Ever looser union? Towards a theory of differentiated integration in the EU

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Introduction[1]

While differentiated integration has been a prominent issue of EU policy-making and policy debate for a considerable time, it has been sidelined by integration theory. By the mid-1990s, the British and Danish opt-outs from Economic and Monetary Union and the development of the Schengen regime outside the treaty framework had shown that European integration would not necessarily develop in a uniform manner. Debates about "closer" or "enhanced cooperation" signaled attempts to give differentiated integration constitutional rank. At the same time, the so-called Schäuble-Lamers paper on *Kerneuropa* (core Europe) by prominent members of the CDU, Germany's main governing party, triggered an intense policy debate in 1994. Yet the dominant integration theories – intergovernmentalism and supranationalism – continued to debate the causes and conditions of growth rather than differentiation in European integration.

In addition to a large amount of prescriptive or policy-oriented work, academic contributions in political science have largely been limited to conceptual work and ad hoc-explanations. The conceptual literature can be subdivided roughly into three groups. In the first group, we find attempts to conceptualize the entire process of European integration as differentiated integration. Schmitter's description of the EU as a potential "condominio" (1996), Walker's multidimensional analysis of sovereignty (1998), Zielonka's "neo-medieval empire" (2006), or De Neve's "Europe as Onion" (2007) belong in this group. The second group of authors seeks to categorize the various

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forms of differentiated integration in the EU. A widely cited classification by Stubb (1996) distinguishes between "multi-speed", "variable geometry", and "à la carte" differentiation according to the dimensions of time, space, and matter. Finally, the legal literature offers typologies of the various legal instruments of differentiation (see e.g. Tuytschaever 1999).

Positive explanations are often ad hoc. There is a kind of "folk theorem" in the literature. It stipulates that both enlargement and the increasing policy scope of European integration have resulted in a higher heterogeneity of state preferences and capabilities and that this heterogeneity has given rise to differentiation in turn (see e.g. Stubb 1997; Warleigh 2002). This explanation, however, is purely demand-driven, does not theorize the supply conditions for differentiated integration, and ultimately cannot fully explain why differentiated (rather than no) integration results from the increase in heterogeneity.

The most elaborate theoretical framework for explaining differentiated integration so far has been proposed by Kölliker (2001; 2006) who draws from the toolkit of collective-action and public-choice theory. His main focus, however, is on the effects rather than the causes of differentiated integration. Plümper and Schneider (2007; Schneider 2009) again analyze a special case of differentiation: the discrimination of new member states in the EU. These authors provide supply-side conditions (mainly policy characteristics and bargaining power) that we can build on and that we can complement with institutional and normative factors to theorize the conditions of differentiated integration more generally.

In this paper, we undertake initial steps in this direction. We start building our case conceptually and empirically. In a first step, we argue that the EU is best understood as a system of differentiated integration. It incorporates elements of federal (type-1) as well as functional (type-2) multi-level governance but does not match either type well.[2] Second, we show that differentiation has become an increasingly relevant aspect of European integration. Whereas our data show that the vertical and horizontal integration of the EU (its "deepening" and "widening") have gone hand in hand over the course of European integration, differentiated integration has strongly increased during the "relance Européenne", which boosted both the competences and the membership of the EU.

In the second part of the paper, we propose an analytical model of differentiated integration that draws on insights from the major integration theories: intergovernmentalism, supranationalism, and constructivism. Although these theories have not dealt with differentiated integration systematically yet, they provide all the basic ingredients. Here, we start from an intergovernmentalist framework but argue that the hybrid nature of the EU as a system of differentiated integration requires us to take into account factors associated with both federal and functional governance. We then spell out the interplay of externalities, bargaining power, institutional costs, and normative influences for different scenarios of differentiated integration: progressive and regressive internal differentiation, external differentiation, and enlargement differentiation.

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[2] See Hooghe and Marks (2003) for the distinction between type-1 and type-2 governance.

The EU: a system of differentiated integration

We suggest that polities can be conceptualized as three-dimensional configurations of authority.

- *Level of centralization.* Polities that monopolize authoritative decisions in the center have a maximum level of centralization, whereas decision-making authority dispersed equally across a multitude of actors indicate a low level of centralization.
- *Functional scope* varies between authority over a single issue and authority over the entire range of policies.
- *Territorial extension.* The authority of a polity can be limited geographically to a single political territory, or it may encompass several territories – up to the entire world.

Figure 1 illustrates different types of polities resulting from variation in the configuration of authority. The level of centralization is shown on the y-axis, functional scope on the z-axis, and territorial extension on the horizontal x-axis. The classical configurations are the (unitary) state and the international organization. In the unitary state, all policies are made at the same (central) level and cover the same (limited) territory. In addition, the state traditionally has maximum functional scope: it covers all policy-areas. By contrast, international organizations are typically decentralized and task-specific but cover more territories.
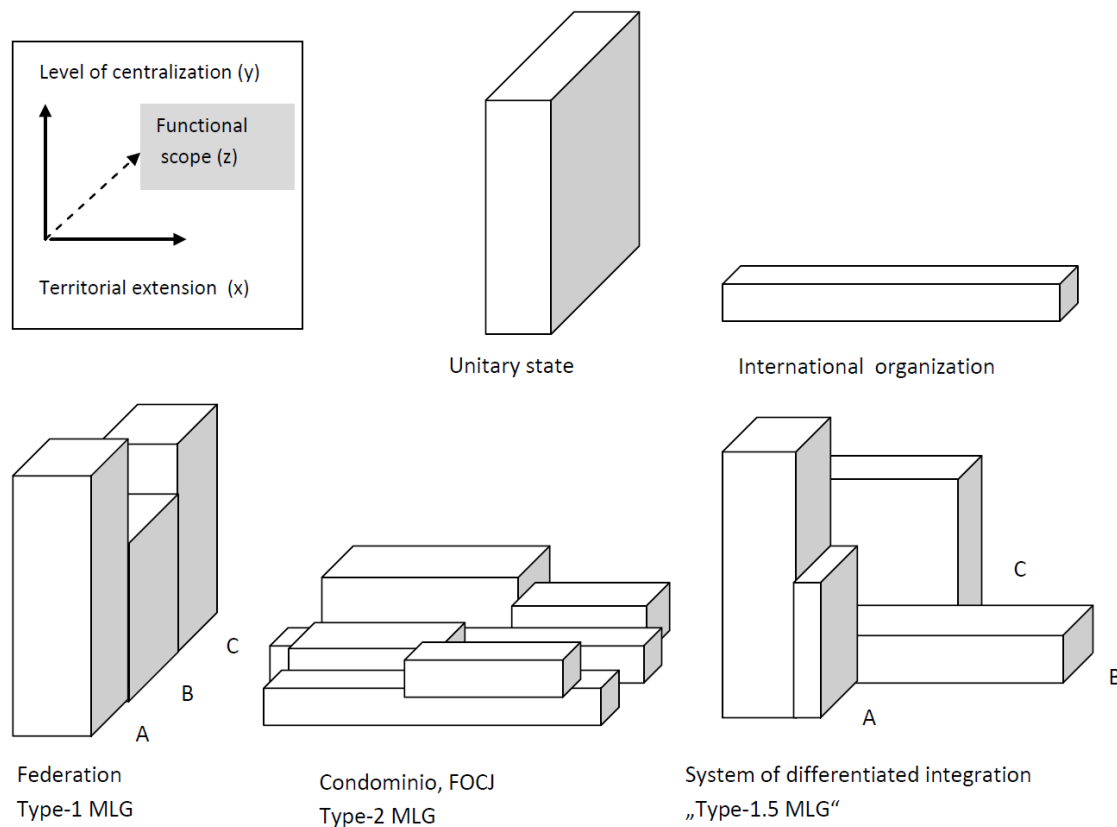
Figure 1   *A three-dimensional representation of polity types*

The lower three shapes represent more complex configurations of authority. The federation differs from the unitary state in that at least one policy area is governed at the subnational (regional) level (sector B) or co-governed by subnational and national authorities (sector C), whereas other sectors are fully centralized (A). The territorial extension and functional scope of the federation, however, is of the same order as that of unitary states. It deals with all policy areas on a closed territory (note, however, that a federation's extension grows with the number of subunits of which it is composed). This is also the basic model of federalist conceptions of European integration, which assume a set of member states that form a Union and allocate the authority over policy sectors to themselves, to the Union or, as mixed competences, to both states and the Union. The federal state is also the prototype of what Liesbet Hooghe and Gary Marks (2003) call "type-1 multi-level governance" consisting of general-purpose jurisdictions with non-intersecting memberships, which are neatly nested in one another.

By contrast, their "type-2" consists of task-specific jurisdictions with intersecting memberships. In the international domain, the coexistence of hundreds of international organizations, most of them highly specialized, some working in the same policy fields, with variable, overlapping membership and different regional focus, follows this type. The idea of FOCJ (functional, overlapping, competing jurisdictions) as "competitive governments for Europe" by Frey and Eichenberger (Frey and Eichenberger 1996) fits here. So does Philippe Schmitter's "condominio", "based on variation in both territorial and functional constituencies", which he considers to be the "most probable trajectory for the EU" (1996: 136). He describes it as "many Europes", in which "there would be multiple regional institutions acting autonomously to solve common problems and produce different public goods" (Schmitter 1996: 136).

In our view, however, the EU is a hybrid type of multi-level governance. In contrast to federal type-1 governance, the extension of membership varies by policy or task. The EU has varying borders for the Euro zone, Schengenland, or the Single Market. On the other hand, categorizing the EU as functional type-2 governance ignores the extent to which the EU has developed an institutional core or center that reaches across the EU's policy sectors with their variation in centralization and territorial scope. This institutional core is constituted, first, by the Treaty on European Union; second, by the EU's institutions, namely the European Council, which gives general directions for all policy sectors of the EU and for treaty revisions, the Council, the European Commission, the European Parliament and the European Court of Justice which are also present – albeit to different degrees and with varying competences – across the board of EU activities and across the territories into which the EU's external relations reach. Finally, there is a core group of member states – mostly the original EC-6 – that takes part in all the activities of the EU at the highest level of centralization. The EU is not "many Europes" with task-specific jurisdictions each having their own organization but one Europe with *a single organizational and member state core and a territorial outreach that varies by function*. This is how we define a "system of differentiated integration".

A graphical representation of a system of differentiated integration is depicted in the lower right corner of Figure 1. It has the same functional scope as the state and the different levels of centralization for the policy areas A-C that characterize a federal state. In addition to variation in the level of centralization, however, the territorial extension is different for each policy sector as well. In this example, the highly centralized sector A is limited to a few territories, resembling a state's authority pattern, whereas sector B is similar to an international organization. Sector C combines medium-high centralization with extended territorial coverage. Policy sector A is more complex than

sectors B and C since there are a few territories that accept a high level of centralization in this sector but one does not. An example would be EMU – with Denmark participating in the Exchange Rate Mechanism but not in the Euro zone.

Conceptualizing the EU as a system of differentiated integration has the potential to generate novel research and insights. First, policy specific variance generates empirical and theoretical questions. Why do different policy areas vary in terms of vertical and horizontal integration? How has differentiation – as a macro phenomenon – developed over time? And how relevant is it? Second, it calls for an explanation of differentiated integration that takes into account factors typically associated with functional as well as with federal governance. The exploration of the middle ground therefore invites a new synthesis of integration theories.

The development of European integration: deepening, widening – and differentiation

Integration theory has traditionally focused on two dimensions of the polity: centralization and functional scope. Both neofunctionalism and intergovernmentalism seek to explain why and under which conditions nation-states do or do not pool or delegate their sovereign competences and the Community does or does not expand its tasks and powers. Correspondingly, integration theorists have concentrated on measuring European integration in these dimensions. Leon Lindberg and Stuart Scheingold (1970) were the first to systematically categorize and map the scope of the EU's system of decision-making with the help of two indicators: extension (functional scope in our terminology) and intensity (level of centralization). Tanja Börzel (2005) provided a more fine-grained and robust measurement (of what she calls breadth and depth), which explicitly builds on the work done by Lindberg and Scheingold but extracts its information exclusively from formal decision rules as laid down in the treaties.

In our mapping of integration, we both simplify and expand Börzel's measurement. There is scope for simplification because breadth and depth are neither conceptually nor empirically independent. Both dimensions have a common origin because you cannot have EU-level policy coordination with "exclusive national competencies", nor EU-level coordination or cooperation when competences are exclusively national. The two dimensions are not independent in the maximum either because it is difficult to conceive of supranational centralization without exclusive EU competencies. Empirically, we also find that levels of breadth are highly correlated with levels of depth. We therefore decided to collapse them into a single dimension, which follows Börzel's conceptualization of "depth" (Table 1). We call it "vertical integration" and extend it until 2010.

On the other hand, we expanded Börzel's dimensions because they do not capture territorial extension or differentiation. We call the territorial extension of EU policies "horizontal integration". Again, horizontal and vertical integration have a common origin because an exclusively national policy will have an extension of 0. But otherwise horizontal and vertical integration are conceptually independent. Following the common perception of a dilemma between deepening and widening in the EU, there has even been a strong expectation that both are inversely related. To assess horizontal integration, individual policy areas need to be scrutinized with a view to determine how many states formally subject themselves to the rules governing a particular policy area at a particular point in time. Note that horizontal integration thus not only includes states that are formal members of the

EU. Therefore we count the number of countries formally participating in different EU-centered policy "regimes" no matter whether they are EU member states or not.[3]

Vertical integration

0   = no EU-level policy coordination
0.8 = intergovernmental coordination (no delegation, no pooling)
1.6 = intergovernmental cooperation (minimal delegation, no pooling)
2.4 = joint decision-making I ("Community method", but limited pooling)
3.2 = joint decision-making II ("Community Method", pooling)
4 = supranational centralization (full delegation to supranational bodies)

Source: Börzel (2005: 221); rescaled to range from 0 to 4.
Definitions: delegation (involvement of supranational bodies in decision-making); pooling (application of super-majority voting rules in the Council)

Table 1   Vertical integration

To keep things simple and capture the general development, in Figure 2 we assign one score per decade to vertical integration, horizontal integration, and differentiation (measured every 10 years from 1950 to 2010). For vertical and horizontal integration, it represents the mean of sector scores (measured as described above). For differentiation, we use two different measures. One is simply the share of differentiated policy sectors of all policy sectors (differentiation/sector).[4] A differentiated policy sector is one in which the participating states are not equal to the full sample of EU member states. Our second measure is the percentage of treaty articles with actual differentiation (differentiation/article).[5]

Three trends can be discerned from the data set as displayed in Figure 2. First, European integration is a story of growth. There are periods of accelerated growth (the 50s and the 90s) and periods of relative stagnation but rollback cannot be observed. The average value for vertical integration rises to a level of about 3, which implies that the strong QMV-based version of the "Community method" is now the average decision-mode. Similarly, the average value for horizontal integration reaches the

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[3] Note that we limit the participation of non-member states to treaty-based obligations. Unilateral adoption does not feature here. In order to align the measurements of horizontal and vertical integration, we equally propose a scale ranging from 0 to 4. For every policy sector and every decade we divide the number of participating states by the total number of European states and multiply this ratio by 4. At the end points of this scale no European state participates (0) or all European states participate (4). The total number of European states changed over time – from 27 in 1950 to 38 currently. We use a definition of Europe that includes all countries that have become EU members or have an acknowledged general membership perspective. This includes Turkey but excludes the former Soviet republics (except for the Baltic countries).
[4] Multiplied by 4 to be comparable with the measures of vertical and horizontal integration.
[5] Actual differentiation means that a treaty article is not valid for at least one member state. The count excludes the enlargement treaties, which only introduce temporary differentiation, and external differentiation. The raw values are at approximately 0.6% from the 1950s to the 1980s, 4.8% in 2000 and 6.9% in 2010. Because enlargement and external differentiation are excluded, these figures underestimate the actual amount of differentiation. The values have been rescaled (divided by 2.5) to fit the figure. These are preliminary data from a database of differentiated integration in the primary law of the EU. Funding for the project "Differentiated Integration in Europe" (directed by Katharina Holzinger, University of Konstanz, and Frank Schimmelfennig, ETH Zurich) by the SNF and the DFG is gratefully acknowledged. We thank Thomas Winzen (ETH Zurich) for providing the data.

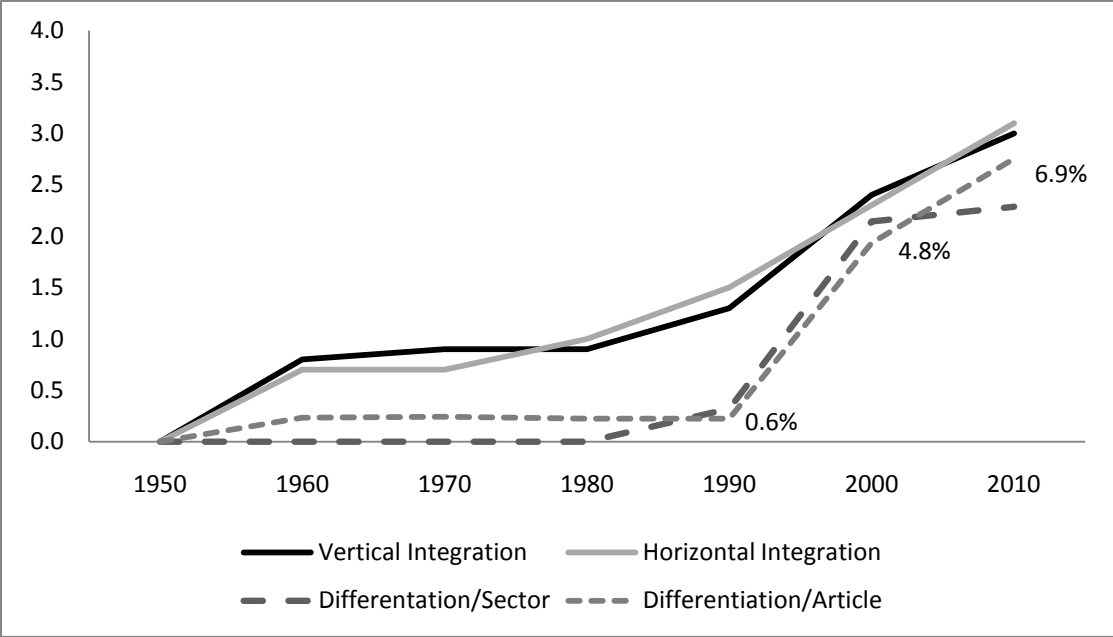level of 3 reflecting that, on average, 75% of European countries partake in the EU's integrated policies.

Figure 2   European integration and differentiation

Second, it is remarkable that the lines for the two dimensions of integration have roughly the same shape and have reached roughly the same level of integration. At first glance, it seems that the alleged dilemma of deepening vs. widening does not exist. It appears as if vertical integration has attracted ever more European countries to the EU and/or that enlargement has produced renewed interest in deepening. It is treacherous, however, to look only at the aggregate figure for horizontal integration. While the value of 3 or 75% roughly equals the current share of EU member states, it hides differentiation.

This is the third general observation. Whereas unity has been preserved throughout the first three decades of European integration, differentiation has started in the 1980s and increased strongly during the 1990s. Currently, less than half of the policy sectors are still undifferentiated. The measurement based on article counts produces lower numbers (7%) but shows the same development. The graph suggests that differentiation is a response to growth in both vertical and horizontal integration. It set in when vertical integration, on average, moved beyond intergovernmental coordination and when horizontal integration reached beyond the EC-9. The largest increase in differentiation came during the 1990s when European integration was extended to a host of new policies, introduced co-decision, and went to full supranational centralization in monetary policy. This pattern of unity before the 1990s and a steep increase in differentiation ever since is confirmed when differentiation is measured on the basis of individual treaty articles rather than at the aggregated level of policy sectors. In contrast to the sectoral aggregation, the article-based measurement does not indicate a major slowdown in differentiation during the past decade.

In addition, we distinguish four constellations of horizontal differentiation. There is *no differentiation* or *unity* if EU rules apply uniformly to all member states and to member states only. If this was the case across all sectors, the EU would fit the federal type of multi-level governance. If outsiders formally adopt these rules as well, we observe an externalization of the *acquis* (*external differentiation*). The EEA is the paradigmatic case for the internal market. A third form of horizontal differentiation is *internal differentiation*: EU rules cease to apply uniformly to all EU member states, since individual member-states decide to "opt-out" (or "opt-in" later) from membership in a particular policy area. EMU is a case in point. Finally, *external* and *internal* differentiation can be combined. A prominent example is the Schengen border regime.
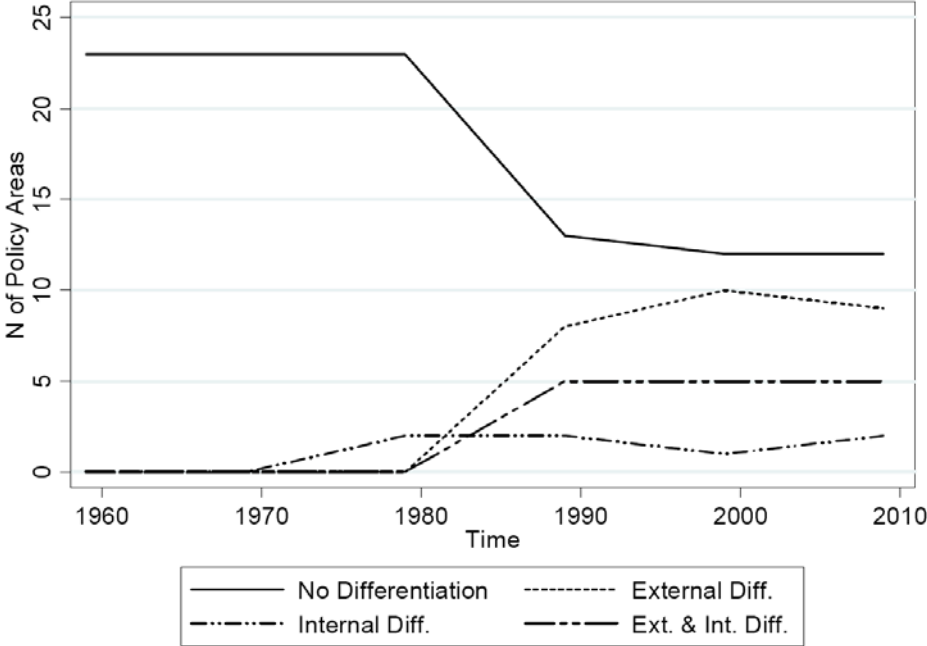

Figure 3   Horizontal differentiation over time

Figure 3 shows that external differentiation is the most common type of differentiation, whereas exclusively internal differentiation only occurs rarely. That is, the largest part of differentiated integration (sector-wise) can be attributed to the strength of the EU in extending its policy regimes beyond the confines of membership.

Finally, differentiation varies across both policies and countries. External differentiation is typical for the EU's regulatory, market-making and market-correcting policies such as environmental or health and safety standards. The single market unites the members and attracts non-member states. In addition, expenditure policies show only very limited territorial differentiation. This lack of internal differentiation appears unsurprising given the implication that all member states want to participate in the distribution of the financial "spoils". In transport and research policies we can also witness EU "outsiders" partaking in the EU money game. Internal differentiation characterizes economic and monetary policy. In the area of internal security, the uniform application of EU rules is challenged by internal as well external differentiation: This applies to areas such as border controls, immigration and asylum as well as policing. In the area of external security, territorial differentiation is lagging

behind even though Treaty provisions exist that allow for "enhanced cooperation". It thus appears as if differentiation is correlated with and possibly caused by characteristics of policy areas.

Figure 4 shows the distribution of differentiation across countries.[6] Here, we count the average number of treaty articles per year (since 1990), for which the member states had an opt-out or derogation. The distribution clearly shows two distinct levels – and the UK as the expected outlier. Low differentiation characterizes the original six member states, the southern enlargement countries plus Austria and Finland. High differentiation is typical for the new member states plus Denmark and Sweden. At the boundary of the two groups, Ireland is an old member state, which has increasingly moved towards more opt-outs in recent years whereas Slovenia has progressed more than other new member states toward unitary integration (time trend is not shown in Figure 4).
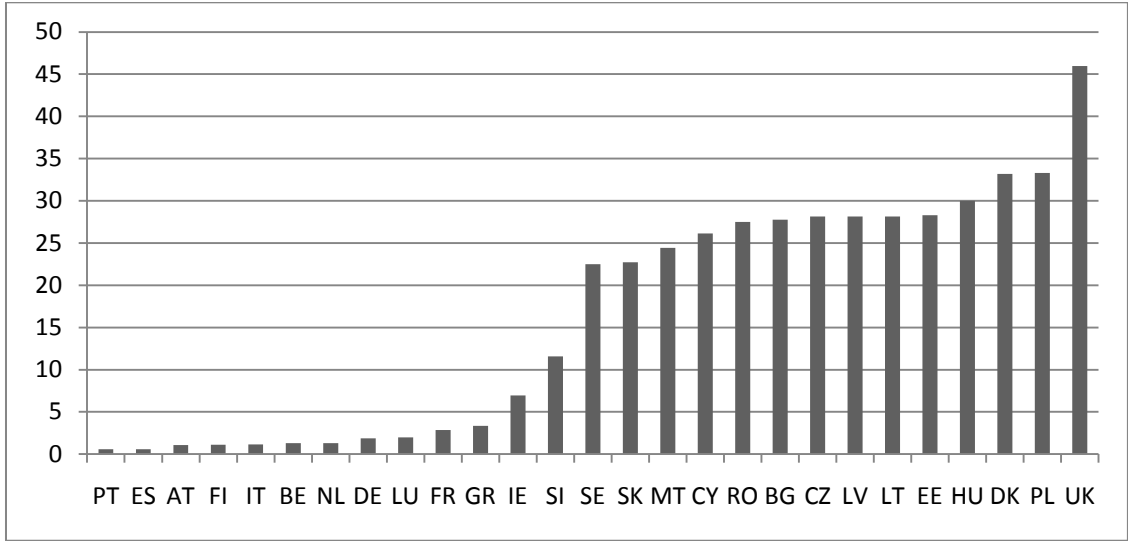

Figure 4   Differentiation across countries

In sum, differentiation gives us a more complete picture of European integration than the traditional focus on vertical integration. There is variation in differentiation over time, across policies, and across countries. For explanation, we turn to theories of regional integration.

Theorizing differentiated integration

The basic story that is being told about differentiated integration is one of heterogeneity caused by the growth of vertical and horizontal integration (e.g. Majone 2009; Warleigh 2002). First, the heterogeneity of member state preferences and capabilities increases with the number of member states. Whereas the original EC-6 was a rather homogeneous group of countries, this homogeneity has been undermined with each round of enlargement. Second, heterogeneity increases with the expansion of the EU's competences. The more policy sectors it integrates, the more likely they will include value-laden or distributional policies that provoke intense conflict and are difficult to manage and settle. The deeper vertical integration becomes, the more it reduces state autonomy and the more likely it is to provoke nationalist backlash. This story fits well with the massive growth of

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[6] See Footnote 4 for the data source.

differentiation since the 1990s when vertical and horizontal integration leaped ahead. It is highly plausible and highly indeterminate at the same time.

A theory of differentiated integration, which we are proposing in the ensuing section, has to provide answers to the following questions. First, we would want to know more precisely which heterogeneity matters: heterogeneity of preferences or heterogeneity of capabilities. Heterogeneous preferences could be material or ideational, societal or governmental. Heterogeneous capabilities could have to do with power, wealth, or institutions. In addition, different kinds of homogeneity and heterogeneity may be at work in internal and external differentiation. Second, the common (demand-side) explanations of differentiated integration based on increasing heterogeneity of preferences need to be complemented by theorizing the supply side. Under which conditions is demand for differentiation translated into actual differentiated integration? Integration theories provide rich material that can be elaborated to answer this question. Finally, whereas explanations based on the heterogeneity of preferences are able to account for the reduction of unitary integration, it cannot distinguish differentiated integration from the simple absence of further integration. It would be equally plausible to predict that increased heterogeneity results in the stagnation or decline of integration. Yet this has not happened.

A theory and a satisfactory explanation of differentiated integration needs, first, to disentangle various triggers and sources of heterogeneity, which could be material, ideational, societal or governmental; second, such a theory should be able to account for both internal and external differentiation; third, it needs to combine demand-side conditions for differentiated integration with the supply-side; and, last, it must discriminate between differentiation and no integration.

Building blocks of a theory of differentiated integration

In the following we develop building blocks for a general theory of how the structure of differentiated integration emerged in Europe. In order to theorize differentiated integration we build on and combine existing theories of European integration. For several reasons, we start from a basic liberal-intergovernmental framework, which assumes rational governments and attributes integration outcomes to constellations of state preferences and bargaining power (Moravcsik 1998). First, we seek to explain *treaty-based* differentiated integration, i.e. decisions that are made exclusively by states and under unanimity. Second, the intergovernmental framework captures both the demand side (national preferences under interdependence) and the supply side (bargaining power and functional institutions). Finally, the systemic (transnational or supranational) factors emphasized by supranationalist theories are better suited to explain uniform rather than differentiated integration. Such factors are best understood as conditioning variables making differentiation more or less likely. By contrast, differentiated integration is more likely to be triggered by state-level or sub-systemic factors.[7]

At the same time, the intergovernmental framework can be complemented with variegated sources of preferences and constraints on bargaining power coming from alternative theories. Whereas Moravcsik combined intergovernmentalism with a liberal theory of preference formation based on

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[7] This set-up also fits well with the existing theoretical contributions by Kölliker (2005: 80-83) as well as Plümper and Schneider (2007).

domestic institutions and interests (Moravcsik 1993), national preferences may be alternatively be informed and shaped by ideational factors such as policy ideas, norms, and identities. In addition, supranationalism and constructivism propose supranational institutions as intervening factors in intergovernmental bargains that facilitate or impede differentiation. If our categorization of the EU as a system of differentiated integration is useful, we should see an interplay of factors typically associated with federal (type-1) governance such as community-based identities and organizations as well as with functional (type-2) governance such as issue-specific constellations of interests and power as well as regime-type institutions.

Within the intergovernmentalist framework, Figure 2.1 displays one integration sequence consisting of four steps. Such a sequence is embedded in a historical process of European integration (not displayed here). Following Pierson (1996), we assume that such intergovernmental exchanges take place in a path dependent institutional context. This is important because we argue that the EC serves as the social reference point of further integration. In the sequence, *agenda-setting* – in line with the policy cycle – is our starting point. Agenda setting need not be formal; rather it captures the demand for integration that in the case of the EU is usually bundled and voiced by the Commission. But the initial demand for integration can stem from (transnational) societal actors, member states or supranational actors.
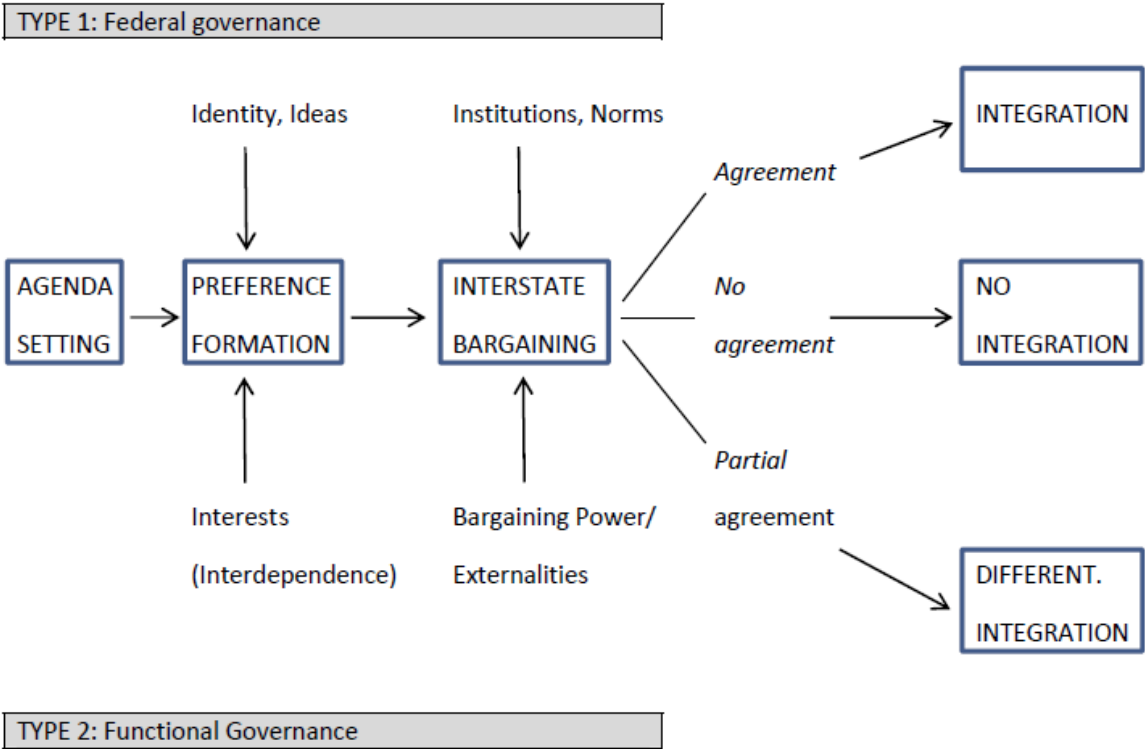

Figure 2.1   Conceptualizing differentiated integration

Step two in our integration sequence is *preference formation* at the level of the nation states. At this level domestic institutions determine who the relevant actors are and how their preferences are aggregated to form a 'national interest'. The preferences of domestic actors are shaped by the

perceived costs and benefits of the proposed integrative measure. Costs and benefits can be material and driven by interdependence (Moravcsik 1993, 1998), or immaterial when national identities are perceived to be at stake. Hooghe and Marks (2008) argue that European politics has become increasingly politicized and that the permissive consensus has been replaced by an elite constraining dissensus. Even though identity-related questions were recently re-introduced into European studies with the constructivist research agenda, perceived identity threats can be integrated in a rationalist framework via national preference formation. That is, while we do not claim that national preferences are necessarily the result of material cost-benefit calculations, we assume that governments seek to realize them as much as possible. All kinds of national preferences feed in similar ways into the subsequent intergovernmental bargaining process about (differentiated) integration.

States are then expected to engage in interstate bargaining in step 3 of the model. Since we here focus on explaining differentiated integration related to primary law – our theory relates to the constitutional level of decision-making (Buchanan and Tullock 1965) – unanimity is the rule and all member states possess a formal veto. If the member states can agree on a pareto-efficient solution, uniform integration is the result. If after bargaining (and with possible package deals and side payments) all member states are better off with the integration proposal as compared to the status quo there is no reason to veto a proposal. If pareto efficiency, however, cannot be reached uniform integration is precluded. If differentiated integration was not an option, integration outcomes could only vary between (uniform) integration (UI) and the status quo (SQ) and would necessarily reflect the lowest common denominator – to the dissatisfaction of many countries that would have preferred more or less integration.

Differentiated integration provides an attractive alternative. It allows two or more groups of countries to cooperate at a level of integration that is closer to their respective ideal points than either uniform or no integration. Or it allows individual countries to remain at the status quo while others move ahead. The typical preference constellation enabling differentiated integration has one group of countries (we call it Club A) with a first preference of further uniform integration (UI), whereas another country or group of countries (Club B) prefers the status quo (SQ) over UI. Differentiation is possible if both prefer differentiated integration (DI) to the status quo as in Table 2. Both A and B can be first movers. In one case, a group of member countries wants to move ahead with integration but agrees to settle for DI when faced with veto threats. In the other case, a group of outside countries (or a single non-member state) seeks differentiation from the start and is able to realize its first preference because Club A prefers DI to the status quo and understands or learns that it cannot achieve uniform integration.

A: UI > DI > SQ
B: DI > SQ > UI

Table 2 Preference constellation for differentiated integration

With such a preference constellation there is demand for differentiated integration in a single policy sector. In other constellations, DI is neither necessary nor feasible. It would not be necessary if B preferred UI to SQ and it would not be possible if either A or B preferred SQ to DI. If that was the only

consideration, however, we would probably observe much more differentiated integration in the EU than we actually do. Yet differentiation entails potential problems and costs which may cause it to lose its attractiveness for the participating states or produce a veto. In other words, in order to realize the preference-based demand for differentiated integration, several conditions have to be in place that we categorize as supply conditions: size, negative externalities, institutional costs, and normative costs.

In the end, and in contrast to type-2 multi-level governance, differentiated integration in EU treaties is still decided within a single organization and on the basis of unanimity. A theory of differentiated integration therefore needs to explain under which conditions states "agree to disagree" rather than "disagree to disagree".

Supply conditions

First, the *size* of at least one of the respective clubs may become too small for differentiated integration to deliver sufficient benefits. Economies of scale will be reduced and problem-solving capacity hampered. At this point, states may prefer the status quo to DI. Second, each club may generate *negative externalities* for the others. Having two clubs in one policy sector or two clubs with different memberships across policy sectors may create free-riding opportunities that would not be possible under uniform integration. If Club B expects the costs of suffering from free-riding to be higher than the benefits of differentiation, it is likely to veto DI – unless it is sufficiently compensated for its losses or threatened with even higher ones by Club A. Compensations can consist in side payments to B or in issue-linkage. Club A can use issue-linkage if it has veto-power in a different sector, in which Club B is interested in institutional change (and provided that Club B's expected benefits in the other sector are at least as high as its expected losses from the negative externalities). Ultimately, the drivers can also threaten the losers with leaving the organization and setting up their club outside the treaty framework in order to circumvent the veto. This will work if Club B fears higher costs from exit than from negative externalities. Finally, the coordination of the clubs (both within the clubs and between them) creates *transaction costs* that reduce its benefits. The supply conditions size, externalities, and transaction costs follow from the functionalist analysis of multi-level governance.

From a federal type-1 governance perspective emphasizing the organizational and communitarian qualities of the EU, additional factors need to be taken into account. These can be inferred from supranationalist and constructivist theories of integration. Supranationalism claims that existing institutions modify the options that governments have in European integration. For one, they may change actor behavior through learning effects. These will not be dealt with here because we assume that they influence demand for differentiated integration. Existing institutions are, however, also assumed to affect the supply conditions of differentiation negatively. A given level of vertical integration is not only a legal norm on paper but engenders a process of institutionalization (Stone Sweet and Sandholtz 1997; 1998): powers are delegated to supranational organizations, treaty rules are elaborated to fill gaps in incomplete contracts, and actors reorient their strategies and behavior toward the integrated policy. In sum, treaty-making is followed by institutional investments and creates new vested interests. Together with the transaction costs of undoing a uniformly integrated policy and coordinating two levels of integration, these investments (also known as "sunk costs") and

the lobbying by vested interests are likely to reduce the expected benefits of differentiation significantly. We refer to them as *disruption costs*.

In addition, higher existing levels of integration should in general increase negative externalities and reduce exit options. The more integrated the member states are, the more tightly-knit is their network of relationships and their mutual dependency. As a result, any differentiated integration is likely to create high negative externalities, and exit threats are becoming less credible. To some extent, however, these impediments to differentiated integration may be compensated by the strong supply of linkage opportunities in a highly institutionalized and interdependent community. In sum, supranationalism generally predicts that the supply of differentiated integration will remain behind intergovernmentalist expectations.

Constructivist approaches emphasize the effects of norms on intergovernmental negotiations (see, e.g., Lewis 2003; Schimmelfennig 2001). In a community-based organization, the norm against differentiation may be so strong that governments seeking differentiation face social sanctions such as a loss of reputation, shaming and shunning. Their costs may be so high that states prefer inefficient uniformity to efficient differentiation. To keep it simple again, we assume two norms to be prominent in the context of differentiated integration: the unity norm and the integration norm. Both follow from the general principle of "ever closer union". The unity norm demands that the member states preserve the unity of the EU and EU law. By contrast, the integration norm obliges the member states to integrate further. Both norms work together in discouraging differentiated integration if it destroys the unity of the EU without promoting integration. If however, DI is used to facilitate further (uniform) integration and is open for the laggards to join the leaders, the normative constraints on DI will be weak.

In the following subsections, we apply these conditions to typical scenarios of differentiation. Whereas we think that differentiated integration follows a single logic, the context conditions are likely to differ in internal, external, and enlargement differentiation.

Internal Differentiation

Internal differentiation is differentiated integration among member states. It means that vertical integration in a specific policy sector differs for two or more subsets of the member states. The EMU is a prominent case: whereas most member states are part of the euro zone, others have not introduced the single currency. The trigger condition for internal differentiation is heterogeneity of preferences and capacities regarding the desired level of vertical integration in a policy sector. In the EMU case, preference heterogeneity started with the British refusal to give up monetary sovereignty. This was followed by the Danish and, later, the Swedish people's rejection of the euro. In all of these cases, the rejection of uniform integration is best explained by identity concerns: the reluctance of the population to give up national sovereignty for European integration (Risse 2005; Hosli 2005: ???). The heterogeneity of capacities played a role in the convergence criteria. They were the reason why

Greece was initially not part of the euro zone and why the new member states did not qualify immediately upon entry.[8]

In principle, internal differentiation can take two directions away from the uniform status quo. Either Club A wants to move ahead further with integration than Club B, or Club B wants to scale down integration, i.e. reallocate policy competences to the national level or make decision-making more intergovernmental. We can call the first case progressive internal differentiation, whereas the second case qualifies as regressive internal differentiation. In the much more common progressive differentiation case, the laggard Club B is closer to the status quo and can use its veto power under unanimity to block Club A. A theory of differentiated integration therefore needs to explain under which conditions B lets A move ahead. Generally, this will be the case if differentiated integration does not create negative externalities, or might even create positive externalities, for the B-group. Whether this is the case depends primarily on the characteristics of the policy, as theorized by the theory of collective goods, and secondarily on the relative size of A and B. Adapting Kölliker's arguments about the effects of differentiated integration (2005: 88-103), we hypothesize that differentiated integration in policy sectors providing non-excludable goods is likely to be accepted by B because B benefits from the goods that A produces. In this case differentiated integration creates positive externalities and B free-rides on A. This effect is likely to increase with the size of Club A (assuming that a large A will also produce large amounts of the non-excludable good). By contrast, excludable goods do not benefit Club B but also do not trigger a veto unless they produce negative externalities.[9] In the event of negative externalities, the size of the A-group has the opposite effect of the positive-externalities case: it increases the likelihood of a veto.

In the EMU case, Club B – i.e. the UK, Denmark, and Sweden – benefits from positive rather than suffering negative externalities. As members of a single market with the euro zone, they benefit from the reduced transaction costs of currency exchange with their trade partners, greater exchange rate stability and from the financial stabilization effects of the single currency. There was thus no incentive for Club B to veto the single currency. And whereas it would certainly have been beneficial to the weight and functioning of the euro zone if it could count the economically and fiscally strong countries of Denmark and Sweden as well as the large market of the UK with its powerful financial services among its members, EMU is sufficiently large without the opt-out countries and not undermined in its functioning by the survival of the Pound Sterling or the Danish or Swedish Crowns. Had the opt-out countries expected an exodus of financial services or business to the euro zone, thus creating serious negative externalities for Club B, a veto would have been likely. In this case, the euro zone would have needed to offer compensation (e.g. in the form of subsidies) or linkages with issues Club B valued highly (e.g. agreement to regressive internal differentiation the Club B countries might seek). Alternatively, they could have threatened Club B with setting up EMU outside the treaties – following the tradition of the European Monetary System (EMS), which did not have a treaty base when it was set up in 1979.[10]

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[8] For some of the new member states, it was actually a mix of divergent preferences and capacity. As Johnson (2008) shows, the less trade-dependent new member states did not have an economic interest in joining the euro zone (soon).

[9] This holds under the assumption that states seek absolute gains not relative gains. If they sought relative gains, Club B might block Club A out of envy.

[10] In the regressive differentiation case, Club A is closer to SQ and can use its veto-power to block Club B. Otherwise, however, the conditions mirror those of the previous case. Club A will consent to differentiation in

Regarding the costs of institutionalization, internal differentiation potentially creates disruption and transaction costs (that increase with the existing level of integration) but also offers opportunities for institutional expansion. In the EMU case, disruption costs can be considered weak because EMU did not require existing institutions to be abolished or split. Rather, it created a new supranational institution - the European System of Central Banks – and new, separate intergovernmental institutions such as the Eurogroup (which certainly increased transaction costs). Moreover, monetary integration started from the very low level of institutionalization in the EMS. In sum, institutional impediments to differentiated monetary integration were moderate. The impediments would be much higher because of massive disruption costs in the case the euro zone split up as a result of the crisis.

Finally, normative costs were moderate as well. The unity norm strengthens Club B in the case of progressive differentiation and Club A in the case of regressive differentiation. By contrast, the integration supports Club A in both situations. It generally delegitimizes moving from uniform integration to internal differentiation by reducing the level of vertical integration whereas it legitimizes differentiated integration in the interest of further integration. Moreover, the violation of the unity norm is (more) legitimate under three conditions: size, openness, and precedent. The larger the relative size of Club A, the larger is also the onus on Club B for blocking further integration. Furthermore, if Club A is entirely open for members of Club B to join (later), it can hardly be accused of cementing differentiation. Finally, to the extent that differentiated integration has happened before, the prescriptive status of the unity norm is weakened. EMU was in line with the integration norm and fulfilled the size and openness conditions. Arguably, there was even a precedent establishment by the differentiated membership in the EMS. Therefore, there was no legitimate normative reason for the opt-out Club B to veto the single currency.

This short section has shown how the general reasoning about differentiated integration can be applied to the scenario of (progressive) internal differentiation. It also illustrated why EMU can be considered a likely case of differentiated integration given the interplay of identity-based preference heterogeneity and favorable supply-side conditions.

External Differentiation

External differentiation extends the analysis beyond the group of EU member states to non-members. Whereas internal differentiation is about the decision to move beyond uniform vertical integration in favor of different levels of vertical integration among the member states, external differentiation is about the decision to move from no integration to selective, policy-specific integration of non-member states. Whereas internal differentiation is likely to be triggered by an increase in heterogeneity among a formerly homogeneous group of member states, external differentiation is triggered by an increase in, or by islands, of homogeneity in a relationship that is too heterogeneous to lead to full EU membership. And whereas in internal differentiation the main supply condition is the absence of negative externalities between two groups integrated at different levels in the same policy sector, the primary challenge in external differentiation is negative externalities emanating from selective integration in one policy sector for other policy sectors

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the absence of negative externalities or in the presence of credible compensation offers, issue-linkage, or exit threats. Note, however, that regressive differentiation conflicts with the norm of an "ever closer Union".

without non-member state participation. Yet we can use the same assumptions and conditions to analyze internal and external differentiation.

We start again from the assumption that there is a demand for selective inclusion. We distinguish two basic scenarios. The first scenario applies well to the European Free Trade Area (EFTA) countries. Here the EU can be assumed to have Club-A preferences; it would like to have these wealthy and well-functioning states as full members. By contrast, at least some of these countries have Club-B preferences (Norway, Iceland, Liechtenstein and Switzerland): constrained by negative referenda or adverse preferences, they prefer non-membership to full membership. Because of high levels of exchange and strong interdependence, both groups, however, have incentives for cooperation. They thus might prefer DI to complete exclusion. The second scenario fits the case of contested candidate states. The customs union with Turkey is an example of DI in the absence of a membership perspective, and so is the concept of "privileged partnership" advocated by the German Christian Democratic Union. Whereas such countries have a strong preference for joining the EU, the EU (or its least willing member state) prefers non-membership. But again there are islands of common interest inciting selective policy integration. In both cases, the strongest demand can either come from the EU or the non-member state(s).

Here we focus on the first scenario. In perspective of the Single Market program, the remaining EFTA states feared growing marginalization in terms of trade and investment. The completion of the Single Market thus had negative externalities for the neighboring states. In order to reduce these costs, there was a general demand for closer cooperation. Some of these states, Austria, Finland and Sweden opted for a full EU membership (the same holds for Norway up until the negative referendum of 1994). The other states were unwilling to go all the way until full membership but expressed demand for partial inclusion. In fact, they took up an idea presented by Commission President Delors to the European Parliament in 1989 of establishing a new type of global agreement between the EFTA states and the EU. The negotiations resulted in the founding of the European Economic Area (EEA). Since the remaining EFTA states had a stronger demand for cooperation than the EU, the Community was in the comfortable bargaining position of the veto power. As in the case of internal differentiation, supply was potentially endangered by negative externalities (for the EU), institutional costs and normative constraints.

Whereas in the case of internal differentiation, the externalities are between groups of member states in relation to a single policy sector, in the case of external differentiation the inclusion of a non-member state in one sector may create externalities in another sector in which the non-member state does not participate. Consider the situation in which the non-member participates in the single market and benefits from negative market integration but does not adopt the EU's market-correcting policies regarding environmental, health, or labor standards or contribute to the EU's market-correcting structural funds. In this case it would free-ride on the EU whose full members need to heed the standards, contribute to the EU's redistributive policies, and thus suffer from higher costs than the non-member state.

If such negative externalities between sectors with and sectors without external differentiation arise, and the EU would have an incentive to veto external differentiation, compensation is required. First, the non-member state can make side-payments to the EU. Second, it may make concessions in other sectors, in which the EU is more interested in cooperating than the non-member state (issue-linkage). Third, it may threaten the EU with foregoing selective integration, participating in a

different regional organization, or creating its own. For neighboring states of the EU, this is, however, hardly a credible threat nowadays. The final compensation is policy extension, that is, the participation of the non-member state in all policies that are affected by or create negative externalities for the original policy of interest. As policy extension means getting closer to full membership, the option has its limits, too.

Free-riding by the non-member states was exactly what the EU feared from the EFTA countries. As a consequence, the EEA countries had to agree on a mix of side payments and extension. Through EEA grants the EEA countries contribute financially to reducing the economic and social disparities in Europe, and they integrated into the flanking policies of the internal market such as research and development, environment, consumer protection, social policies and cohesion. In addition, the EEA states have a limited capacity of influencing internal market legislation, but are obliged to dynamically incorporate the relevant *acquis* into their domestic legislation. In the case of the bilateral agreements with Switzerland, issue-linkage was the main mechanism of reaching agreement. Areas of Swiss interest (having mainly to do with access to the EU market) were balanced with and linked via the so-called guillotine clause[11] to areas of EU interest (such as transit and free movement of labor). Side-payments such as the "cohesion billion" were also part of the deal.

How do the supranationalist and constructivist factors affect external differentiation? In the supranationalist perspective, progressive external differentiation can be analyzed in the same way as progressive internal differentiation. On the one hand, external differentiation should be easier than internal differentiation because it usually adds new institutions (such as bilateral committees, association councils, or joint courts) rather than disrupting existing EU institutions. On the other hand, however, the transaction costs are likely to be higher than in the case of internal differentiation. Whereas common institutions (the Commission, the Parliament, and the ECJ as well as the European Council) provide a bridge across internal differentiation and facilitate coordination, external differentiation is often characterized by separate institutions for each non-member state and policy sector. As in the case of internal differentiation, transaction costs and negative externalities are likely to increase as the selective integration of non-member states deepens. That means, selective integration becomes less sustainable and pressure towards further internalization all the way up to full membership (or at least quasi-membership entailing the obligations of a member-state) grows and the exit option loses credibility further. For some time, however, this effect can be balanced by further compensation and linkage opportunities that may also arise as a consequence of deepening selective integration.

In the EEA case, we can clearly see the Community's concern about transaction costs in the institutional settings. For instance, new Community legislation is dynamically incorporated into the agreement, assuring a homogenous application of internal market related rules in the EU and EEA states. Moreover, the EC tried to establish an EEA judicial system that was integrated as closely as possible with its own. Switzerland resisted such transaction-cost reducing institutional arrangements but EU-Swiss bilateral agreements have reached at point at which the EU links the conclusion of further agreements to the dynamic incorporation of EU law into the agreements.

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[11] The guillotine clause stipulates that all bilateral agreements can only enter into force jointly. It was included to prevent free-riding in the case that popular referendums in Switzerland would block the issues of EU interest.

By contrast, the norms emphasized in a constructivist analysis of differentiated integration should clearly have a more negative impact on external differentiation than on (progressive) internal differentiation. First, these norms do not bind the non-member state. That is, one potential veto-player is not normatively constrained in using the veto. Second, external differentiation not only violates the unity norm but also the integration norm because it opens up the Community to countries that are unwilling to become members. This negative effect can again be mitigated by size, openness, and precedent. In the case of external differentiation, the violation of the unity norm is the more acceptable, the fewer and smaller the associated non-member states are and the more external differentiation is designed as the first step toward full integration. Indeed, Austria, Finland and Sweden decided to apply for membership in the course of the EEA negotiations.

Enlargement differentiation

We conclude with a brief description of the special type of enlargement differentiation. The transitional provisions negotiated in accession negotiations are a special case of differentiation that is situated between the types of internal and external differentiation. As in external differentiation, it starts with non-member states seeking integration with the EU – but full membership and not only selective integration. And just as internal differentiation, enlargement differentiation creates two groups of member states with different levels of vertical integration. We can further distinguish two situations of enlargement differentiation. In the first situation, the EU (or at least one member state threatening to use its veto) wants the new member state to join at a lower level of integration than the old member states (B preferences), whereas the candidate seeks uniform membership (A preferences). In the second type of situation, the new member state seeks to avoid the full obligations of membership upon joining the EU, whereas the EU prefers uniform membership.

As in other types of differentiation, enlargement differentiation in a specific policy sector is acceptable and sustainable if it increases the utility of both (in comparison with the status quo of for both old and new members (as compared to non-membership) and if it does not create negative externalities in other policy-sectors. Otherwise, it requires side-payments, issue-linkages, or exit threats. In contrast to external differentiation, however, the EU (or the member state least interested in enlargement) clearly benefits from veto power in both scenarios because the candidate countries have an overriding interest in membership. The EU can credibly threaten the candidates with non-membership (exit) unless they accept the EU's terms; and it can credibly link the acceptance of discrimination by the new member states to their full integration in other policy sectors. This is the differentiated integration scenario analyzed by Plümper and Schneider (2007; Schneider 2009). The new member states accept the discrimination unless the sum of the foregone benefits renders the complete balance sheet of accession negative. By contrast, differentiation sought by the new member states will be limited to those policies and measures that do not impose externalities and costs on the old member states. In general, candidates are obliged to take on the entire *acquis*. For instance, the Tampere European Council underlined that all new member states – if capable – should become members of the Schengen group.

As in the other scenarios, institutional and normative factors constrain enlargement differentiation. The institutional costs, however, are light in comparison with those of internal and external differentiation: in contrast with internal differentiation, enlargement differentiation does not

threaten to disrupt existing institutions; and in contrast with external differentiation, it does not require the creation and coordination of additional institutions. Yet the normative costs are of the same order as those of regressive internal differentiation. Enlargement differentiation not only violates the unity norm but, in its most frequent discriminatory form, also the principle of equality between member states. Whereas it would be acceptable to discriminate states that only seek selective integration, enlargement transforms non-members into community members – a status that is incompatible with discrimination. At the limit, enlargement differentiation is acceptable as facilitating integration as full members. The fact that enlargement differentiation is generally transitory in nature, with pre-set dates for the expiration of differentiation, can be plausibly attributed to the integration and the unity norms.

Conclusions

In this paper, we have made the case for elaborating integration theory into a theory of differentiated integration. Moving beyond the traditional focus of integration theory on vertical integration ("deepening"), we provided preliminary data showing that vertical integration was accompanied by a similar growth of horizontal integration ("widening") and differentiation. Whereas enlargement has been integrated into integration theory in the past decade (e.g. Schimmelfennig and Sedelmeier 2005), differentiated integration is still sidelined. As an initial step to address this deficit, we established a theoretical framework for analyzing and explaining differentiated integration in the EU.

We define a system of differentiated integration as a polity with a single organizational and member state core in which the territorial outreach varies over different sectors. We argue that if the EU falls between the poles of functional and federal governance, a combination of intergovernmentalist, supranationalist and constructivist insights can best explain the emergence of such a complex structure. While intergovernmentalism stresses a functionalist logic of integration – basically, it would predict a loosely connected bundle of policy regimes – supranationalism and constructivism can stronger account for the centripetal forces of the Community project. Our framework considers the demand and supply side of integration. It incorporates key actors of the integration process: the Commission bundles and voices demands for integration, societal preferences are aggregated to form member state positions, and differently endowed states negotiate the integration outcomes under unanimity. Our actors are boundedly rational and they are embedded in the institutional context of the EU. While interdependence is important for explaining state preferences, norms and ideas also matter.

In a simple logic, differentiation should occur whenever all veto players prefer differentiation over the status quo while uniform integration cannot be reached. This holds for internal, external and enlargement differentiation as an intermediate, special case. We contend that the differentiated integration, be it external or internal, follows a unified logic and is conditioned by the same set of factors such as the ratio of drivers and brakemen, the existence of negative externalities and transaction costs and finally the willingness of those that expect to gain from differentiated integration to compensate the expected losers. By including actors, preferences, institutions and norms the framework is of a general nature, which should allow a wide application to different cases of differentiation and across different policy areas. In this paper, we have illustrated our framework

by drawing on examples from the EMU (internal differentiation) and EEA (external differentiation). In our future research we plan to more systematically compare different policy sectors in order to explore whether our framework is well suited for accounting for important mechanisms of European integration.

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