions. According to De Rynck [2016], the action of the ECB can be explained by two arguments. First, a change in governor and board members brought a new thinking in the ECB. The new members had one thing in common; they all pushed for a more centralized architecture. Second, the Long-Term Refinancing Operations (LTROs) of the ECB increased the probability of moral hazard

[53] The name of the report refers to the Presidents of the European Council, the European Commission, the Eurogroup, and the European Central Bank.

behavior by national supervisors. In the absence of a single supervision, this functional pressure may easily lead to serious problems. Realizing these shortcomings, the ECB started to expand its tools in an unconventional way in order to manage the debt crisis. However, these unconventional actions soon spilled over into a formal competence expansion (De Rynck [2016]). In other words, institutional triggers can be discovered in the realm of European financial sector.

In reaction to the above-mentioned endogenous (functional, political and institutional) triggers, member states started establishing the multi-pillar European Banking Union in 2012 (see *Table 21*).

Table 21: The structure of the European Banking Union (EBU)

<table>
<tr><th colspan="3">EUROPEAN BANKING UNION</th></tr>
<tr><th>Pillar 2</th><th>Pillar 3</th><th>Pillar 4</th></tr>
<tr><th>Single Supervisory Mechanism (SSM)</th><th>Single Resolution Mechanism (SRM)</th><th>European Deposit Insurance Scheme (EDIS)</th></tr>
<tr>
<td>• ‘SSM Regulation’ (Council Regulation no. 1024/2013/EU)
• Micro-prudential and macro-prudential banking supervision (macro-prudential over smaller banks is shared with national supervisors)
• Distributed responsibilities between the ECB and national supervisory authorities
• Governance framework:
o Supervisory Board
o Steering Committee
o Administrative Board of Review
o Mediation Panel</td>
<td>• Bank Recovery and Resolution Directive (Directive no. 2014/59/EU of the European Parliament and the Council)
• ‘SRM Regulation’ (Regulation no. 806/2014/EU of the European Parliament and the Council)
• Single Resolution Board (SRB)
o central resolution authority since January 2015
o manages the Single Resolution Fund (SRF)
• Single Resolution Fund (SRF)
o emergency fund financed by the annual fee (contribution) of banks
o Fiscal Backstop as an additional emergency fund</td>
<td>• ‘DGS Directive’ (Directive no. 2014/49/EU of the European Parliament and the Council)
• Raised the minimum level of coverage for deposits to € 100 000 (harmonization)
• Objective: elimination of fragmented national systems and market distortions
• In fact, the pillar is still missing (incomplete)</td>
</tr>
<tr><td colspan="3">Pillar 1: Single Rulebook (SR)
• Objective: harmonization of different national regulations
• Applicable to all financial institutions in the European Union
• Tightening and unification of capital requirements through the Capital Requirement Directive IV (CRD IV) and the Capital Requirement Regulation (CRR)</td></tr>
</table>

Source: Own table and compilation based on Angeloni [2015], Benczes [2019], De Rynck [2016], SRB [Web], SRB [Web1], and Tröger and Kotovskaia [2022]

The first pillar of the EBU is the *Single Rulebook* (SR), which was actually established by the European Supervisory Agencies (ESAs) (Cappiello [2015]) before the official plan of the Banking Union. The term Single Rulebook was first used by the Larosiére Report and the European Council in 2009 (Deslandes et al. [2019]). The main objective of the SR is to harmonize heterogeneous national regulations in the EU through the Capital Requirement Directive IV (CRD IV), and the Capital Requirement Regulation (CRR). In relation to this, it should be noted that the SR is applicable to all financial institutions in the Union (Benczes [2019]). Simply speaking, the Single Rulebook plays an important in rule-making, whereas the other pillars of the Banking Union provide an integration mechanism. As Cappiello [2015] notes, the European Banking Authority and the Banking Union are complementary, rather than overlapping, institutions. According to his metaphor, the EBA and the Single Rulebook are functioning as the software while the Banking Union is the hardware of the system (Cappiello [2015]).

The second pillar is the so-called *Single Supervisory Mechanism* (SSM), which is based on a set of legislative proposals adopted by the European Commission in September 2012 (Quaglia [2013]). The major task of the SSM is to ensure the safety of the European banking system through macro-prudential banking supervision. Put differently, with its supervisory function, the SSM pillar contributes to financial integration and stability in the member states. According to the ‘SSM Regulation’ (Council Regulation No. 1024/2013/EU), responsibilities are distributed between the European Central Bank and the national supervisory authorities. In addition, the Regulation differentiates ‘significant’ and ‘less significant’ financial institutions (Angeloni [2015]). The ECB, *inter alia*, is responsible for authorizing banks, supervising compliance with capital requirements, and sanctioning (Benczes [2019]; Quaglia [2013]). To sum up, within the framework of the SSM, very important tasks and functions were conferred to the ECB, but due to the tight cooperation with national institutions and authorities, one can speak only about partial supranationalization in this area.

The governance framework of the SSM consists of four bodies, the Supervisory Board, the Steering Committee, the Administrative Board of Review, and the Mediation Panel. The Supervisory Board serves as the ‘major’ entity in the decision-making system. It prepares and approves draft supervisory decisions, which are forwarded to the ECB for final approval.[54] The Steering Committee is responsible for preparing the meetings of the Supervisory Board. The task of the Administrative Board of Review is to carry out internal administrative reviews of the ECB's decisions. Lastly, in case of an objection by the European Central Bank, the Mediation Panel tries to resolve disagreement (Angeloni [2015]).

The third pillar of the EBU is the *Single Resolution Mechanism* (SRM)[55], which was designed and established[56] to complement the SSM (Howarth and Quaglia [2014]). The European Commission defines the term resolution as a mechanism that facilitates the orderly restructuring of a bank (financial institution) by a resolution authority when the financial institution in question is failing or likely to fail (European Commission [Web]). Since the Bank Recovery and Resolution Directive (BRRD – Directive No. 2014/59/EU of the European Parliament and the Council) proved to be insufficient, the SRM was set up to complement the BRRD and partially supranationalize the resolution process (Tröger and Kotovskaia [2022]). The SRM was established by the Regulation No. 806/2014/EU, and comprises of two elements (or sub-pillars), the *Single Resolution Board* (SRB) and the *Single Resolution Fund* (SRF).

Single Resolution Board became an independent EU Agency, the central resolution authority in January 2015, playing a proactive role by focusing in the first place on resolution planning. Nevertheless, it has to be emphasized that the SRB cooperates closely with other bodies and institutions such as the European Commission, the EBA, and National Competent Authorities (NCAs) (European Commission [Web]; SRB [Web]). According to the outcome of the negotiations, and similarly to the case of the SSM, supranationalization with respect to the SRM remained partial. It is true, on the one hand, that the SRB became the decision-making body in the resolution process, and the Commission evaluates discretionary aspects of the decisions. But, at the same time, in special cases, the Council may also play a role in decision-making process (Schäfer [2016]). Tröger and Kotovskaia [2022] share this view when concluding that

[54] The ECB, more precisely the Governing Council, decides on the draft via a non-objection procedure. Practically, it means that, in the absence of objection, draft decisions will be adopted.
[55] The mechanism applies to all banks that are subject to the SSM.
[56] It should be stressed that, due to initial divergencies of national preferences, it took a while for the member states to come to an agreement. On the negotiation process and preferences see for example Benczes [2019] or Schäfer [2016].

"[t]he intertwined relationship of the SRB with NRAs as well as with the Commission and the Council […] may preclude desirable outcomes in common resolution" (Tröger and Kotovskaia [2022: p. 26].

The Single Resolution Fund[57] managed by the SRB is an emergency fund financed by the banks of the Banking Union countries. Banks are obliged to pay a fee (contribution) into the fund annually, thus, taxpayers do not have to bear the costs when a crisis hit. The SRF is being established over a transition period of eight years by 2023. Furthermore, member states decided on the creation of an additional emergency fund, the so-called Fiscal Backstop, that would increases the size of the SRF significantly (SRB [Web1]).

Finally, the fourth pillar of the EBU would be the *European Deposit Insurance Scheme* (EDIS). Unfortunately, this element is still missing, thus, this incompleteness results in a Pareto-inferior solution. The Deposit Guarantee Scheme directive (DGS directive), adopted already in 1994, required the member countries to operate national deposit guarantee schemes with the aim of harmonizing this area. Following the outbreak of the Eurozone crisis, the directive was revised and modified by the Directive No. 2014/49/EU of the European Parliament and the Council.[58] However, due to the opposition of some countries, especially by Germany, national competences remained dominant in this pillar (Howarth and Quaglia [2018]).[59]

Wolff [2016], in his contribution, also argues in favor an integrated deposit insurance scheme. His statement is that a deposit insurance is indispensable in building and maintaining trust of depositors that contributes to banking stability. Paradoxically, this line of thinking is very simple. Adequate level of trust helps to prevent bank runs, which, in turn, makes the insurance fund less likely to be used. Beyond this reason, Wolff enumerates three further arguments why a European Deposit Insurance Scheme would be necessary. The first argument has to do with size, i.e. an insurance system does better if it includes more financial institutions. Second, a centralized supervision with decentralized (national) insurance scheme might lead to inconsistency when the

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[57] For the sake of completeness, it has to be noted that the SRF was set up by a supplementary intergovernmental agreement (Tröger and Kotovskaia [2022]).
[58] The modified directive raised the minimum level of coverage for deposits to € 100 000 (Howarth and Quaglia [2018]).
[59] Howarth and Quaglia [2018] provide a detailed analysis on the difficulties of creating the European Deposit Insurance Scheme.

European supervision works inadequately. Finally, the EDIS would be essential to complete decoupling banks from sovereigns (Wolff [2016].

In summary, the European Banking Union contains a centralized supervision and a centralized resolution mechanism (EBF [Web]). It is true that, as Tröger and Kotovskaia [2022] highlight, the EBU is still incomplete and supranationalization is only partial. However, on the other hand, we totally agree with those who treat the EBU as the most significant milestone (agreement) since the Maastricht Treaty (Schäfer [2016]). Despite of its incompleteness, the Banking Union can be assessed as a truly supranational solution in the system of European Economic Governance that led to a considerable transfer of sovereignty. According to our neofunctionalist model, functional, political, and institutional triggers can be identified, which finally led to vertical institutional outcomes, i.e. the EMU moved upwards in dimension *y*. Therefore, due to the spillover mechanism, the integration moved out from the neutrality zone and shifted to a new equilibrium, which improved the functioning of the EU.

4.2. The European Fiscal Union

The sovereign debt crisis have led to (heated) debates about the fiscal developments of the Eurozone. Fundamentally, there are two major (and simplified) approaches regarding this issue. According to this discourse, the first option would be a decentralized fiscal framework in which member states should comply with EU-level fiscal rules and reinforce their individual (state-level) responsibility. For instance, the intergovernmental structure of the Fiscal Compact is a good example of this orientation. On the other hand, a (more) centralized fiscal framework can be imagined, which means a (much) deeper budgetary integration (Gadatsch et al. [2018]). The second option leads us closer to the notion and phenomenon of a European Fiscal Union or fiscal federalism.

The major issue of fiscal federalism is the division of fiscal competences (responsibilities), i.e. the centralization or decentralization of different tasks (Szalai [2002]). In his seminal volume, Musgrave [1959] distinguishes three basic economic roles (branches) of governments: allocation, (re)distribution and stabilization. Within the framework of the allocation branch, public policy provides public goods, and tries to eliminate market failures. The objective of the distribution branch is to decrease income and wealth inequalities in the economy through the budgetary system. Finally, the stabilization branch intends to maintain high level of resource utilization, price stability and aims at alleviating the amplitude of business cycles (Musgrave [1959]). In his paper, Oates [1968] applies Musgrave's categorization to the case of federal political entities. Accordingly, the main question focuses on the division of fiscal responsibilities among various levels of government. Oates concludes that stabilization and distribution functions should be provided by the central-government level. However, allocation responsibilities are divided between the central government and local governments (Oates [1968]).

Demertzis and Wolff [2020] emphasize that the debate on the exact form of a fiscal union in Europe stretches back to before the launch of the EMU. Based on the literature, they differentiate two major standpoints. According to the first one, the implementation of a fiscal union was rejected before the establishment of the Eurozone because there was no political will among the member states to create a political union. Nevertheless, the second approach argued that the single currency would ultimately result in irreversible political integration (Demertzis and Wolff [2020]).

In the words of Eichengreen [2019], *"[f]or a monetary union to operate smoothly, it must be accompanied by banking, fiscal and political union or at least by something resembling them"* (Eichengreen [2019: p. 15]. Thus, given the dichotomy between the supranational monetary policy and national budgetary policies, it seemed logical after the sovereign debt crisis to focus on the fiscal side of the EMU. Nevertheless, member states are seemingly reluctant to delegate further fiscal competences to supranational level because of divergent state preferences (Kollárik [2019a]).

Early debates and the asymmetric structure of the EMU indicate that the absence of a (really) tight budgetary cooperation, i.e. a fiscal union, can be assessed as a serious underlying functional pressure. In chapter 3, we have mentioned that, according to De Grauwe [2018], the establishment of a budgetary union would probably be the most powerful element in completing the architecture of the Eurozone (vertical interdependence). As in the case of the Banking Union, these pressures became obvious after the exogenous shock triggered by the Great Recession and the sovereign debt crisis. This exogenous trigger, in turn, activated the above-mentioned endogenous functional triggers and made the equilibrium unstable.

The idea of a European Fiscal Union was first published in the report of the European Council chaired by Herman van Rompuy in June 2012. The report proposed a vision for a stable EMU based on four building blocks. These are as follows: (1) an integrated financial framework to ensure financial stability; (2) an integrated fiscal framework to strengthen coordination and enforcement and to make steps towards common debt issuance; (3) an integrated economic policy framework with various elements to promote sustainable economic growth, employment and competitiveness; and (4) democratic legitimacy and accountability (Rompuy [2012a]).

A few months later, on 28 November, the European Commission released a document (blueprint), in which it outlined the plan of a deeper EMU. The blueprint also stresses the incompleteness of the EMU by referring to the asymmetry between supranational monetary and national fiscal policies, and to the absence of a centralized budgetary capacity (federal budget). The document envisaged a deep and genuine Economic and Monetary Union in three phases (European Commission [2012b]).

Based on the Commission Blueprint, on 5 December 2012, a detailed report was published by the President of the European Council. The so-called ‘Four Presidents’ Report’ was prepared in close collaboration with the President of the European Commission (José Manuel Barroso), the President of the Eurogroup (Jean-Claude Juncker) and the President of the European Central Bank (Mario Draghi). According to the report, the major task of the first stage (End 2012-2013) was to ensure fiscal sustainability and to break the diabolic loop between banks and sovereigns. The goal of the second stage (2013-2014) would have been the completion of the integrated financial framework and the promotion of sound structural policies separately from the multiannual financial framework. Finally, the objective of the third stage (post 2014) would have been the strengthening of the EMU’s resilience through the creation of a shock-absorption function at the EU-level (Rompuy [2012b]).

The objectives of this report were later confirmed in the ‘Report of the Five Presidents’ published by the European Commission. In line with this contribution, a genuine EMU including a fiscal union should be implemented in two stages until 2025 (Juncker [2015]).

The establishment of a European Fiscal Union (EFU) would be one of the key elements of European Economic Governance. Fiscal 'federalism' would strengthen the economic (or more precisely the budgetary) side of the EMU. Unfortunately, one cannot find a single definition to fiscal union in the literature. Accordingly, various scholars mean (very) different things and structures by the concept.[60]

For instance, Dabrowski [2015] defines fiscal union in broad terms, *"[a]s transfer of part of fiscal resources and competences in the area of fiscal policy and fiscal management from the national to supranational level"* (Dabrowski [2015: p. 7]). Bordo et al. [2011] stress that a fiscal union entails fiscal federalism among its member states (Bordo et al. [2011). Thirion [2017] emphasizes that the term fiscal union has different meanings from a set of fiscal rules to a fully-fledged federal government with tax and spending authority. The author identifies the following building blocks of a fiscal union: (1) rules and coordination; (2) crisis management mechanisms; (3) banking union; (4) fiscal insurance; and (5) joint debt issuance (Thirion [2017]). Fuest and Peichl [2012] also identify five criteria: (1) fiscal rules, policy coordination and supervision; (2) a crisis resolution mechanism; (3) joint guarantee for government debt; and (5) a larger (EU) budget and own (European) taxes. However, the authors stress that a fiscal union does not have to contain all these elements. The first element consists of a set of rules as the Stability and Growth Pact, supplemented with the Excessive Deficit Procedure and sanctions. In response to the Eurozone crisis, new rules (e.g. the Six-Pack, The Two-Pack or the Fiscal Compact) have been introduced in order to strengthen the budgetary discipline and supervision within the EU (Fuest and Peichl [2012]). Benczes [2018b] underlines that the EU has always been in favor of fiscal rules. Following the entry into force of the Maastricht Treaty, several national and supranational fiscal rules have been adopted in the Union (Benczes [2018b]). Crisis resolution mechanisms play a key role in dealing with insolvencies of member states. Unfortunately, prior to the crisis, such instruments did not exist in the Eurozone. Presently, the European Stability Mechanism can provide financial assistance for insolvent countries, although it is questionable whether its capacity is sufficient in case of a deep crisis. Joint guarantee for government debt could be the third building block of a fiscal union and may exist in several forms (e.g. Eurobond or a debt redemption fund). The fourth possible element is a kind of fiscal equalization system and other

[60] Iara [2016] provides an exhaustive summary on different views and proposals regarding fiscal union.

mechanisms for permanent transfers between member states. It is very important to underline that the current EU budget does not include permanent transfers related to the EMU. Member countries can get transfers only in the framework of the Regional (Cohesion) Policy and the Common Agricultural Policy (CAP). Permanent redistribution transfers would require a larger budget, which should be the fifth element of the fiscal union (Fuest and Peichl [2012]).

Jürgen von Hagen [2014], in his excellent paper, provides a very good overview on different modes of fiscal governance in monetary unions. As von Hagen notes, according to the OCA-theories and the MacDougall Report, a fiscal union is a system of fiscal transfers fostering macroeconomic stabilization. Unfortunately, this approach can be criticized from conceptual and empirical point of view as well. Conceptually, it is uncertain whether stabilization results in more or less stability of key macroeconomic variables such as GDP or unemployment. The result depend largely on the nature (type) of the economic shock. Empirically, it can be shown that fiscal transfers are able to offset only a small part of asymmetric shocks. Thus, as von Hagen argues, fiscal union is more than a simple risk-sharing function. The author identifies and clearly defines three types of fiscal cooperation: (1) fiscal union, (2) debt union and (3) fiscal freedom (Hagen [2014]). For the sake of simplicity, we call this typology the 'von Hagen-trinity of fiscal governance' (*Table 22*). By fiscal union (fiscal federalism), we mean the definition of von Hagen.

Table 22: The von Hagen-trinity of fiscal governance

Mode of governance	Features
1) Fiscal union	• Existence of a (Fiscal) Center • Strong centralization of fiscal resources and competences • Common debt issued and guaranteed by the Center (member states are not allowed to borrow individually) • No need for rescue funds/mechanisms • The Center distributes the funds it borrows among the members • Better status of the Center as a borrower on the financial markets • Own tax revenues (resources) of the Center • Existence of a fiscal administration (authority) collecting own taxes • Some degree of authority of the Center over the central bank • Strong authority (coercive power) of the Center over the members • Member states have a room for maneuver within their budget constraints
2) Debt union	• Member countries have the right to borrow • Debt is guaranteed by the union through rescue funds and/or issuance of common bonds • The Center has much less financial, political and legal resources • Tight fiscal rules (fiscal straightjackets) are needed

	• Common pool externality problem (free-riding, especially by small states) • The Center lacks information and coercive powers to control member states trying to circumvent the rules (illusion of control)
3) Fiscal freedom	• Member states are solely responsible for their own public finances • Credibility needs good fiscal institutions • In case of fiscal crisis, monetary financing is not possible

Source: Own table and compilation based on Hagen [2014]

According to this categorization, a *fiscal union* is characterized briefly by the strong centralization of fiscal resources and competences. Establishing such an arrangement requires the existence of a (Fiscal) Center in the first place. An additional important feature is that existing public debts are merged into a common debt issued and guaranteed by the Center. Practically it means that member states are not allowed anymore to borrow individually. The Center will be the actor who borrows and distributes the funds among the member countries. The centralization of these functions may have a positive external effect since the Center will possess a better status as a borrower on the financial markets. Assuming this type of fiscal governance, there is no need for rescue funds or mechanisms. However, strong centralization requires more resources, thus, the Center must have its own ('federal-level') tax revenues collected by a central fiscal authority. Furthermore, the Fiscal Center needs to have some authority over the central bank in order to be able to manage potential fiscal shocks. Lastly, the Center needs sufficiently coercive power over the member states to prevent irresponsible fiscal policies. Beyond these regulations, countries have a room for maneuver within their budget constraints (Hagen [2014]).

Under the second type of fiscal governance, *debt union*, member countries have the right to borrow on the financial markets, and the union, i.e. the countries, guarantee the debt through rescue funds and/or issuance of common bonds. Of course, a debt union is a more decentralized and weaker arrangement regarding financial, political and legal resources. This mode of governance, however, raises the possibility of the fiscal common pool externality problem that leads to a free-riding behavior. The problem is rooted in the fact that countries, especially small states, are prone to borrow more than they would otherwise. Put differently, member states expect that other countries will not let them default in a debt crisis. Consequently, this kind of expectation leads to the presence of moral hazard, which in turn may jeopardize the whole debt union in the form of unsustainable debt stocks. Therefore, in order to ensure responsible budgetary policies in the member countries, the union has to create stricter fiscal rules, norms and targets than budgetary unions. Unfortunately, these ‘fiscal straightjackets’ sacrifice short-term flexibility on the altar of sustainability, which instigates member states to circumvent the rules. In short, the major disadvantage of a debt union comes from the fact that in the absence of information and coercive powers, the union is unable to prevent excessive borrowing (Hagen [2014]).

The third type of the von Hagen-trinity is the case of a monetary union with *fiscal freedom*. Within this structure, member countries are solely responsible for their own budgetary situation but, at the same time, they have (fiscal) freedom in shaping and adopting policies. In the case of fiscal freedom, credibility depends largely on good budgetary institutions such as rules, constitutional debt brakes etc. Of course, the main vulnerability of this mode of governance is the impossibility of monetary financing when a fiscal crisis hit (Hagen [2014]).

It is important to underline that, based on historical experiences and according to the conclusion of von Hagen, debt unions are not viable solutions in the long run. This is because these arrangements lead either to indebtedness or to high inflation. The author argues that the Eurozone has become (at least partly) a debt union after the crisis. It also means that the EMU will have to choose, sooner or later, between fiscal union and fiscal freedom (Hagen [2014]).

Accepting the categorization of von Hagen [2014], we can conclude that a fiscal union has three major pillars: (1) common debt issuance and central distribution of funds borrowed by the Fiscal Center; (2) a considerable common budget with own tax revenues and tax-collection authority; and (3) strong coercive powers of the Center to prevent irresponsible state-level budgetary policies.

Federal countries typically have sizeable budgets, therefore, it is possible to centralize important functions (Wolff [2012]). However, it is quite problematic that fiscal sovereignty is one of the most sensitive areas, which may hamper the progress in this field (Szemlér [2017]). Compared to existing federations, especially to those, which are also currency unions, the EU’s fiscal capacity is extremely undersized, and represents only 1 percent of the EU GDP (Kakol [2017]; Cottarelli [2016]). The revenue side consists of custom duties (traditional own sources), of a small percentage of VAT revenues, and, predominantly, of national contributions. In parallel, the spending side contains only some programs related to the regional (cohesion) policy and the common agricultural policy (Cottarelli [2016]; Dabrowski [2016]).

The MacDougall Report in 1977 already argued in favor of a large common budget. The report determined the optimal size of the budget somewhere between 5 and 25 percent of the Community's GNP (Szemlér [2017]).

Cottarelli [2016] argues that a larger budget would be necessary to ensure the good functioning of the monetary union. This is because a sizeable central budget may promote macroeconomic convergence within the Euro Area through different channels. First, centralization of certain spending and revenue policies fosters the convergence of product and factor markets; second, centralization of fiscal policy decisions may help to reduce the risk of free-riding; third, centralization of automatic stabilizers may be the best way to achieve risk-sharing; and fourth, a larger budget can implement discretionary counter-cyclical policies more easily (Cottarelli [2016]). However, it is a big question whether the EU budget should be increased or the Eurozone should set up an own budget. Of course, both solutions have their advantages and disadvantages. Currently, a separate Eurozone budget seems more feasible, but it would lead to institutional fragmentation (Iara [2016]) and promote the model of the multi-speed EU.

Garcia and Vacca [2016] enumerate five reason why the EMU should have an own budget. First, such a fiscal capacity would strengthen macroeconomic convergence by supporting long-term policies. This, in turn, would make the EMU more resilient and decrease the probability of (symmetric and asymmetric) economic shocks. Second, an EMU budget would be able to provide automatic and discretionary tools and financial sources to react in case of economic shocks. Third, the EMU could provide European public goods by financing investments of pan-European relevance such as infrastructure. Fourth, an EMU budget would have the capacity to back certain financial assistance instruments established after the sovereign debt crisis. Lastly, it would prevent the refragmentation of essential sectors of the common market (Garcia and Vacca [2016]).

The so-called Meseberg Declaration [2018] adopted by Germany and France proposed the establishment of a Eurozone budget: *"[W]e propose establishing a Eurozone budget within the framework of the European Union to promote competitiveness,* *convergence and stabilization in the euro area, starting in 2021. […] Resources woud come from both national contributions, allocation of tax revenues and European resources. The Eurozone budget would be defined on a pluriannual basis. […] It could finance new investments and come in substitution of national spending. We will examine the issue of a European Unemployment Stabilization Fund, for the case of severe economic crises, without transfers. France and Germany will set up a working group with a view to making concrete proposals by the European Council of December 2018. Strategic decisions on the Eurozone budget will be taken by the Eurozone countries. Decisions on expenditures should be executed by the European Commission"* (Meseberg Declaration [2018: pp. 6-7]).

The idea of a larger fiscal capacity obviously raises the issue of own resources that do not depend on the decisions of the member states (Garcia and Vacca [2016]). It brings us to the topic of European tax(es), because the existence of such common revenues are almost indispensable to create a genuine economic (fiscal) federation. Several proposals can be found in the literature related to the issue of European taxes. Marján [2013] claims that a potential European tax should be introduced in a 'budget-neutral' way. Probably, the sharing of VAT revenues between the EU and the member states would be the best way of this (Marján [2013]).

Le Cacheux [2007] identifies several potential forms of European taxes. He argues that indirect taxes should be potential revenues at the EU level. A European VAT may be regarded as a neutral form of taxation (assuming it does not tax savings). Furthermore, the transfers of a part of VAT revenues to the common budget would technically easy. On the other hand, it has to be highlighted that VAT is often considered to be unfair since it taxes low-income individuals who spend relatively more on consumption. Alternatively, excise duties levied on alcohol, tobacco and fuels could be possible instruments as well. The same principles apply to eco-taxation, i.e. to Pigovian taxes, which may also provide revenues by taxing environment-damaging activities. The second type of European tax instruments could be a European corporate income tax. The advantage of such a tax item would be relatively small costs of the administration, given the small number of taxpayers. However, relatively large fluctuations in the annual yield of corporate income tax caused by business cycles may be the main disadvantage of the item. Finally, other taxes (such as a European personal income tax or financial transaction tax) might also play a role in a larger common budget (Garcia and Vacca [2016]; Le Cacheux [2007]).

Of course, a large and separate fiscal capacity requires a common payment procedure and taxation powers. For example, Garcia and Vacca [2016] assert that the Economic and Monetary Union should be given tax-collection power, which, obviously, would demand the reform of the Treaties. In addition, the EMU should be given taxation powers in order to be able to determine its own revenues. With respect to these matters, the authors draw the attention that the introduction of co-decision and majority voting procedures in this area is indispensable in the long run to reach a fully-fledged fiscal union (Garcia and Vacca [2016]). In summary, potential solutions are available; the implementation depends primarily on the attitude and political willingness of the member states.

Demertzis and Wolff [2020] offer another way of strengthening the EMU's budgetary framework gradually. Their proposal is based on three steps (phases). In the short run, the EMU should complete the Banking Union to break the doom loop as much as possible. In the second step, common fiscal capacity should be increased to finance some European public goods, such as external security, climate policies, or pan-European infrastructure investments. The authors highlight that this part could involve the whole EU since the above-mentioned European public goods have positive impacts for all member states. Furthermore, the 'draft' envisages the establishment of an insurance system to provide temporary transfers to Eurozone-countries hit by considerable shocks. Finally, the third phase would mean the implementation of a true fiscal federation with taxing and spending powers at the supranational level. Demertzis and Wolff consider this last step presently to be unrealistic, although they note it would be desirable in the long run (Demertzis and Wolff [2020]).

In spite of strong functional, (EU-level) political and some institutional triggers, the implementation process of a European Fiscal Union became standstill. Demertzis and Wolff [2020] explain this phenomenon by the lack of trust, the considerable heterogeneity among the member countries, and the volatile political situation in key member states. Moreover, they claim that political pressure to deepen the integration has decreased by now since the EU managed to overcome the sovereign debt crisis (Demertzis and Wolff [2020]).

In our opinion, three major factors can be mentioned that (might) explain the standstill of the deepening in this area. First, a truly supranational fiscal union requires core budgetary functions to be delegated to the EU-level. However, member states are currently unwilling to give up their sovereignty in this policy area. We may call this phenomenon *sovereignty dilemma* to describe a situation whereby member states are reluctant to resort to supranational solutions when seeking the best answer to a crisis. Put differently, national governments are the primary obstacles of the optimal solution. Second, as a result of the sovereignty dilemma, member states strengthened fiscal governance in Pareto-inferior ways, mostly through intergovernmental solutions. As Garcia and Vacca [2016: p. 2] note, *"[s]uch steps are far from ensuring the long-term sustainability and robustness of the EMU."* Mileusnic [2021] draws the same conclusion when claiming that an ideal fiscal integration, i.e. a fiscal union, would ideally extend beyond the current rule-based system (Mileusnic [2021]). In line with our neofunctionalist model, it basically means that in spite of existing triggers, member states chose marginal answers to overcome the crisis. These reactions managed to alleviate functional pressures in the medium-term, but underlying pressures continue to exist. Lastly, the absence of a clear and single definition of fiscal union accepted by all member states makes it almost impossible to reach a compromise about the optimal institutional outcome. Consequently, we argue that this *conceptualization problem* should be resolved in the first place. After all, we agree with the findings of scholars who assert that a supranational solution (a fiscal union or fiscal federation) in this policy area is inevitable in the long run.

5. SUMMARY

The establishment of the European integration has been the greatest achievement of European nation-states since the Second World War. By the end of the 20th century, through multiple stages, the cooperation led to the introduction of the single currency in several member states. Unfortunately, the Economic and Monetary Union was severely hit by the Great Recession and the sovereign debt crisis in the end of the 2000s. The crises revealed the underlying problems of the EMU. Thus, the Eurozone arrived at a critical juncture where member countries had to choose between disintegration and tighter cooperation.

These events are very important from a theoretical perspective as well. The purpose of our dissertation was to test whether neofunctionalism provides a satisfactory framework in explaining the Eurozone crisis management. We chose neofunctionalism as a theoretical framework because in the thesis we focused on general trends and development of the integration (Cooper [2011]). More precisely, the Neofunctionalist Research Program provide an adequate toolkit to analyze regional integrations as adaptive complex systems.

In Chapter 2, we have introduced the ontology and evolution of the Neofunctionalist Research Program (NRP). We have seen that the theory underwent a series of modifications and refinements. In order to synthetize the research program, we defined four phases: foundation, withdrawal and transformation, recovery, and uncertainty. In addition, we presented briefly the main contending theories and approaches, which had had significant impact on the neofunctionalist thinking. Based on our review, we concluded that the school was able to explain the long-run developments of the European integration until the second half of the 2000s.

Finally, drawing on the NRP, we elaborated a modified neofunctionalist framework with the aim of establishing a comprehensive but parsimonious model that might provide a better explanatory framework for current and future developments. The reason why we intended to build an own methodological framework was threefold. First, due to the considerable level of interdependence, in a highly globalized world, regional integrations cannot be separated from exogenous (external) impacts. In relation to this, these external shocks might be strong enough to become endogenous and may 'force' political and institutional players to deepen the cooperation. Second, in order to avoid the existing, and sometimes ambiguous interpretations of the term spillover, we defined it as a complex, two-stage process, which can be seen as a bridge between two different equilibria (neutrality zones). Finally, we incorporated relatively new non-governmental actors who/which might be interpreted as political triggers.

In Chapter 3, we have focused on the Eurozone crisis and the European Economic Governance. Following the theoretical introduction, i.e. a short description of the OCA-theories, we presented the original design and the first decade of the EMU. In the next section, we analyzed the causes and consequences of the sovereign debt crisis with special respect to the incompleteness of the monetary union. Based on the analysis and the scholarly literature (especially on Baldwin and Giavazzi [2015; Dyson [2017]; Hooghe and Marks [2019]; Jones et al. [2015]; Lefkofridi and Schmitter [2015]), we could accept the first hypothesis (H1) of the dissertation. According to H1 **"the global financial and economic crisis of 2008 and 2009, as an exogenous spillover trigger, generates through the sovereign debt crisis further endogenous spillover triggers in the Economic and Monetary Union."** In line with our model, we can conclude that the Great Recession can be assessed as a critical exogenous economic spillover trigger that was strong enough to make the initial equilibrium unstable and induce endogenous triggers. In the last subsection, we scrutinized the new elements of the EEG, which made the EMU's architecture extremely complex. We found, on the one hand, that the sovereign debt crisis led to the strengthening of fiscal and economic cooperation in the EMU. On the other hand, new components of the economic governance were established mostly on intergovernmental basis, however, supranational institutions played an important role in some cases. To sum up, we drew the conclusion that the setting up of this complex structure of the so-called *de novo* bodies (institutions) can be best explained by recent theories such as New Intergovernmentalism and New Supranationalism. Nevertheless, some of these mechanisms might be a springboard towards a deeper integration in the long run.

Lastly, in Chapter 4, we have elaborated the two exploratory case studies, European Banking Union (EBU) and the European Fiscal Union (EFU). Through the case study of the EBU, we explored each types of endogenous triggers, i.e. functional, political, and institutional. It practically means that political players (elites) and supranational actors played a key role in answering to functional triggers came from the incompleteness of the EMU. Furthermore, these triggers resulted in a vertical integration that improved the functioning of the integration. In sum, the case of the EBU supports our second hypothesis (H2), according to which "**endogenous triggers lead to institutional outcomes that result in the deepening of the Economic and Monetary Union."** In addition, based on the institutional outcomes of the Banking Union, we can accept our third hypothesis (H3) as well, which states that **"spillover triggers and outcomes can be detected and identified regarding the plan and implementation of the European Banking Union (EBU) and/or the European Fiscal Union (EFU)."** However, it is important to emphasize that the Banking Union is still incomplete, thus the completion of the EBU remains an important task for the future.

Finally, in the last subsection, we analyzed the case of the European Fiscal Union (EFU). The establishment of a fully-fledged EFU would be another key element of the European Economic Governance. Fiscal federalism would strengthen the economic (fiscal) pillar of the EMU. However, as we argued, there are three basic factors impeding the creation of the EFU. First, a supranational fiscal union would require core budgetary functions to be delegated to the EU-level. However, member states are presently unwilling to give up their sovereignty in this policy area. Paradoxically, due to this sovereignty dilemma, member states strengthened fiscal governance via marginal (and Pareto-inferior) solutions. In line with our neofunctionalist model, it means that in spite of existing triggers, member countries chose marginal (mostly intergovernmental) answers to overcome the crisis. These reactions managed to alleviate functional pressures in the medium-term, but underlying pressures continue to exist. Finally, the conceptualization problem should be resolved, i.e. a clear and single definition of European Fiscal Union would be necessary in order to negotiate on the optimal institutional architecture. We finally concluded that in spite of strong functional, (EU-level) political and some institutional triggers, the implementation process of a European Fiscal Union became standstill. Nevertheless, we share the view of observers who claim that a supranational solution (a fiscal union or fiscal federation) is indispensable in the long run. To sum up, the (absence of) the European Fiscal Union supports only in part of Hypothesis 3 (H3), i.e. while functional and institutional triggers can be explored, divergent national preferences hamper political triggers. As a result, in the absence of vertical institutional outcome, the fiscal side of the EMU is still incomplete.

In the dissertation, we intended to contribute to the existing literature in three ways. One of our objectives was to systematize the entire Neofunctionalist Research Program. In relation to this, our second goal is to introduce the NRP in the Hungarian literature, even if the dissertation is written in English. Furthermore, we made a proposal to a modified neofunctionalist model that, on the one hand, synthetizes the previous versions and other relating approaches such as historical institutionalism, transactionalism, or supranational governance. Last, but not least, we scrutinized the expalantory power of the theory in the post-crisis period, i.e. in the uncertainty phase of the NRP.

Of course, the dissertation can be further developed in several directions. Here, we mention three of them. First of all, there is an opportunity to refine further the modified neofunctionalist framework. Second, the model can be applied to analyze cases and events in other policy areas, such as the Common Foreign and Security Policy. Lastly, the model might be useful in scrutinizing the development of other regional integrations in the world economy.

In our thesis, we tried to capture the developmental trajectory of an extremely complex system, the Economic and Monetary Union, and, indirectly, the European Union as a whole. To do so, we invoked the Neofunctionalist Research Program, which helped us with ordering and describing the post-crisis events from a theoretical point of view. Our major purpose was to test the explanatory power of the neofunctionalist approach in the uncertainty phase. We found that, in spite of the complex architecture of the European Economic Governance, the EMU reached a critical milestone in the area of financial regulation (Pillar 3). The establishment of the European Banking Union was considerable reaction to underlying pressures, which had to be managed after the Great Recession and the sovereign debt crisis. In accordance with the transfer of sovereignty in this policy area, we can conclude that neofunctionalism is still relevant in explaining long-run developments of the integration. Of course, the EMU (and the EU) is far from a fully-fledged economic federalism. Nevertheless, the NRP, and our theoretical framework may serve as a good tool in analyzing the developmental tendency of the EU.

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