Peer monitoring and its capacity to decrease negative effects of moral hazard
PROJECT DETAILS

Title: Peer monitoring and its capacity to deal with negative effects of moral hazard

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“Out of clutter, find simplicity.”

Albert Einstein
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PREFACE

I started my master thesis project motivated, eager to complete my graduate degree before the summer. However, as I am writing this last page of my thesis, I feel both excited and sad. Excited that I have actually finished my graduation project and I can now embark on a new challenge and phase of life, but sad that my days at TBM are over. No more lectures, no more Curius activities and, worst of all, no more study breaks with all my dear TBM friends. That is why I present you my graduation report with both feelings of pride and feelings of nostalgia. I hope you enjoy reading the last milestone of my master System Engineering Policy Analysis and Management (SEPAM) at the Delft University of Technology.

However, before you start reading I would like to thank all those who have supported me the last five months. First of all, I would like to thank my graduation committee Ernst ten Heuvelhof, Haiko van der Voort and Aad Correljé. Their ideas and feedback always provided me with direction and boosted my motivation. I am especially grateful to Haiko, who put many hours into reviewing draft versions of chapters and always had encouraging words of advice.

Secondly, I have to thank my graduation teammates, Cornelis Eikelboom and Bert van Meeuwen. I enjoyed all our endless discussions about different theories and concepts, your sharp remarks and ideas, but also your jokes and life stories. Without you I am sure the project would not have been completed in this short time frame and would not have been as much fun to work on.

Jessica van der Puil
TU Delft, 19th of June 2013
SUMMARY

Research problem: peer monitoring in the EU
Many argue that the European sovereign debt crisis was set in motion by the global financial crisis, but was further exacerbated by weak financial regulation in the European Monetary Union (EMU). The Stability Growth Pact (SGP), which is responsible for fiscal regulation in EMU, should have disciplined member states’ financial behaviour so that governments would not have been able to expose themselves to too much risk. Instead, the SGP allowed moral hazard to manifest, member states defaulted and needed other member states to bail them out. This is contrary to what one would expect to happen based on theory, as the execution of the SGP involves peer monitoring, i.e. member states monitor each other’s financial behaviour themselves.

Theory argues that peer monitoring can reduce problems of moral hazard, because peers are capable of monitoring each other. Because the member states have the same expertise, know what information to look at and how to interpret it, they are better able to overcome issues of information asymmetry as opposed to a vertical regulator. In addition, theory argues that peers have an incentive to take part in such a regulatory arrangement, because they share risks. In this case member states, especially the euro countries, collectively carry the risks of euro imbalances. As a result, member states should be interested in preventing defaults and bailouts. This is, however, not in line with the recent developments in the crisis and therefore raises the question why peer monitoring did not work as expected by theory.

Goal research project & main research question
The aim of this project is to understand why peer monitoring in the SGP had a different outcome than was expected according to theory. Theory argues that because member states have the same kind of knowledge and expertise, they are able to regulate one another. Furthermore, because they share a currency, they have an incentive to regulate one another to minimize losses and spill over effects from each other’s behaviour. However, as literature on peer monitoring is limited, there could be other still unknown factors involved, that could explain the functioning of peer monitoring in the SGP. A study of the peer arrangement in the SGP could therefore provide more insight into the arrangement’s capacity to manage moral hazard and adverse selection. Therefore, this research aims to answer the following research goal: “What is the capacity of peer monitoring in the SGP to decrease the negative effects from moral hazard between the member states and can this be improved?”

Research approach & propositions:
To answer this research questions, this project started with a literature study. This helped broaden the understanding of peer monitoring and moral hazard, but also showed that the design of the SGP and its context are an important part of understanding regulatory performance. As this context and regulatory design was of such importance, the empirical study was conducted by means of an explorative case study and institutional analysis. These analyses allowed for a study of the system of the peer arrangement, the peer interactions and peer characteristics of Greece, the Netherlands and Ireland. To
answer the first part of the main research question and help determine whether any improvements are needed, the following propositions were formed and tested:

1. Peers have a sense of urgency to regulate one another
2. Peers have information about each other’s behaviour
3. Peers may interfere with each other’s business
4. Peers have formal and informal means to act
5. Peers have enough degrees of freedom to adjust regulation to the situation at hand

Proposition findings
Overall, the institutional analysis and case study showed that none of the propositions could be confirmed. The findings for each proposition were as follows:

*Peers have a sense of urgency to regulate one another:* First of all, the fact that there is a formal peer arrangement in the SGP indicates that member states indeed have sense of urgency to regulate one another. Furthermore, the adoption of a no-bail-out clause and the adoption of a provision separating fiscal policy from monetary policy suggest that there is a sense of urgency to regulate financial behaviour of member states. On the other hand, the design of the peer arrangement in the SGP suggests that peers are also interested in a flexible fiscal regulation that gives them the room to pursue their own interests. Moreover, the case analysis showed that the sense of urgency can change over time. Especially when there are several peers in violation of the Pact the interest in a flexible SGP rises. The sense of urgency is higher when there are only few violators amongst the peers and lower when there are many violators amongst the peers. It was only when the credit rating agencies started to drop credit ratings of certain member states, that they had a sense of urgency to regulate one another despite the presence of many violators. Overall, this shows that sense of urgency to regulate one another is not always present.

*Peers have information about each other’s behaviour:* Like the first proposition there is evidence to support this claim and evidence to deny this claim. The institutional analysis showed that member states exchange knowledge about their past and planned financial performance. Besides that, Eurostat collects statistical data from each member state to verify whether past performance was in compliance within the norms. This indicates that member states indeed have information about one another. However, the case analysis showed that member states can hide information or be sloppy when it comes to information gathering. Furthermore, the case analysis showed that peers exchange insufficient information, as the information does not fully cover the risk exposure of a member state. This means that peers can have information about each other, but that this information can be inaccurate or incomplete.

*Peers have formal and informal means to act:* According to the provisions of the SGP member states have three means to discipline each other: recommendations, early warnings/notices and fiscal penalties. From these measures two of them are considered soft and only one of them is considered
hard. Moreover, the provisions of the SGP only allow the use of the fiscal sanction after several years of non-compliance. This suggests that peers lack the shadow of hierarchy to discipline each other, as the real threat is always several years away. In addition, these sanctions can only be handed out if a qualified majority is in favour of the sanction. This means that a member state always needs to form a coalition to discipline another member state. Past performance of the SGP shows that this coalition can be difficult to form when there are many member states in violation of the norms. On top of that, the events of the crisis showed that a fiscal penalty was too severe to hand out. This means that in practice peers only have soft measures to discipline each other.

Peers may interfere with each other’s business: Like the first proposition, the fact that the peers take part in the SGP suggests that they interfere in each other’s business. They exchange information and then comment on each other current and planned fiscal behaviour. The case analysis, however, showed that the degree of interference can change over time. In the beginning of the crisis member states explicitly asked for a flexible interpretation of the SGP, so that each member state could address the crisis individually without any interference from each other. This suggests that when many member states face financial problems, the willingness to interfere is low. Member states stop criticising each other, because they would rather not be criticised themselves. The willingness to interfere increased when credit rating agencies started downgrading ratings of member states. This increased the financial distress in certain member states to such and extent, that it became in the peers interest to start interfering in each other’s business despite their initial desire to solve their problems individually.

Peers have enough degrees of freedom to adjust regulation to the situation at hand: The institutional analysis showed that the adaptability of the peer arrangement to the situation at hand is limited, because (1) the peers have a limited variety of sanctions and (2) the SGP is executed according to a set procedure with set rules. The reason why the SGP is executed according to a rule-based framework is that in order to get the member states to take part in the SGP, they need to be ensured that they will be treated equally. This means that any changes to the current procedures and rules will need to be supported by all the member states. As there are many member states with different interests, it difficult to adapt the peer arrangement to the rapidly developing crisis and to approach the regulation of the SGP on a case-by-case basis.

Conclusion
The answers to the propositions answered the first part of the main question, namely: “What is the capacity of peer monitoring in the SGP to decrease the negative effects from moral hazard between the member states?” For moral hazard to occur there needs to be information asymmetry and goal conflict. According to theory peer monitoring can mitigate these conditions, because peers have similar knowledge and expertise and know how to interpret the given information. Moreover, they are willing to take part in regulating one another, because they share risks. However, the answers to the propositions show that these assumptions are not necessarily true. There is still a significant amount of information asymmetry between member states. Member states do not always have accurate information due to hidden action and sloppiness. Moreover, the exchange of information does not fully
cover a member states exposure to risk. On top of that, member states are not always willing to regulate one another; it can fluctuate over time due to changing political interests. Especially when there are several member states in violation of the norms the willingness to regulate can be low and regulatory procedures can be replaced with political games. This means that for the case of peer monitoring in the SGP the ability to decrease the negative effects of moral hazard is limited.

**Recommendations for improving peer monitoring in the EU**

In this case it appears that the short-term interests of member states often replace regulatory procedures with political games, which hampers the effectiveness of peer monitoring. Therefore, the SGP should be improved by implementing more check and balances in the regulatory procedures. This way long-term regulatory interests would be more balanced out against the short-term interests of member states. This could be achieved by involving a vertical regulator, which for the case of the SGP could mean an increased role for the Commission. Especially in the tasks of norm setting and sanctioning a stronger influence of a vertical regulator is desired, as these tasks determine the regulatory objective and pressure and are currently limited by political game playing.

**Recommendation for future research**

This case study highlighted several factors that can hamper the effectiveness of peer monitoring, but, as it is only one case, more case studies need to be conducted to get a proper overview of what factors make peer monitoring more likely to be effective and what factors do not. Moreover, this could provide further insight into the influence of characteristics of the arrangement on the performance of regulatory tasks. This case study also recommends that peer monitoring in the SGP is combined with more vertical regulation. However, how peer monitoring should be balanced with vertical regulation is still unclear at this point. Therefore, further research is needed to understand the balance between peer monitoring and vertical regulation. Eventually this might lead to a framework that helps choose a suitable combination of horizontal and vertical regulation for each case. Another interesting topic of further research could be the relationship between responsiveness and peer monitoring. According to theory responsiveness is an important criteria for good regulation. This research project, however, found that responsiveness was difficult for peers. This raises the question whether peers are in fact able to be responsive?
PART I

RESEARCH PLAN & THEORY
1. INTRODUCTION

Cause
In 2007-2008 a financial crisis hit the globe, caused by a bursting of the U.S. housing bubble. Troubles in the US housing market triggered a global financial panic when Lehman Brothers filed for bankruptcy in September 2008; real estate prices degraded, stock prices dropped and several financial institutions ran into trouble forcing their national governments to step in and bail them out (Allen & Carletti, 2010; Blundell-Wignal & Slovik, 2011; J. B. Foster & Magdoff, 2009). On top of that, the crisis also initiated a wave of debt crises throughout the European Union (EU) (Blundell-Wignal, 2012; European Commission, 2012a). Debt levels of certain Euro-countries rose to the point where other parties had to step in to carry their financial losses.

The European crisis started when the newly elected Greek minister of finance, Papaconstantinou, announced that its predecessors had concealed deficits and that Greece’s deficit would increase to 12.5% for the year 2009, which was more than double the amount stated in the previous forecast (Papaconstantinou, 2010; Willis, 2009). Quickly thereafter the sovereign debt crisis in Dubai aggravated concerns about the ability of Greece and some other member states to pay back their debts. This resulted in the downgrading of Grecian debt by the rating agencies, increasing Greece’s costs of borrowing (Bloomberg News, 2012). At this point, Greece was unable to require loans with an affordable interest rate on the open market and was faced with the possibility of having to leave the euro. Another option was to ask for financial support from the European Union (EU). In fear of a Greek exit causing a wider financial crisis throughout the EU and initiating a sequence of member state exits from the EU, the European leaders announced their willingness to help Greece in cooperation with the IMF (Bagus, 2010; Tokic, 2010). As a result Greece received a bailout package of 110 billion euros in May of 2010 from the EU, International Monetary Fund (IMF) and European Central Bank (ECB) (Europa, 2010a), also referred to as the troika (BBC News, 2010). In return for the bailout Greece agreed to cut public spending.

In the meantime, other Member States had run into financial trouble as well. For example, the burst of Ireland’s housing bubble after the collapse of Lehman Brothers had resulted in heavy losses for their domestic banks (Conefrey & Fitz Gerald, 2010). To calm the markets the Irish government promised to cover all the banks’ losses. These losses, however, kept increasing, resulting in the nationalization of one of its major banks in 2009 and bailouts of several others in 2010 (Acharya, Drechsler, & Schnabel, 2011). By April 2010, Ireland had overtaken Greece as the member state with the largest budget deficit. Credit rating agencies were downgrading Ireland and in November 2010 the Irish government announced they had asked the troika for financial support. A few weeks later Ireland received an 85 billion Euro bailout package (Europa, 2010b).

Another member state that received a rescue package from the troika was Portugal. Portugal’s financial problems started with the Greek debt crisis that had created panic throughout the country. The Portuguese economy, like that of Greece, was deemed uncompetitive with high public spending and a
strict labour market (Bagus, 2010). Concerns were expressed about the country’s long-term ability to grow and the forecasts of higher deficits. By November 2010, interest rates had rose to the point where Portugal became pressured to ask for financial support. This pressure intensified when parliament failed to pass budget cuts in March 2011. Portugal received a bailout package in May 2011 of 78 billion Euros (Europa, 2011).

The latest member state to receive a bailout was Cyprus in March 2013 (Europa, 2013). Before the crisis Cyprus’s economy was described as having a long period of high growth, low unemployment, and sound public finances (IMF, 2011). However, their banking system had grown rapidly too, which had extended many loans to Greece. When the Greek sovereign debt crisis hit, banks in Cyprus took a hit too. Like Ireland, the government of Cyprus rescued their banks weakening public finances. Slow economic growth in the Eurozone weakened public finances even further.

Besides all these sovereign bailout packages, the troika also gave Spain a banking bailout package of 39.5 billion Euros in December 2012 (EU Observer, 2012; Europa, 2012a, 2012b). Like Ireland, Spain had a housing bubble that burst when the crisis hit. To save its banks the Spanish government had to spend large amounts of money increasing their deficits (Confrey & Fitz Gerald, 2010). However, bank losses kept increasing forcing Spain to ask the EU for help. Despite this bailout and implemented austerity measures by the Spanish government, there is still a risk that Spain will need a government bailout in the future. Furthermore, there are speculations of Italy, Ukraine, Slovenia and France requiring a bailout in the future too.

**Problem**

Many argue that the European sovereign debt crisis was set in motion by the global financial crisis, but was further exacerbated by the design of the European Monetary Union (EMU) (Blundell-Wignal & Slovik, 2011; European Commission, 2012a; Giavanti, Krueger, Pisani-Ferry, & Hagen, 2010; Schuknecht, Moutot, Rother, & Stark, 2011). Whilst monetary policy was organised centrally, fiscal policy was organised at a decentral level, which could lead to a situation where some member states would be unable to carry their own financial risks and would need other parties to help them out (De Grauwe, 2012). Literature describes this as the result of moral hazard or adverse selection (R. J. Arnott & Stiglitz, 1988; Arrow, 1968); because member states bare risks collectively due to economic interdependencies and a common currency, they do not carry the full burden of their own risk taking behaviour. This can make member states more eager to take risks. In addition, this risk taking behaviour is often difficult or too costly to observe (Eisenhardt, 1989).

Since the introduction of the euro in 2002, fiscal policy has been coordinated through the Stability Growth Pact (SGP) (European Commission, 2013a; Heipertz, Verdun, & Juncker, 2010). Member states realised that a form of fiscal policy would be required if they were going to share a common currency. Without coordination the euro would never be stable and fiscal policy of one member state could affect the fiscal position of another member state (Annett, 2006; Morris, Ongena, & Schuknecht, 2006). As a result member states decided to report their fiscal position and forecasts to the European Union, where they could evaluate each other’s financial sustainability in the Council. In
other words, the member states agreed to an arrangement where they would be monitored by their peers and not by an independent regulator.

Literature describes some examples where monitoring by peers is used as a form of regulation (Armendáriz de Aghion, 1999; Demirgüç-Kunt & Huizinga, 2004; Nier & Baumann, 2006; Stiglitz, 1990). It is based on the assumption that peers are capable of monitoring each other; because they have the same detailed knowledge; know what information to look at and how to interpret it. This can improve observation of behaviour and therefore reduce the negative effects of moral hazard (R. Arnott & Stiglitz, 1990). Another important condition is that, because peers share risks, they are incentivized to monitor each other’s behaviour and prevent damages (Armendáriz de Aghion, 1999).

Both conditions for peer monitoring appear to be present in the SGP. Member states judge each other’s financial sustainability and member states, especially the euro countries, bear the risks of euro imbalances together. However, the recent bailouts of member states’ suggests that despite the presence of these conditions, peer monitoring did not regulate possible negative effects of moral hazard. Therefore, this research project aims to explore the question: “What is the capacity of peer monitoring in the SGP to decrease the negative effects from moral hazard between the member states and can this be improved?”

To answer this research question, a case study research will be conducted that explores the relationship between the fiscal policy of member states and the SGP on the one side and theory on the other side. More specifically, it will test several propositions derived from theory by studying the actual functioning of peer monitoring in the SGP. A study like this can increase the academic understanding of peer monitoring and can also help European policy makers improve their regulation.

Structure

To answer this research question this report starts off by describing the research goal, frame and relevance in chapter 2. More importantly, it also describes the research question that will be answered in this report. Chapter 3 entails a description of the theoretic lens that was adopted in for this research topic. It describes different theories that helped understand the research problem, but also described different theories to analyse the research system. In Chapter 4 the research approach is discussed. It explains what research method will be used, how data will be collected, stored and analysed. This chapter also identifies propositions about peer monitoring that will be tested throughout the research project. Chapter 5 embarks on the empirical part of the research project. It gives an overview of the institutional set-up of the SGP, but also describes the environment of the SGP. Chapter 6 looks at the experience under the SGP and takes a closer look at the involvement of three member states in the SGP. After that, chapter 7 concludes on the findings of the empirical research and what these mean for each proposition. These answers give insight into the actual functioning of peer monitoring in the SGP and the possible barriers it may face. Chapter 8, therefore, discusses how these barriers may be overcome by implementing certain improvements. Finally, chapter 9 will finish off by reflecting on the research results, approach and process.
2. RESEARCH GOAL & FRAME

As mentioned in the introduction, the goal of the research project is to understand the capacity of peer monitoring arrangements in the SGP to decrease the negative effects from moral hazard or adverse selection. This chapter further specifies the research goal, the aggregation level of the analysis, the research questions as well as the scientific and societal relevance of the research project. Once these elements have been clarified, the theoretic framework and the research approach can be discussed.

Paragraph 2.1 explains the research goal of the research project. The frame of the research problem is discussed in paragraph 2.2, while the scientific and social relevance are described in paragraph 2.3. Paragraph 2.4 discusses the research questions of this research project and the last paragraph describes the sequence of research steps.

2.1 RESEARCH GOAL: UNDERSTANDING PEER MONITORING

The aim of this project is to understand why peer monitoring in the SGP had a different outcome than was expected according to theory. More specifically, it aims to understand how peer monitoring can deal with negative effects of moral hazard by analysing the peer-monitoring situation in the SGP. Theory argues that because member states have the same kind of knowledge and expertise, they are able to regulate one another. Furthermore, theory argues that because member states share a currency, they have an incentive to regulate one another to minimize losses and spill over effects from each other’s behaviour. This explanation suggests that peer monitoring works if these two conditions are met. From a real world perspective, however, these conditions seem rather simplistic. A study into the peer monitoring arrangement of the SGP could show if these two conditions are indeed enough for peer monitoring to be effective in dealing with negative effects of moral hazard in the EMU or if more factors should be considered. Besides that, little literature is currently available on peer monitoring. Therefore, an exploration of peer monitoring arrangements in the SGP could also contribute to a deeper theoretic understanding of peer monitoring and its capacity to manage moral hazard and adverse selection.

2.2 FRAMING: A PUBLIC ADMINISTRATION & MULTI-LEVEL VIEW

An important part of the research project is to determine an academic view that will be used to analyse the research problem. This is important, because each scientific discipline has its own particular frame to look at a research problem. For this specific research project an academic view should be chosen that is suitable for exploring the functioning of peer monitoring. As a public administration view acknowledges that peers are actors whom can have different interests, powers and interrelations it is an appropriate approach for this research project. It can provide insight into coordination and decision-making processes, which in turn can explain the overall functioning of peer monitoring in the SGP. In
other words, this view can provide insights into the system of the peer arrangement, the characteristics of the peers and the interactions between the peers.

However, because the research project concerns the EU, a complex community of nations, it is also crosses borders with international relations studies and European integration studies. Both studies have different theories and each theory offers a different way of analysing the complex system of the EU. Within international relations the two most prevalent theories are that of realism and liberalism (Walt, 1998). There are many more theories in international relations, but for purposes of saving time these theories were chosen to provide a basic understanding of theories that have been used to analyse international relations. Realism views member states as unitary actors, which are primarily concerned with maximising their own interest (Donnelly, 2000). This view is also referred to as the billiard ball model of international relations, as the development of one state can be explained by the development of all other states together (Singer, 1961). Applying realism to the research project means that peers would be treated as black boxes and that the total movement of these peers would explain peer interactions. The liberal view, however, does not view the member state as a unitary actor (Jackson & Sørensen, 2007). It acknowledges that transnational interdependencies between people, groups or organisations can influence state preferences. In other words, it believes that international relations are explained by interdependencies between state and sub state actors. Therefore, the liberal view does not treat the peers as a black box, but appreciates the domestic political context of peers. Moreover, interdependencies between the member state as well as sub-state actors would account for peer interactions.

Within European integration discourse the most prevalent theories are that of intergovernmentalism and neofunctionalism (Risse-kappen, 1996). Neofunctionalism is based on the liberal view and was for many years the dominant approach to explain European integration (Haas, 1964). The most important players in this view are supra-national actors, supra-national institutions and certain transnational actors (Stone Sweet & Sandholtz, 1997). The last group of players refers to any state agent that directs it activities towards the European level because of transnational interdependence. This theory would thus for instance look at the Commission, the European Central Bank (ECB), the European Parliament and the European Court of Justice to explain peer interactions. Intergovernmentalism is the realist approach towards European integration (Hoffmann, 1966).

With these descriptions of international relations and European integration theories, it is clear that each theory applies a different level of analysis to issues pertaining to the EU. Furthermore, each view deems different actors as key players in explaining developments. As this research project applies a public administration view to analyse the system of the peer arrangement, the characteristics of the peers and the interactions between the peers, it is difficult to determine what the key actors are in advance. Only when the empirical data has been gathered can remarks be made about what players have the biggest impact on the functioning of the peer arrangement. However, it is important to realise what theory was used when consulting studies on the European Union. Moreover, these theories can provide some structure when analysing empirical data. Together these theories can roughly be divided into three different levels of analysis, namely the system level, the national or domestic level and the individual level. Whereby the system level concerns the international system of Europe and involves
supra-national actors like the Commission and the ECB, but also member states can be seen as an important actor at this aggregation level. The national level focuses on the individual member state. It concerns the social and cultural embeddedness, the political system, national rules and regulations, but also political parties, public opinion and interest groups. The individual level focuses on individual people, their views, choices and personalities. As each level has a different focus, each level can provide different insights into understanding the functioning of peer monitoring and its capacity to deal with negative effects of moral hazard.

2.3 SOCIAL AND SCIENTIFIC RELEVANCE

The SGP should have prevented member states from building up unsustainable deficits and debts. Instead, some members build up such excessive deficits and debts that they required a governmental bail out. Both the number and the amount of bailout packages have brought opprobrium and tension throughout the EU. Citizens from member states paying for the bailouts do not appreciate their tax money going to countries with excessive spending, while citizens from bailout-countries do not welcome the terms and agreements that come with the bailout packages (Cash.online, 2010; NOS Nieuws, 2012; The guardian, 2010; Thepost.online, 2012). This political tension indicates that there is a social need to improve fiscal regulation so that bailouts will not be required in the future. Exploring how peer arrangements in the SGP have functioned can provide insights into previous regulatory difficulties and can, therefore, be an important input for improvements to the SGP.

As the research goal already pointed out, there is currently little literature available on the topic of peer monitoring. An empirical research of peer monitoring in a system like the EU can therefore contribute to the current scientific understanding of peer monitoring.

2.4 MAIN QUESTION AND SUB QUESTIONS

In the introduction the following main question was introduced for this master thesis project:

“What is the capacity of peer monitoring in the SGP to decrease the negative effects from moral hazard between the member states and can this be improved?”

In this research question the terms peer monitoring and negative effects of moral hazard are important from a theoretical perspective. They are the independent and dependent variable of this research. Both terms are explained in the next chapter. The term SGP is an important term from an empirical perspective; it indicates the practical scope of the research question. More information on the SGP is given in the next part of this research in chapter 5.

In order to answer this research question, several sub questions are formed that specify how the capacity of the peer monitoring arrangement will be determined. The first two sub questions aim to understand the actual peer arrangement that exists between the member states in the SGP and what the
surroundings of this arrangement looks like. These questions together will provide a picture of the system of the peer arrangement.

1) What was the institutional set-up of the peer arrangement in the SGP?
2) What was the context of the institutional set-up of the SGP?

The next two sub questions aim to understand the ability of the peers to function as a regulator and the willingness of the peers to function as a regulator. These questions predominantly provide insight into the characteristics of the peers and the relations between them.

3) What is the ability of peers to regulate one another?
4) What is the willingness of peers to regulate one another?

Based on the derived insights into the nature of the peer monitoring system, the characteristics of the peers and the relations between the peers, the first part of the main question can be answered. After that, the research project can focus on answering the second part of the main question. Naturally, the answer to this question needs to consider the barriers first, before it can consider improvements.

5) What are the main barriers facing peer monitoring in the SGP?
6) How can the capacity to decrease the negative effects of moral hazard be improved?

2.5 THE RESEARCH SEQUENCE

To answer the research questions, this research project will first of all start by performing a literature study. This will help broaden the understanding of peer monitoring and moral hazard. After the literature study, the report will continue by choosing and describing an appropriate research approach for the research questions. This will be followed by an empirical study of the research problem according to the described research approach. In the event that the empirical study indicates that peer monitoring in fact faces barriers when preventing negative effects of moral hazard, then the project can commence by prescribing improvements for these barriers. An overview of the research sequence is shown in Figure 1.

Figure 1: Overview of the research sequence
3. THEORETIC FOUNDING

To understand the interactions between the member states and the SGP it is pivotal to perform some form of empirical research. However it is just as important to adopt an appropriate theoretic framework to study the research problem. The choice of framework will influence the scope of the research project and should therefore be chosen carefully. This chapter describes the theories selected to understand the research problem. More specifically, it explains why each theory is needed and what the basic principles and developments of each theory are.

The first paragraph will start by giving a brief overview of moral hazard research. Paragraph 3.2 will continue to explain moral hazard, but will use principal agent theory to do so. After that, research on peer monitoring will be discussed. This will be followed by regulatory theory in paragraph 3.4 and multi-actor network theory in paragraph 3.5. Both paragraphs will explain how these theories can help analyse the research problem. Finally, an explanation will be given of how new institutional economics can help to analyse the research problem.

3.1 THE DEPENDENT VARIABLE: NEGATIVE EFFECTS OF MORAL HAZARD

The main research question already contains two theoretical concepts, namely moral hazard and peer monitoring, whereby the negative effects of moral hazard is the problem that is being researched and peer monitoring a way of dealing with the problem. This research projects wants to find out how peer monitoring affects the negative effects of moral hazard in the context of the SGP. Hence, negative effects of moral hazard are the dependent variable and peer monitoring is the independent variable. Since negative effects of moral hazard is the main problem of this research, it is important to start by studying moral hazard theory first.

History of the moral hazard: Insurance versus economics

The term moral hazard originated more than 200 years ago and has primarily been observed in the insurance industry. Two different research disciplines have studied the phenomenon of moral hazard, namely research on insurance and economics (Dembe & Boden, 2000; Rowell & Connelly, 2012). Interest in moral hazard started within the discipline of insurance when insurance firms were introduced in England in the 18th century (Hale, 2009; Pearson, 2002). Economists followed later in the 19th century, especially in the 1960’s when decision making under uncertainty received increased attention (Dembe & Boden, 2000; Rowell & Connelly, 2012). Both disciplines have their own meaning for the term moral hazard, which will be addressed in this paragraph.

When the insurance discipline started to develop in England, moral hazard was described as the phenomenon that insurance encouraged the insured to show behaviour for which he or she is insured. The insured was furthermore described as having an unethical, criminal, immoral or dishonest character (Baker, 1996). As a result, the term moral hazard became a normative notion within the insurance industry (Baker, 1996; Hale, 2009). Later in the 1940-1980’s the insurance industry introduced a distinction between intentional and unintentional moral hazard, also known as moral
hazard and morale hazard. Moral hazard referred to increased risk taking due to immoral behaviour, while morale hazard referred to increased risk taking due to unintentional carelessness (Vaughan, 1996). This distinction is, however, rarely mentioned in contemporary literature on insurance and is seldom used in practice (Dembe & Boden, 2000).

As opposed to the insurance industry, the economics discipline views moral hazard as changes in risk taking behaviour due to incentives rather than immoral characters or careless behaviour (Pauly, 1968). The economics discipline furthermore states that these changes in risk taking behaviour are difficult to observe because of information asymmetry, i.e. the insured individuals have more knowledge of their behaviour and actions than the insurance company who carry their risks. Economists also introduced a distinction between moral hazard and so-called adverse selection (Dembe & Boden, 2000; Rowell & Connelly, 2012). Whereby adverse selection refers to the influence of unfavourable characteristics (e.g. criminal or immoral intent) of individuals on risk taking behaviour when insured and moral hazard focuses on the change in behaviour due to incentives (Pauly, 1974). In other words, adverse selection concerns the situation where (high risk taking or immoral) individuals purchase insurance with the intention to take high risks or commit fraud (Dawson, 1894; McClintock, 1892) and moral hazard refers to the situation where insured individuals put in less preventive effort than they would without insurance, whereby the effort is difficult or too expensive to observe by the insurer (Holmstrom, 1979; Marshall, 1976; Shavell, 1979). Hence, the word moral hazard has a value neutral meaning as opposed to the normative meaning in the insurance industry.

Besides that, economists also made a distinction between ex ante and ex post moral hazard (Rowell & Connelly, 2012). Ex-ante moral hazard is defined as “the impact of insurance on the incentives to reduce risk” (Winter, 2000, p. 155), while post ante moral hazard is defined as “the effects of incentives on claiming actual losses” (Abbring, Chiappori, & Zavadil, 2008, p. 1). Thus, an example of ex ante moral hazard is a driver that drives less carefully than he would without insurance. An example of post ante moral hazard is a girl that experiences allergy symptoms each spring. Without insurance the costs of treatment for the allergy would be too high for her to consider it, she would rather endure the inconvenience of allergy than pay the costs for treatment. However, because she has insurance she decides to enter into treatment and make an insurance claim for treatment. All in all, it is important to realise when consulting moral hazard literature whether it has been written from an economics or insurance perspective. That been said, it is also important to realise that in both perspectives it is difficult to claim that moral hazard actually happened. Because of the information asymmetry it is difficult for an insurance company to claim that moral hazard or adverse selection took place, i.e. the insured increased its risk taking because of insurance. Moreover, the insured will not openly admit that it has started to take more risks since it got insurance. These reasons can make it in practice difficult to argue that moral hazard or adverse selection occurred.

Good or bad moral hazard?
As moral hazard studies gained popularity among economists, an important discussion arose as to whether moral hazard was good or bad for economic welfare and whether public intervention in insurance was required. The discussion started when Arrow stated that: “[t]he welfare case for
Peer monitoring and its capacity to decrease negative effects of moral hazard

insurance policies of all sorts is overwhelming. It follows that the government should undertake insurance in those cases where this market, for whatever reason [e.g., moral hazard], has failed to emerge.” (Arrow, 1963, p. 961). One of the assumptions that this argument was based on was that individuals are risk averse, they prefer the certainty of paying a premium than the uncertainty of being faced with large medical bills. The other assumption was that insurance premiums are fair. Because Arrow observed that there was no widespread insurance coverage, he concluded that the market had failed. He furthermore reasoned that because the insurance market provided a good that was part of the optimal output of the economy, the market failure resulted in welfare loss.

Pauly (1968) challenged this conclusion and argued that the lack of insurance coverage was not a sign of market failure, but a consequence of good economic reasoning. He reasoned that individuals with insurance face less medical expenses than individuals without insurance with similar medical conditions. Because insured individuals face less expenses, they purchase more medical care. Consequently, demand increases over time and leads to higher costs (e.g. higher premiums, taxes, wage increases etc.). These increased costs make insurance unattractive, resulting in a lack of wide insurance coverage. Pauly furthermore concluded that insurance artificially reduces the price of medical care, which most likely reduces economic welfare. Pauly’s argument was backed by subsequent empirical studies that conclude that the moral hazard welfare loss is much larger than the gains from risk avoidance (Feldman & Dowd, 1991; Feldstein & Friedman, 1977; Feldstein, 1973)

Nyman later challenged the research of Pauly. Nyman (1999) stated that Pauly’s argument relied on the assumption that income does not influence the purchasing behaviour of medical care. Nyman argued that this was not true, because empirical studies show that this purchasing behaviour is in fact responsive to income (Feenberg & Skinner, 1992; Manning & Marquis, 1996; Parkin, McGuire, & Yule, 1987). By incorporating this income effect into the analysis, Nyman (1999) argued that much of the increase in health care utilization due to insurance represents an improvement in economic welfare. More specifically, he argues that the moral hazard welfare loss in insurance can be cancelled out by three gains:

- The gains of risk bearing for medical care expenditures that occur with or without insurance
- The gains from income transfers that result in access to otherwise unaffordable medical care
- The gains from income transfers that lead to greater expenditure of medical care and other consumption when a person falls ill

Thus, contradictory to Pauly’s argument, Nyman argues that public intervention of medical care insurance is needed, because of moral hazard. The debate on whether moral hazard in medical insurance is good or bad for society is, however, still going to this day.

Definitions and core conditions

As the phenomenon of moral hazard received increased attention from the economics discipline, moral hazard problems were also researched in different sectors than insurance (e.g. trading, unemployment, agriculture etc.) (Diamond, 1967; A. D. Foster & Rosenzweig, 1994). It appeared that the role of incentives and asymmetric information played a role in almost all areas of economics (Coyle, 2007). Other disciplines, like organizational and public administration theory, also started researching moral
hazard. As a result many descriptions of moral hazard can be found in scholarly literature. Table 1 provides some examples of the different descriptions.

Table 1 Examples of moral hazard definitions in literature

<table>
<thead>
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<th>Description</th>
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<tr>
<td>“A problem of moral hazard may arise when individuals engage in risk sharing under conditions such that their privately taken actions affect the probability distribution of the outcome” .... “The source of this moral hazard or incentive problem is an asymmetry of information among individuals that results because individual actions cannot be observed and hence contracted upon.”</td>
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<tr>
<td>Moral hazard is “hidden action” by the agent</td>
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<tr>
<td>“Moral hazard occurs when risk is present, individuals are risk averse, and “effort” is costly to monitor. And it arises not only in insurance markets, but also when insurance is provided by governments, through social institutions, or in principal-agent contracts.”</td>
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<tr>
<td>“Moral hazard refers to the problem of inducing agents to supply proper amounts of productive inputs when their actions cannot be observed and contracted for directly.”</td>
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<tr>
<td>“Moral hazard is any misallocation of resources which results when risks are insured with normal insurance contracts and only with such contracts.”</td>
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<tr>
<td>“Commercial banks and savings and loan associations (S&amp;Ls) create a moral hazard problem by shielding creditors from the consequences of risk taking. As a result, banks and thrifts have a greater desired level of risk than they would otherwise have in the absence of deposit insurance.”</td>
</tr>
<tr>
<td>“Moral hazard is, in its conventional sense, an agency problem in which agents do not expend as much effort on their tasks as the principal desires. This occurs in situations where the agents' choice of effort is their private information, and the principal's observation of their performance is confounded by uncertainties.”</td>
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<td>“Moral hazard is the behaviour of the agent after the adoption and the coming into effect of the arrangement. In his behaviour, the agent manages to evade the arrangement, at any rate in part, which, generally speaking, will harm the principal's interest. He will succeed in hiding some of his actions from the principal (hidden actions (Neelen, 1994, p. 67). Moral hazard is a well-known phenomenon in the world of performance measurement. The actor (agent) to whom the performance management apply will make sure he scores a flattering, good assessment by means of hidden actions, even though this performance is less satisfactory on closer inspection.”</td>
</tr>
<tr>
<td>“Moral hazard refers to the lack of effort on the part of the agent.”</td>
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From these descriptions it is clear that moral hazard concerns the misplacing of risks due to incentives, the impact of these risks on outcomes and the difficulty or costliness of observing behaviour. To cover all these elements this research project will use the following definition for moral hazard: Moral hazard is unobservable behaviour of an actor from which the risks are dispersed between that actor and other actors.
As is clear from the definition, one of the core conditions for moral hazard to manifest is asymmetric information (Holmstrom, 1979). If the insurance company knew the behaviour of the insured then the company could always distinguish whether losses occurred due to bad luck or due to increased risk taking. The other important core condition is that there are conflicting goals (Eisenhardt, 1989). If the insurer and insured both want to prevent damages as much as possible then there is no real issue between them despite asymmetric information. However, when they have conflicting goals they do have a problem. Both conditions for moral hazard require another underlying condition, namely the separation of ownership and control. This can either be in the form of total separation of ownership and control or co-ownership. An example of total separation is a manager of a firm and its shareholders. While the shareholders own the firm, the manager controls the operations of the firm and thus its performance. An example of co-ownership could be the different countries surrounding the river Rhine. The countries use this river for different economic reasons, but they are collectively responsible for the management of the river.

Classifying negative effects of moral hazard in the EU

Now that a basic understanding of moral hazard has been achieved. It is important to specify what is meant by “negative effects of” moral hazard. As discussed earlier, moral hazard is a value neutral concept, which resulted in a discussion by welfare economists on whether moral hazard is positive or negative. This discussion illustrated that moral hazard comes with benefits and disadvantages. Naturally, these advantages and disadvantages of the welfare economics case cannot literally be transposed to the case of the European Union. However, positive and negative sides of moral hazard in the EMU can be thought of.

First of all, government spending can be seen as an investment in society, i.e. improving transportation infrastructure to facilitate trade or improving medical care to increase wellbeing of citizens. Link & Link (2009) explain that the government plays an important role as entrepreneur in society as it can be the only party willing to undertake certain risky investments that are vital for the wellbeing of citizens and/or economic growth of the nation. Incentives for increased risk taking could enhance this positive side of government spending and can thus be classified as positive effects of moral hazard.

On the other hand not all government spending is an actual investment in societal welfare. Transaction costs, pressure from lobby groups, opposition parties and voters can all lead to less than optimal financial performance. Moreover, government investments in general can decrease its financial buffer for unexpected events. Both factors can result in an increase of borrowing. In the worst-case scenario this can result in a governmental default. This means that moral hazard can also stimulate a government’s endeavours in less than optimal financial spending and increase its default probability, which can be classified as the negative effects of moral hazard.

Concluding, moral hazard has positive as well as negative effects. This research project aims to understand how peer monitoring can influence these negative and positive effects of moral hazard. More specifically, how peer monitoring can decrease the negative effects of moral hazard while maintain the positive sides of moral hazard.
3.2 Moral hazard in principal agent relationships

Because separation of ownership, asymmetric information and goal conflict are often present in principal agent relationships, moral hazard often emerges (Ross, 1973). Therefore, principal agent theory, also referred to as agency theory, is often used to describe the general phenomenon of moral hazard. Agency theory focuses on the relationship between two parties, the so-called principal and agent. The principal needs the agent to perform certain work that is too complex or costly for the principal to do himself (Bergen, Dutta, & Walker Jr., 1992; Harris & Raviv, 1981; Jensen & Meckling, 1976; Ross, 1973; Sappington, 1991). In practice the principal and agent relationship can be found in many situations, between an employer and its employees, a builder and its contractor(s), or even a regulator and a firm that it regulates (Rai & Kim, 2002; Sappington, 1991). To manage the relationship between the principal and the agent a contractual arrangement is made (Bergen et al., 1992; Jensen & Meckling, 1976; Rai & Kim, 2002). The aim of agency theory is to determine the most efficient contract given certain assumptions about people, organisations and information (Eisenhardt, 1989). People are hereby assumed to be risk averse, self-interested and have a limited rationality, while organisations are assumed to have members with conflicting goals and information is assumed to be a commodity that can be purchased (Eisenhardt, 1989; Harris & Raviv, 1981). Moreover, an efficient contract is often defined as one that maximizes the outcome for the principal (Rai & Kim, 2002), because the principal is assumed to be the dominant party in the relationship (Bergen et al., 1992).

Two problems can be identified in the relationship between the principal and the agent, depending on the circumstances, namely the agency problem and the risk-sharing problem (Eisenhardt, 1989a; Laffont & Martimort, 2009). The agency problem occurs when the principal and agent have different goals (e.g. the principal wants to minimize costs, while the agents wants to maximize profit) (Rai & Kim, 2002) and when it is difficult or costly for the principal to observe the agents work (Grossman & Hart, 1983; Sappington, 1991). The risk sharing problem occurs when the principal and agent have different risk preferences, which can result in different preferences for further action (Wilson, 1968), e.g. the principal wants to build a highly innovative building, while the agent would rather use proven technologies.

Dealing with moral hazard in principal agent relationships

In the case of moral hazard or adverse selection, the relationship between the principal and the agent is characterized by information asymmetry and conflicting goals (in other words, an agency problem). In such a situation the principal has two alternatives (Jensen & Meckling, 1976; Laffont & Martimort, 2009). The principal can either invest in information systems so that the agent’s behaviour becomes observable and the self-interest of the agent is limited (Alchian & Demsetz, 1952). In such a situation, a behaviour-based contract becomes the most efficient, whereby the principal monitors the agents behaviour and rewards the behaviour (Eisenhardt, 1989). However, monitoring efforts will rarely generate perfect information in real life, let alone information about the agent’s goals (Barney & Hesterly, 2006).

The other option for the principal is to monitor the agent’s behaviour based on consequences with a outcome based contract. An outcome based contract tries to align the goals of the agent with the
goals of the principal (Rai & Kim, 2002). This limits the conflicting goal of the agent and motivates the agent to behave as desired by the principal (Bergen et al., 1992; Eisenhardt, 1989). The difficulty with outcome-based contracts is that tasks are not always measurable (Eisenhardt, 1989; Mahoney & Pandian, 1992). Moreover, the outcome of the agents work is not only determined by the behaviour of the agent. There is also environmental uncertainty involved that can have a varying influence on the outcome (Arrow, 1971; Bergen et al., 1992; Wilson, 1968). These risks have to be carried by someone. When an outcome based contract is implemented, a certain amount of risk is transferred to the agent (Eisenhardt, 1989). However, in order to get the agent to carry these risks, the principal has to pay a certain price. The more uncertain the outcome, the higher the price will be of transferring risks to the agent. Hence, the principal is faced with a trade-off between the costs of implementing information systems and the costs of transferring risks to the agent (Eisenhardt, 1989) when managing moral hazard and adverse selection.

In essence, agency theory can provide an abstract view of the relationship between member states and the SGP under different levels of uncertainty, information, goal confliction and risk-aversion. As a result, it also provides an abstract picture of how moral hazard can cause negative effects for the principal.

3.3 Peer Monitoring, the Independent Variable

In some situations market forces can also provide a form of regulation and reduce agency problems (Fama, 1980). Stiglitz (1990), for example, studied how peer monitoring was used to improve the financial performance of the Grameen Bank of Bangladesh. Stiglitz describes Bangladesh as a country with an underdeveloped capital market where local information is an important success factor in the financial services business. Many financial institutions do not have access to this local information and are therefore unsuccessful, except for Grameen Bank. Instead of providing loans to individuals Grameen bank provides loans to groups of five that have been formed by the group members themselves. These group members are collectively responsible for paying back their loans; no group member can obtain credit until the loan is paid back. Because the gains from monitoring your group members outweigh the costs of increased risk bearing, the system works. By providing loans to self-formed groups, the bank created a system where they did not require the local knowledge, but used the group members to monitor each other. Stiglitz refers to this system as peer monitoring.

In the Bangladesh example of Stiglitz market forces in the form of peer monitoring is the only form of regulation to manage agency problems like moral hazard. However, market forces can also be complementary to vertical regulation. For example, Brousseau and Glachant (2011) argue that network industries need regulators who create “fora” where peers and other interested parties can coordinate and exchange knowledge. Brousseau and Glachant (2011) claim that this role of the regulator is needed, because networks are characterised by long-term investments with risks for system failure and continuously developing knowledge that is fragmented among different parties. One party can cause system failure. Consequently, regulators should facilitate an environment where peers can discuss, share knowledge and monitor each other’s behaviour and plans in the network. Literature on banking
regulation also describes how market forces can assist regulation by letting investors discipline banks for their risk-taking behaviour (Nier & Baumann, 2006). This example argues that investors can remove their investments from the bank if they believe they are not receiving the appropriate interest for the amount of risk that a bank is taking. Other examples of market forces as a form of regulation focus on corporate control or managerial labour markets (Fama, 1980).

All in all, all the examples are a form of horizontal regulation. And even though they might have different names for it, they all have a setup whereby similar organizations or neighbours monitor or coordinate an agent’s action. All examples use this setup so that the detailed knowledge of the similar organizations or neighbours is used to judge the agents behaviour, hereby overcoming the obstacle of information asymmetry. On top of that, the similar organizations or neighbours in each example have an incentive to regulate due to a form of co-ownership. The group of borrowers in Bangladesh have an interest in monitoring, because a missed payment of one member means increased payments for the other group members. Actors in the network industry are incentivised to regulate each other, because bad investment can potentially cause failure of the system, hurting all the actors involved. Finally, investors have an interest in regulating banks, because risky decision-making by banks means a higher risk of the investor losing its investments.

Concluding, the concept as applied by the examples involves regulation in a group of peers or neighbours that have the knowledge to regulate each other and the incentive to regulate each other. This research project will from here on refer to this concept as peer monitoring.

3.4 Principal Agent Relationships and Regulation

Because the relationship between the SGP and the member states concerns a regulatory relationship, theory on regulation can provide further information about the relationship between the SGP and the member states. Among other things it can explain the different regulation tasks that a regulator has. For instance, in some theory the task of the regulator is divided into three different steps: gathering information to determine whether a case complies with the norms, judging the gathered information and determining sanctions if needed (Bekkers, Homburg, & Ringeling, 2002; Janssens, 2005). These three tasks suggest that another task needs to be fulfilled before any of the other tasks can be performed, namely setting norms. Generally rules and regulations as defined by law determine these norms. However, in most situations the rules and regulations will leave a certain amount of room for professional interpretation. Because the regulator has the required expertise for an interpretation, it is allowed to do so (Mertens, 2006). This means that the activity of setting norms is often an important task of the regulator too. In the event of peer monitoring it means that all for tasks will require a certain amount of coordination between the peers.

Responsive regulation

Besides describing regulation tasks, regulatory theory also describes different styles of regulation to address the challenge of enforcement from which the most important contribution is responsive regulation from Ayres and Braithwate (Baldwin & Black, 2008). Responsive regulation proposes to
Peer monitoring and its capacity to decrease negative effects of moral hazard balance deterrence and compliance strategies in the enforcement strategy of a regulator. Before that, regulatory theory mostly focused on the debate of deterrence versus compliance, i.e. one or the other was used but they were never combined (Baldwin & Black, 2008). This changed with responsive regulation. Ayres and Braithwate (1992) advised regulators to first of all enforce with compliance strategies and apply more deterrent strategies when the firm in question did not behave as desired. Moreover, they argued that regulators with a wider explicit range of enforcement strategies are more likely to reach compliance. This range of enforcement strategies is depicted in the left pyramid in Figure 2. This pyramid shows six types of sanctions that can be used to regulate the single firm. The bottom of the pyramid contains more soft sanctions that can be used to get the firm to comply; if these soft sanctions are ineffective the regulator can move up a layer in the pyramid. The idea behind this pyramid is not that every regulator should exactly have these sanctions; obviously not all these sanctions can be applied to member states. However, the principle behind this pyramid is that a regulator should have a variety of sanctions so that he can switch between more soft and hard sanctions depending on the situation at hand. The more variety a regulator has the more responsive a regulator can be. Besides that, Ayres and Braithwate (1992) state that the more severe the sanctions of a regulator are, the more likely it will be for a regulator to ensure compliance. Soft sanctions in the pyramid are more effective when there is a threat of more severe sanctions than when there are none.

The pyramid on the right in Figure 2 called the ‘pyramid of regulatory strategy’ does not show regulation sanctions, but shows different regulation regimes (see Figure 2). In this pyramid governments should first of all seek self-regulatory solutions, but if ineffective should move up to enforced self-regulation, command regulation with discretionary punishment and finally command regulation with no discretionary punishment. Again the regulation styles on the bottom of the pyramid represent more compliant styles while the top ones are more deterrent.

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Figure 2: The Pyramid of Sanctions & the Pyramid of Regulatory Strategy (Ayres & Braithwaite, 1992)

Summarizing both pyramids provide a tool-based framework to map out the regulation sanctions and the regulation regime of the SGP. More specifically, the left pyramid can provide an overview of the types of sanctions the member states have in the SGP and the ability of the SGP to be responsive to the situation at hand, while the right pyramid can help identify the enforcement style of the SGP.
3.5 Regulation in Multi-Actor Networks

Agency theory and responsive regulation focus primarily on the bilateral relationship between the principal and the agent. However, as peer monitoring indicates regulation not only involves the principal and the agent, it can involve a network of actors. First of all, agents can be confronted with several regulators (De Bruijn & Ten Heuvelhof, 2005). In this research problem, member states are confronted with each other when it comes to fiscal regulation, but they are also regulated by the ECB for monetary policy and by the Commission for other policy areas, e.g. procurement law, environmental law etc. These different regulators can have conflicting regulatory instructions, which member states can use to delay enforcement processes (Ten Heuvelhof et al., 2009). Moreover, the regulator is confronted with resource constraints which often make it only possible to focus attention on certain aspects of a member state. For instance, the Directorate Generals and Services in the Commission whom all serve different policy areas have to compete with one another for their annual budget. Moreover, the Commission and the Council have internal bodies or individuals whom represent different public goals that might constrain other goals, like enforcing fiscal regulation. This can decrease regulatory effectiveness. Furthermore, member states can face domestic political pressure to focus on other policy areas of interest in the EU or even to not stimulate fiscal enforcement at all. Besides that, there can also be third parties who can influence the enforcement process (Ten Heuvelhof et al., 2009). For instance, National Central Banks and the IMF can release statements on the SGP and monetary policy. Moreover, credit rating agencies give government bonds ratings, which should give an indication of the risk of the financial products from governments. Last but not least member states can also form friendships and coalitions with one another to influence European policy. In essence, this means that regulation does not take place within the bilateral relationship between the Council and the member states, but that it takes place in a multi-actor network. Figure 3 shows an example of what the regulatory network of the SGP could look like.

![Figure 3: From bilateral regulatory relationship to regulatory network (based on De Bruijn & Ten Heuvelhof, 2005)]
The operation of this complex network of actors is influenced by interdependencies, self-interest, social class, cultural differences, assymetrical relations and differences in power positions (Mukherji, Wright, & Mukherji, 2007). How these factors come together influences the degree of cohesiveness and goal sharing in the actor network at certain moments in time. When the actors in the network share the same goals and are cohesive then agency problems due to moral hazard or adverse selection can be avoided. In some cases when actors only share the same goals unity can still overcome agency problems despite there being lower levels of cohesion (Macneil, 1981). However, when it is the other way around, no goal sharing but high levels of cohesion, conflict and confrontation are likely to cause agency problems to occur (Mukherji et al., 2007).

Thus, because the multi-actor network has an impact on the effectiveness of regulation, it is important to take this into account in the research project. More specifically, it is important to consider the interdependencies, self-interests, cultural differences, assymetrical relations and differences in power positions when studying the network of the SGP. The variable social class is of less importance, because this study focuses on a european and country level and not at an individual person level.

Transnational regulatory networks in the European Union

Because the multi actor network of this research problem does not confine itself to the borders of one region or one country, Mojone (2000) states that regulatory preferences, costs and benefits can vary locally. Mojone (2000), therefore, argues that decentralised regulation can be a more suitable form of regulation to deal with these differing geographic conditions. He continues by stating that transnational regulatory networks is a model of regulation that deals with local differences and integration credibility. In a transnational regulatory framework the European regulating agencies are central nodes in a network of national regulators and international organisations. In other words, the European regulatory agency does not replace the national regulatory agencies, but they cooperate with one another.

For transnational regulation to work, Mojone (2000) prescribes three important criteria. First, there must be trust and cooperation within the network, European agencies and national statistics agencies should be able to forward eachother files if they believe the other party to me more suitable for the case. Second, the regulators in the network need to possess a certain level of professionalism so that they can all deal with the cases with the same level of professionalization. Third, the regulators in the network need to have a common regulatory philosophy. However, as this philosophy may change due to all sorts of developments, the members of the network need to discuss their views over time.

As these criteria are prescriptions, Mojone (2000) argues that these criteria are often not present at the beginning, but that these prerequisites can be developed if a transnational regulatory network is present. For this research project it means that these criteria can be used to analyse and improve the capacity of peer monitoring to decrease the negative effects from moral hazard. It is hereby important that during the project the question is raised as to whether a transnational regulatory network exists and if so, whether each criteria is currently satisfied.
3.6 Looking at Regulation in a Context

In 2008 Baldwin and Black (2008b) argued that responsive regulation should also respond to the institutional context and not merely study the relationship between the regulator and the organization that is under regulation. Institutions hereby refer to “humanly devised constraints that structure political, economic and social interactions” (North, 1991, p. 97). These constraints can either be formal (rules, regulations, contractual agreements) or informal (traditions, norms and values etc). In society institutions play an important role, because they can reduce uncertainty by establishing a stable (but not necessarily efficient) structure for human interaction. How efficient the institutions are in shaping structure for human interaction depends on the informal constraints, formal rules and enforcement (North, 1990). These informal constraints, formal rules and enforcement can interact with one another and can complement or stand in each other’s way. For instance, in the peer monitoring example of Brousseau and Glachant’s (2011) “fora” (the enforcement) are reasoned to be the best way to compliment the formal and informal constraints of network industries¹. Network industries are characterized by long-term investments that have risk of causing system failure. At the same time these network industries are continuously confronted with innovations that stimulate competition, but can also cause inefficiencies. Consequently, network industries do not merely require a traditional independent regulator, but a regulator that stimulates coordination and knowledge exchange to safeguard the performance of the industry. At the same time the regulator should also stimulate competition so that the industry is incentivised to innovate.

Williamson’s (1998) designed a framework that covers four different layers of institutions (see Figure 4). This framework considers the entire institutional context. It not only looks at the interactions between the principal and agent or the multi-actor network, but also considers formal institutions and embeddedness. More specifically, it shows that the top layer focuses on the social and cultural embeddedness, namely the informal institutions, customs, traditions and norms. The layer below the top looks at the formal rules, e.g. laws and regulations. The layer after that focuses on contractual agreements between parties and the final layer looks at the resource allocation and employment. Not only does the framework describe the different institutional layers, it also describes the frequency of change in each layer. As the model shows the bottom layer changes continuously, the frequency of change decreases as one moves up the layers. Williamson (1998) constructed this framework to analyse and minimize the transaction costs between two companies. That is why the third column of the framework shows the purpose and importance of each layer for transaction costs economists. However, it can also be used as a tool to create an overview of and explain the institutions in play (North, 1990).

Koppenjan and Groenewegen (2005) altered Williamsons layer model to make it more suitable for the analysis (and design) of the functioning of complex systems (see Figure 5). Their framework has two important differences from that of Williamson. Firstly, the framework allows for interactions between the layers and secondly the framework has added a layer that describes the interactions between actors (Koppenjan & Groenewegen, 2005). In other words, it explicitly analyses the multi-actor network, which as the before mentioned literature study showed to be an important part of understanding how regulation

¹ Network industries hereby refers to physical networks (e.g. gas/electricity/telecom) and not multi-actor networks as described in paragraph 3.5
Peer monitoring and its capacity to decrease negative effects of moral hazard

functions. Thus, this report will use the framework of Koppenjan and Groenewegen to attain an overview of institutional context of the functioning of peer monitoring in the SGP.

Figure 4: Institutional layer framework from Williamson (1998)

Figure 5: The four levels of institutional analysis from Koppenjan & Groenewegen (2005)
The institutional framework vs. theoretic views on the European Union

It is also important to consider how the different international relations and European integration views relate to the institutional framework. As each view focuses on different key players, they also focus on different institutions. Realism, for instance, will only consider institutions governing the actions of member states, whilst liberalism will also consider institutions governing sub state actors.

Based on these different views from international relations and European integration studies paragraph 2.2 identified three different levels of analysis bases: the system level, the national or domestic level and the individual level. Up until now it was clear that each level involves different actors, however, these levels will also find different institutions important. It is thus important to realise that the institutional framework will give different results for each level of analysis. For the first layer, which describes the actors and the games they play, it might be relatively easy to see how each level of analysis can give different results. The system level, for instance, will only consider supra-national actors and unitary member states. A national level would allow analysis of state and sub state actors, increasing the complexity of the layer. By adding the individual layer of analysis this complexity could be increased even more.

If the system level was adopted in layer 1, it is likely that layer 2 and 3 will especially look at European formal institutions. It will focus on the European political system and European policies, rules and regulations in place. The individual and national level, however, will focus on national political systems, policies, rules and regulations. Layer four can also become very complex when an individual or national level is applied, as it would consider the norms, values, traditions and cultures of each individual member state. A system level on the other hand would be more interested in the norms, values, traditions and cultures of the European as a whole (if there are any).

In essence, this means that the institutional framework of the peer arrangement in the SGP is likely to be a complex mixture of international, European and national institutions. This is important to realise when analysing the institutional context of the SGP, as the frameworks in figure 4 and 5 suggests that there is a certain logic between the institutional levels.

The institutional framework vs. other theories

This theoretic framework has found several theories to analyse the research problem. However, seen as the institutional layer framework encompasses the whole institutional environment of the SGP, it can be helpful to describe how the other identified theories in the theoretic framework fit into this institutional layer framework. To start with moral hazard, moral hazard involves the difference in risk taking of an individual or group due to incentives, it involves the interaction between the first and second layer of the framework. The second layer provides the incentives; while the actors in layer one take the increased risks that can cause damages for itself and other actors. Peer monitoring is an example of governance in layer two, which can align rules and regulations in layer two with the interactions between actors in layer one. Peers monitor each other, but they do so because they have agreed to share risks in layer two. Hence, peer monitoring can decrease the incentives from layer two that stimulate moral hazard in layer one. Regulatory theory, and then specifically the pyramids of Ayres and Braithwate, also concerns layer two of the layer framework. The pyramids describe sanctions and regulatory styles that can align interactions in layer one with rules and regulations in layer three. When responsive regulation is a part of the governance system, the regulator can
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customize its relationship with each organisation that it needs to regulate. Actor network theory can be a helpful tool in analysing the interactions between actors and thus concerns layer one. Both the regulator as the organization that is being regulated can be part of a network. Each network can have different degrees of cohesiveness and goal sharing, which influences outcomes. A multi-actor network analyses can furthermore show how the institutions in layer two actually affect the interactions within layer one.

Thus overall the theories described in the theoretic framework relate to layer two or one of the institutional framework of Williamson. However, as described earlier all layers interact, thus layer three and four can have an influence on the interaction between the SGP and the member states as well. This should be kept in mind when analysing the research system.
4. RESEARCH APPROACH

Now that the research problem, goal and theoretical founding have been made clear, it is time to determine an appropriate approach for the research project. This approach determines how the empirical part of the research project will be conducted. More specifically, it determines what empirical data will be collected, how it will be collected, and how it will be analysed and validated. Moreover, it is important to select an approach that can answer the main research question.

The first paragraph will start by explaining what type of research approach is adopted for this project. Paragraph 4.2 continues by describes the research method that will be used and what research choices were made. The last paragraph provides an overview of the different research phases in the research project.

4.1 A QUALITATIVE RESEARCH APPROACH

Because this research project is interested in the influence of peer monitoring on the negative effects of moral hazard, this research project is interested in the interactions between the SGP and the member states. By exploring the relationship between the SGP and member states, it aims to get an impression of the functioning of the SGP and how it interacted with fiscal policy in member states before the crisis; are these interactions country specific or can they be found in all three member states?

When a research project involves a study of countries, it can be classified as a comparative study of countries. Korsten et al (1995) identifies three different research strategies when performing a comparative study of countries, namely a case study, survey or experiment. The choice for one of these three research approaches depends on the research question that needs to be answered. Both the survey and experiment are often forms of exact and objective type of research that involves numbers and statistics. Thus, a researcher has to have a clear idea of the data that it needs in order to answer the research question. A case study can use qualitative data as well as quantitative data, or a combination of the two. Furthermore, case studies are very suitable when context-dependent knowledge needs to be produced (Flyvbjerg, 2006). When context-dependent knowledge is important, the researcher often doesn’t know what data he is looking for exactly in the beginning of the research. This makes case studies especially useful when contemporary complex issues are being analysed and when ‘how’ and ‘why’ research questions need to be answered. Furthermore, a case study is suitable when the study object cannot be separated from its context and when the researcher cannot control the behaviour of the investigated object.

In this research project a case study approach seems most suitable. The research question that needs to be answered concerns the problem analysis of a contemporary context dependent event. It is still unclear what factors contributed to the functioning of peer monitoring in the SGP and its influence on moral hazard. Data requirements are therefore difficult to specify in advance. Moreover, it seems safe to assume that the researcher cannot influence the development of the European crisis and/or the behaviour of the member states.
4.2 RESEARCH METHOD: A CASE STUDY

According to Yin (2003, p. 21) every case study consists of five components, namely:

1. The case study’s questions
2. The propositions
3. The unit of analysis
4. The logic linking the data to the propositions
5. The criteria for interpretation

The first two components help focussing the research approach towards the goal of the research project, while the unit of analysis determines what the case is. The fourth component determines how the empirical data will be linked to the study’s research questions. Finally, the fifth component focuses on the iteration between propositions and data and the matching of empirical found patterns to data. From the five components the last two are the least developed and therefore the most difficult steps in a case study (Yin, 2003).

Chapter two already identified two of the five components, namely the questions and the unit of analysis for this research project. The goal is to find out how peer monitoring can influence negative effects of moral hazard in the EU; is peer monitoring capable to prevent these negative effects of moral hazard in the EU? And if not, why? To answer this question the member states and the relationship between them needs to be explored. Therefore, the case study must explore the relationship between the SGP and several Euro-Countries. The remaining components will be explained in the following paragraphs.

4.2.1 THE CASE DESIGN CHOICES

When designing a case study several choices need to be made, namely the type of case study research, the selection of cases, and the setting in which the case study will be investigated. According to Yin (2003) a case study can be explanatory, exploratory or descriptive. Whereby descriptive case studies are used to illustrate events, exploratory case studies are used to find research questions and hypothesis, and an explanatory case study is used to determine causality. Each of these types of research can focus on a single case or multiple cases. Furthermore, each type of case study can be investigated in a longitude setting or a comparative setting. A case study in a longitude setting describes changes within (a) case(s) over time, while a case study in a comparative setting compares cases with each other. In addition, the case study design can be holistic or embedded. A holistic case study focuses on a single unit of analysis; it studies a global nature of a phenomenon. An embedded case study on the other hand focuses on multiple units of analysis. It looks for consistent patterns of evidence across units, but within a case.

The type of case study design that will be used in this research project is influenced by the following factors:

Nature of research questions: as previously mentioned the case study explores what the capability is of peer monitoring to reduce the negative effects form moral hazard in the EU. As there currently is little knowledge available about peer monitoring and it is not clear what exactly influences the functioning of peer monitoring, an holistic approach is necessary. Furthermore, this research question was
formed based on the events occurring in the European sovereign debt crisis. This may suggest that a descriptive case study in a longitude setting is required. That been said, it is not entirely clear if a description of the crisis will answer the main research question. Therefore, an exploratory case study of the crisis seems more fitting. Moreover, an exploratory case study also offers the opportunity to form hypothesis about peer monitoring.

**Availability of time:** the research project needs to be conducted in 21 weeks. This limits the amount of cases that can be researched. A trade-off needs to be made between the available time and the ability to generalise the results. This factor does not necessarily exclude the investigation of multiple cases, but limits the amount of cases that can be selected.

**Availability of cases:** there are different amounts of information available on each member state. Most information can be found on the member states that have asked the troika for a bailout. Furthermore, information on the Netherlands is easier to access, because this is the country of residence of the researcher. The availability of information on each member state influences the amount of cases that can be researched.

**Unit(s) of analysis:** the overall object of analysis is the peer monitoring arrangement in the SGP, whereby the peers in the arrangement form the unit of analysis. However, to understand the peers information about the system of the peer arrangement and the interactions between them is also needed. This would imply that a holistic case study is most appropriate.

All in all, these variables argue that a multiple case, holistic and exploratory case study is needed for this research project. Whether a comparative or longitude case study is required is not exactly clear. An argument to use a comparative case study is that it allows for the comparison of peers. This also fits with the conclusion that multiple case studies of peers are needed to answer the research question. A case study in a longitude setting, however, would also seem fitting as the case concerns the event of the European sovereign debt crisis and knowledge about the system of the peer arrangement is needed to understand the peers. In other words, it might be difficult to understand the peers without a longitude description of the crisis. For this reason, the choice has been made to first perform a case analysis of the crisis. With this analysis a comparison can be made of the peers involved in the SGP.

Now that the choice has been made to analyse multiple cases, the amount of cases need to be selected. The selection of case studies determines the ability to generalize the findings, but also influences the amount of resources that will be needed to complete the study. Hence, the selection of case studies involves a trade-off between the available time and information and the ability to generalise the results. From a time perspective it seems realistic to study three case studies. More case studies would be likely to make the research project longer than 21 weeks. Furthermore, while one or two cases might imply a coincidence, three case studies can provide more certainty of the findings. From an information availability perspective three case studies also seems doable. A lot of information can be found on the bailout receiving countries and from the member states that have not received a bailout it is easiest to find information on the Netherlands.

The next choice that needs to be made is what countries will serve as a case study. Two criteria were considered for this decision, namely the similarity of member states and the available data. Similarity concerns the financial differences between member states; have they all received bailouts? And if so, did they receive them for the same reasons? To find relevant insights about the interactions between the
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member states, it is best to choose cases that are different. Availability of data refers to the amount of data that is available for each case. It is best to choose cases that offer a sufficient richness of data.

To get a proper overview of the functioning of the case studies the case studies can’t only concern bailout countries. This would reduce the generality of the results for the SGP and would therefore limit the contribution of the case study to the research goal. This automatically implies that the Netherlands should be one of the case studies. The other two case studies can be member states that have received a bailout. There is a lot of information available for all the member states that have received bailouts: Greece, Portugal, Ireland and to a lesser degree Cyprus. There is less information available on Cyprus, because the bailout only took place a few weeks ago. This leaves us with three candidates for the last two case studies, namely Greece, Ireland and Portugal. From these three countries it appears that the reason for requesting a bailout in Greece and Portugal is quite similar (see the introduction). Considering the research goal, it seems more rational to select only one of these two countries for a case study. Selecting similar cases would limit the differences amongst cases and could possibly reduce the findings on peer monitoring in the SGP. From the member states Greece and Portugal, the most has been written about Greece. This is mainly because it was the first country to receive a bailout. Therefore, Greece and Ireland were also selected as cases.

4.2.2 Formulating Propositions

Because the case study is of an exploratory nature propositions are not required; exploratory case studies are often conducted to find hypothesis or propositions. However, since the research project is very broad and data requirements are difficult to specify in advance, propositions could offer the research project a bit more focus. Furthermore, the construction of propositions can help make this case study comparable to other case studies on peer monitoring if they apply the same propositions. Finally, propositions can also help answer the main research question, namely: “What is the capacity of peer monitoring in the SGP to decrease the negative effects from moral hazard between the member states?”

When studying peer-monitoring theory one could argue that Peers have the ability to regulate one another. This because, theory states that peers have similar knowledge and therefore know what information to exchange with one another and how to interpret the given information. Deriving from peer monitoring theory one could also argue that peers have the willingness or sense of urgency to regulate one another. Because peers share risks together, they are interdependent. This interdependency makes peers willing to regulate each other’s behaviour.

One could even state that ability and willingness are core conditions for peer monitoring to work, because for each regulatory task that peers execute they need to have the ability and willingness to execute them. That been said, the regulatory tasks (setting norms, collecting data, judging the data and sanctioning) can be used to analyse the ability and willingness of peers to regulate one another, meaning that the ability and willingness of peers can be tested for each individual task. Hence, a total of 8 propositions can be identified to test the peers’ ability to regulate one another and peers’ willingness or sense of urgency to regulate one another (see table 2).

Of course there is a certain relationship between these propositions; for example, if no data is collected it will be difficult for peers to make a judgment about each other. However, this also means that
not necessarily each proposition needs to be answered to get an impression of the peers ability and willingness to perform the regulatory tasks. That is why only four propositions were formed. Table 2 shows the 4 propositions that were specified. Two of the propositions say something about the willingness or sense of urgency of peers to regulate one another. The other two propositions say something about the ability of peers to regulate one another. Furthermore, the propositions cover three of the four regulatory tasks. The only task that is not covered by the regulatory tasks is judging data. The reason for this is that judging data is the most difficult task to uncover. This task often takes place behind closed doors, while the setting of norms, the type of data is collected and the handing out of sanctions is often made public by the regulator or organisation subject to regulation.

Table 2: Propositions

<table>
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<tr>
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<th>Ability to regulate</th>
<th>Willingness/sense of urgency to regulate</th>
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<tbody>
<tr>
<td>Set norms</td>
<td></td>
<td>Peers have a sense of urgency to regulate one another</td>
</tr>
<tr>
<td>Collect data</td>
<td>Peers have information about each other’s behaviour</td>
<td></td>
</tr>
<tr>
<td>Judge</td>
<td></td>
<td>Peers have formal and informal means to act</td>
</tr>
<tr>
<td>Sanction</td>
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Each of the four propositions identified in table 2 was derived from theory as discussed in chapter 3. The theoretic reasoning behind each proposition is as follows:

1. **Peers have a sense of urgency to regulate one another:** As principal agent theory showed the principal has an urgency to regulate the agent’s behaviour, because the agent is performing a task for the principal that is too difficult or costly to perform himself. Moreover, as the agent’s interests can be different than that of the principal, it is in the interest of the principal to monitor the agent’s actions to make sure the task is performed as desired. This same urgency to regulate also plays a role in peer monitoring. The only difference is that the principal is now formed by a group of peers. The peers, in this case the member states, need each other to behave in the common interest of the group, namely maintaining a stable and sustainable fiscal union. However, as member states are also individual agents and at times can pursue national interests that do not align with the common interest of the group, member states have a sense of urgency to regulate one another. This sense of urgency could mean that member states collectively set norms for each other’s fiscal behaviour to indicate whether a member state is in compliance with the common goal or not. On the other hand, really responsive regulation argues that not regulation, but sector culture and market forces drive behaviour. Moreover, multi-actor network theory argues that regulation involves a complex web of actors, whereby interdependencies, self-interest, cultural differences, asymmetrical relations and differences in power positions determine the operation of peers. This means that this
network of actors can also bear incentives that are in conflict with the collective goal of maintaining a stable and sustainable fiscal union.

2. **Peers have information about each other’s behaviour:** the few examples of peer monitoring in literature illustrated that peers are, because of their detailed knowledge, more able to determine what information is important to monitor and better equipped to interpret the information as opposed to traditional ‘vertical’ regulators. This reduces information asymmetry, one of the core conditions for moral hazard. It is because of this theoretic argument that peers are believed to be able to collect data about each other and that the proposition “peers have information about each other’s behaviour” was formed. At the same time institutional theory showed that the institutional context can influence enforcement. Both formal, e.g. rules and procedures, as informal, e.g. games that actors play, can have an influence on the peers ability to collect data.

3. **Peers have formal and informal means to act:** regulatory theory showed that regulators need sanctions to enforce compliance. More specifically, responsive regulation argued that these sanctions should be a combination of more soft informal sanctions and stricter formal actions. A wide variety of sanctions can prevent over enforcement, create credibility amongst the regulatees and provide the regulator with a shadow of hierarchy. That been said, responsive regulation also argued that regulators do not always have a wide variety of soft and hard sanctions and that some of these sanctions are too severe to apply. Moreover, the institutional context can influence the amount of means available to peers.

4. **Peers may interfere with each other’s business:** In the previous proposition it was argued that based on regulatory theory peers should be able to sanction one another. This proposition continuous by stating that peers should also be willing to sanction one another. Like the other proposition, this proposition is based on principal agent theory. Because peers need each other to behave in the common interest of the group, but realise that they at times can direct action towards interests that are in conflict with the common interest, they are willing to interfere in each other’s actions. On the other hand, a multi-actor network perspective could show that self-interest, culture and short sightedness might also affect this willingness to interfere in each other’s business.

Besides the four regulatory tasks, responsive regulatory theory also describes that a regulator should be able to be responsive. This leads to the formulation of a fifth proposition:

5. **Peers have enough degrees of freedom to adjust regulation to the situation at hand:** Responsive regulatory theory does not describe responsiveness as a separate task of a regulator, but rather positions it as a criterion for regulation. It is thus more prescriptive than descriptive. Responsive theory argues that a regulator should have a wide enough variety of sanctions and have severe enough sanctions to adopt an appropriate regulatory strategy for each organisation subject to regulation. The sanction pyramid in responsive theory might suggest that responsiveness should only be sought in the regulatory task of
sanctioning. However, responsive regulatory theory shows that responsiveness within the regulatory tasks of sanctioning also requires a certain degree of responsiveness in the other three tasks. As the behaviour of organisations subject to regulation changes over time, it is necessary that the regulator can change norms, information needs and judgement to stimulate compliance with its sanctions as time progresses. This requires a certain amount of institutional flexibility, which the empirical analysis might find to be present or could find to be lacking.

4.2.3 ANALYSING THE PROPOSITIONS

Yin (2003) identified two analytic strategies to analyse the data collected during the case study. The first strategy entails the development of a framework for the case study description. This framework helps organize the gathered data for each case. The second strategy analyses the data based on the theoretical propositions determined in paragraph 4.2.2. Given that propositions are already defined, the data can be analysed according to the second strategy.

In addition the theoretic framework can be used to make the empirical data and propositions easier to interpret. For instance, the institutional analysis can provide information on how the four tasks of the regulator are organised formally, thus the formal ability and will peers have to regulate one another. However, it can also provide insights in how the informal layers might compliment or constrain the formal ability and willingness of the peers. On top of that, the sanction pyramid can also give insight into the responsiveness of peers to sanction one another. Furthermore, the actor network theory can provide insights into the willingness of peers to regulate one another. Actor network theory identifies the relationships between the peers and specifies differences in interests and power positions. As a result it can help identify the extent to which the peers share the goal of wanting to monitor each other in the SGP.

If the empirical research shows that the peers are both willing and able to regulate one another, it can either mean two things. One, peer monitoring within the SGP was in fact effective despite its appearance and other factors contributed to moral hazard. Two, factors outside of the research scope are important to make peer-monitoring work in the EU. In the event that the empirical research does not support (one of) these claims, the conditions for peer monitoring to work are not met.

4.2.4 DATA COLLECTION AND DOCUMENTATION

Stake (1995) and Yin (2003) identified six sources of data: documents, archival records, interviews, direct observations, participant-observation and physical artefacts. Not every source is always relevant for a case study; each source offers its advantages and disadvantages. Hence, it is important to select the sources that are of most value to the case study. However, to determine this value, it is first of all important to identify what type of information is needed to answer the research questions.

Case study information needs and structure

Because the case study analyses the member states (the peers), the interactions between them and the system in which they regulate one another, the following topics need to be discussed in the empirical study:
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- The peer arrangement: what did the peer arrangement of the member states look like?
- Regulatory tasks within the SGP: how is each regulatory task organised in the SGP?
- Institutional context: what is the institutional context of the SGP and, more specifically, what informal and formal institutional factors play a role in the operation of the peer arrangement?
- Fiscal behaviour of the three member states during crisis: what risks did the member states take and why?
- Reaction of member states to the risks of the three member states: who acknowledged the risks of the member states and how could and did they react to this?

Selecting sources
With the data needs identified, the appropriateness and availability of each of the six sources of data can be considered. Documents can be policy documents, newspaper articles, scholarly literature, memoranda etc. The advantage of using documents is that they provide broad coverage of information and can be reviewed repeatedly. The disadvantage is that the reporting can be biased and the access might be limited or even blocked. Examples of archival reports are ministry records and statistical data. These reports can be quantitative and precise as opposed to documents, but like documents accessibility can be difficult to access. Interviews have the advantage of being targeted and providing a wide range of information. Furthermore, the interview can be steered so that all the questions are answered. A disadvantage of interviews is that responses can be biased. Moreover, the respondent might not be willing to answer the question or could even be unable to answer the question due to bad recall. Direct observations can be a source of information when field visits are conducted. This source of information is especially useful for gathering information on the object of study in a contextual situation. However, direct observations can be very time consuming and the observed object might react differently due to the observation. In participant-observations the researcher becomes an active part in the object of study. This source has the same advantages as direct observations, but can also provide insights into interpersonal relationships. The disadvantage of this type of source is that the researcher might influence the course of events. The last type of source is an artefact, which can be tools, instruments or other physical evidence. Physical artefacts are favourable when observing technical operations or cultures. However, they have the disadvantage of being selective and not always available.

To increase the reliability of the case study and prevent tunnel vision, multiple sources should be used in the case study. In this specific case study artefacts are not really relevant and direct and participant observations are too time consuming and require access into organizations that is currently not feasible. Documents and archival records, however, are accessible. In addition, a few interviews can be set up.

Collecting data
Besides identifying the sources that will be used to extract data, it is important to discuss how this data will be collected and stored. First of all, documents and archival records will both be gathered by means of a systematic desk research. Literature for the theoretical framework was found by consulting several books and using search engines, like Scopus and Web of Science. Examples of keywords used in these engines are ‘regulation’, ‘agency theory’, ‘moral hazard’, ‘monitoring’, ‘peer monitoring’, ‘market discipline’,
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‘enforcement’, ‘agency networks’, ‘European Union’, ‘Stability Growth Pact’ and ‘institutional framework’. The articles found with these initial key words identified more key words, like ‘responsive regulation’, ‘compliance’, ‘European Monetary Union’ and ‘incentives’. Articles in the search results were selected on their amount of citations and their general applicability of the article to the case of the European Union. Besides scholarly search engines, several websites and online databases were consulted for more specific information on the EU. The online database of Eurostat and OECD were used to gather statistics on individual member states and the European Union. Websites like EurActiv, EUobserver, Europe and EUBusiness provided much information about the SGP and the supranational actors involved. European think tanks also offered useful information; many of their reports are accessible on their websites. Besides that, websites from national governments were consulted as well as national newspapers. Interviews were arranged via personal acquaintances and professors at the faculty of TPM in Delft. Each interviewee was, furthermore, asked if he or she knows anybody else that could be interviewed. All interviews were semi-structured; meaning that they started open and then if needed became more structured. On top of that all interviews were recorded if allowed and sent back to the interviewee for reviewing.

4.2.5 PLANNING FOR CREDIBILITY

In order for a case study to be scientifically convincing and credible, a certain set of requirements needs to be met. The most important requirements according to Yin (2003) are: construct validity, internal validity, external validity and reliability. Construct validity concerns the degree in which the case study evidence supports the intended interpretation of the propositions. One way to increase construct validity is by using multiple sources of information. This research project aims to meets this requirement by using several sources of information, namely documents, archives and interviews. A second way to improve construct validity is by having the draft version of the case study reviewed by a key informant. This way possible misunderstandings can be avoided. A possible key informant could be another researcher at the TU Delft or interviewees. A third way to improve the construct validity is by maintaining a chain of evidence so that an external observer can examine the research process from the initial research question to the final results of the case study. This criteria could be met by constructing the report of the research project in such a way that the observer is carefully taken through the research process and the findings. Internal validity is especially important when a case study is used to determine causal relationships. It concerns the degree in which one can be sure that event y is caused by event x. Internal validity is therefore only important for explanatory case studies and is not important in exploratory and descriptive case studies. External validity concerns the degree in which the results can be generalised for the entire population. In other words, do the results on the peer interactions and three member states apply for all member states? In a case study with multiple cases replication logic can increase external validity. This means that each case study should be used to replicate previous cases or to expand emergent theory. The last conceptual requirement is reliability. Providing good documentation of the case study research via a case study protocol and database makes the case study replicable and shows that the case study is reliable. A protocol also provides a researcher with an overview of research steps and what needs to be done (see Figure 6).
Besides the conceptual requirements, certain soft requirements also must be met; a scientifically credible case study does not mean that the reader is also convinced. Abell (1997) defined five soft success factors that can be applied to all forms of case study research, namely relevance for the audience, voyage of discovery, controversies, include all necessary data but not too much, and the formal structure and elaboration. Relevance for the audience concerns the need for the research topic to be described in such a way that the readers deem it as important. Voyage of discovery means that the reader must be taken on a journey through the research project whereby all supporting, unexpected and contradicting findings are discussed in an attractive way that makes the reader want to continue reading. The requirement controversies mean that the research project should also discuss the contradictory findings. This will help make the findings more realistic for the reader. The fourth criteria might be self-evident, but it often happens that a researcher is so entrenched in its research project that it finds all data important and wants to include everything making the research report unreadable. The last criteria formal structure and elaboration means that the report should be written in a structured way and topics should be elaborated on sufficiently but not too much.

4.3 OVERVIEW OF RESEARCH PHASES

With the research approach and methodology explained, an overview can be created of the different research phases (see Figure 7). The research consists of three parts. The first part entails a literature study, which was already described in chapter 3. It discusses all the literature relevant to this research project and provided propositions for the case study analysis. Moreover, it provided insights as to what should be considered when analysing the case analysis. The second part of the research focuses on the case analysis of the research project, it contains the empirical part of the study. On the one hand this analysis focuses on the peer arrangement in the SGP, it describes how the system functioned. On the other hand the analysis looks at the member states, what risks they took, who acknowledged these risks and how they reacted to these risks. Ultimately this analysis will confirm or deny the propositions and provide insights into the actual
Peer monitoring and its capacity to decrease negative effects of moral hazard

functioning of peer monitoring within the EU. Based on the conclusions from the analysis, improvement to peer monitoring will be explored in part three of the research project.

Figure 7: Research overview
PART II
RESEARCH SYSTEM ANALYSIS
5. The Set-up of the SGP

This chapter marks the beginning of the empirical part of this research project, which starts off by describing the formal peer arrangement in the SGP as it was until the crisis. This analysis will provide insight in the moral hazard issues within the EMU, the organisation of the four regulatory tasks in the SGP as well as the institutional context of the SGP. Eventually this chapter will provide insight in the consequences of the formal regulatory set-up and its environment for peer monitoring and its capacity to prevent negative effects from moral hazard.

Paragraph 5.1 starts off by describing how the member states were confronted with moral hazard and adverse selection issues when they created the EMU. Paragraph 5.2 explains how peer monitoring was established to prevent negative damage due to moral hazard. After that, paragraph 5.3 describes how the four regulatory tasks are organised in the SGP, which is followed by a description of the regulatory strategy of the SGP in paragraph 5.4. Paragraph 5.5 gives an overview of all the institutional factors that have been played a role throughout the SGP’s life until the crisis. Finally, this chapter will end with a conclusion about the peer arrangement and its context and, more specifically, what this means for the propositions.

5.1 Moral Hazard due to Euro Insurance

When the Maastricht Treaty was established in 1992, the twelve member states at the time set out on a path to introduce a common currency, the Euro. A common currency would bring Europe several economic advantages like the abolishment of fluctuating exchange rates, the creation of a strong global currency, the simplification of price comparisons and the stimulation of a stable economy within the EU (Rijksoverheid, n.d.) (for more information see Appendix A). However, a common currency also introduced new challenges in the form of macro-economic policy coordination. The member states, especially the euro-countries, would now share the responsibility of maintaining a stable currency.

Part of these challenges were anticipated when the three phase plan for the European Monetary Union (EMU) was created (Grieco, 1995). This plan involved the creation of the European Central Bank (ECB) that would be responsible for monetary policy. Whereby the main goal would be to ensure stability of the euro. Another measure adopted in the EMU plan was to have the member states that wanted to adopt the Euro meet certain convergence criteria (for more information see Appendix A). These criteria would align the different economic policies of the member states so that the transition to the Euro would run smoothly. Part of these convergence criteria was to limit the member states to a deficit to GDP ratio of 3% or less and a debt to GDP ratio of 60% or less.

However, as the member states were busy with meeting the convergence criteria, they realised that a form of fiscal policy would be required after the introduction of the Euro as well (Brunila, Buti, & Franco, 2001). They realised that the removal of exchange rates would give the financial markets reduced means to discipline the fiscal behaviour of governments. Moreover, it was very likely that higher interest rates on borrowing would not only merely be held by the borrowing member state, but would to some extent spread over the entire currency, and that excessive borrowing in one member
state would be more likely to spill over into the other (Morris et al., 2006). In other words, a government would not carry their own fiscal risks independently any more, but they would be carried by all the governments that were part of the EU, especially the euro-countries. Together they would become owners of the Euro. This collective risk bearing meant that the Euro would introduce a form of insurance for a government’s fiscal risk, which could incentivise a member state to take on more fiscal risks.

Now is the introduction of collective risk bearing not enough to cause moral hazard or adverse selection, but the member states were also faced with problems of information asymmetry and conflicting goals. Member states had a history of rarely directly agreeing with one another in the Council; member states changed from coalition based on the policy area being discussed, but member states also changed standpoints within policy area due domestic policy changes (Middlemas & Crowe, 1995). On top of that, the quality of statistics and administration differed significantly (Everson, Majone, Metcalfe, & Schout, 1999). Even though Eurostat had been stimulating cooperation and harmonisation between national statistics agencies, the agencies did not necessarily share fiscal data or apply the same methods and procedures to gather and analyse the data. Moreover, coordination on topics that did not have a legal framework was difficult due to confidentiality reasons (Sverdrup, 2005).

5.2 Peer Arrangements in the SGP

As the member states came to realise that the euro would create the conditions for moral hazard or adverse selection, they decided that a European fiscal policy would be required. As a result, they agreed to the SGP, which would establish peer monitoring as the primary form of regulation.

Legal basis

In June 1997 the European Council established the political basis for a Stability and Growth Pact that would coordinate fiscal policy among member states, known as the Resolution of the European Council on the Stability and Growth Pact, Amsterdam, 17 June 1997. This resolution lay down the organisation of fiscal policy in the EU and the roles that the Council, the Commission and the Member States would have to perform (European Commission Economic and Financial Affairs, 2012).

Currently, the legal basis of the SGP can be found in articles 121 and 126 of the Treaty on the Functioning of European Union (TFEU), also known as the Treaty of Lisbon. Article 121 legalises the process of surveillance of fiscal behaviour of the member states and article 126 legalises the process for an excessive deficit procedure (EDP). The Pact consisted of a so-called preventive arm and corrective arm, whereby the preventive arm applied to all member states and the corrective arm only applied to member states with the Euro. The goal of the preventive arm was to prevent excessive deficits by monitoring and coordinating fiscal behaviour and policy in member states and the goal of the corrective arm was to correct any excessive deficits according to rules that are laid down in the EDP (European Commission Economic and Financial Affairs, 2012). What these rules were was specified in
protocol 12 that was attached to the TFEU. It stipulates that the deficit can be no more than 3% of a member states GDP and/or a sovereign debt can be no more than 60% of a member states GDP. Thus, part of the convergence criteria of EMU had become the norms of the SGP.

**Peer arrangement**

According to the legal provision of the SGP, the Commission and the Council together have the role of the regulator. The Commission is responsible for the collection and judgement of data from member states (thereby also interpreting the norms) and the Council is responsible for sanctioning member states when needed. Consequently, the Commission and the Council can together be classified as the principal and the member states as the agents (see figure 8), while the SGP can be seen as the contract that manages the relationship between the principal and the agent. However, as each member state is represented in the Council, each member state or agent is in fact also partly the principal. In other words, the fiscal behaviour of a member state is monitored by its peers.

![Figure 8: The principal agent relationship in the SGP](image_url)

**Other moral hazard relevant regulatory measures**

Besides the SGP, the Maastricht Treaty also stipulated two other rules that would discipline the member states fiscal behaviour (Bagus, 2010). Article 101 contained the first rule, which stated that member states were not allowed to finance their debt via the system of European System of Central Banks (ESCB), which is composed of the European Central Bank (ECB) and the national central banks (NCBs). The ESCB was responsible for monetary policy, which primary aim was to safeguard stability. By prohibiting governments from borrowing from the ESCB, fiscal and monetary policy remained separate and excessive borrowing could not directly harm the stability of the monetary union. The other rule was adopted in article 103 of the Maastricht Treaty and was also referred to as the “no bail out clause”. This clause stated that the Union and the member states would not be liable for the financial commitments of another member state. This rule would encourage financial markets to value the debt instruments for each individual member state.

**5.3 REGULATORY TASKS**

The provisions of the SGP established a rule base framework, which contained procedures for each of the four regulatory tasks. It is important to understand how each regulatory task is organised as it can
provide insights into the propositions formed to analyse the capacity of peer monitoring arrangements to deal with negative effects of moral hazard.

5.3.1. Setting the Norms

In the provisions of the SGP two norms are defined: the 3% deficit to GDP ratio and the 60% debt to GDP ratio. Both norms are also part of the convergence criteria that member states need to meet to adopt the euro. These norms were considered important during the establishment of the Maastricht Treaty, because most euro-countries had shown a trend between the years of 1977 and 1991 of accumulating debt and running persistent deficits (Morris et al., 2006). On average the euro-countries of that time had a deficit of above 4% and a sovereign debt that on average increased from 30% to almost 60% (see Figure 9). Luxembourg and Finland were the only countries that did not have persistent deficits; Luxembourg even reduced its debt.

### Table 1: Deficit and spending biases: fiscal developments in the euro area, United States and Japan, 1977-1991

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<th>Change</th>
<th>Total expenditure</th>
<th>Change</th>
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Figure 9: Fiscal developments of Euro countries before the Maastricht Treaty (Morris et al., 2006)

These deficit and debt ratios improved after the Maastricht Treaty was signed, because most countries were in favour of adopting the euro. Figure 10 shows that the deficits and debt levels of most countries improved over time and were below the norms in 2002. However, despite the improvements in fiscal balances concerns remained that after the introduction of the Euro member states would fall back into their old patterns of accumulating debt and running deficits (Briotti, 2004). As a result, member states agreed to make the 3% deficit to GDP ratio and the 60% debt to GDP ratio the norms of the SGP as well. These norms were adopted in the EDP and were stipulated as follows:

- The government deficit to GDP ratio may not exceed 3% at the end of the preceding fiscal year. If this criteria cannot be met it must at least be close to 3%, only exceptional or temporary deficit excesses can be exempted from this criterion.
The gross government debt to GDP may not exceed 60% at the end of the preceding fiscal year. In the event that the ratio cannot be achieved due to specific conditions, the ratio must have decreased at a satisfactory pace.

From these norms it was most difficult to violate the 3% deficit norm. It could only be crossed by a member state under exceptional circumstances, which was defined as an annual fall in real GDP of 2%. In some cases an annual fall in real GDP between 0.75% and 2% was also considered exceptional, although the member states would have to provide evidence that showcased the abruptness of the downturn as well as the accumulated output loss. The 60% debt to GDP ratio norm was less hard (Strauch, 2004); it was encouraged, but the member states did not necessarily need to meet the 60% debt norm as long as they could show that their debt levels were decreasing at a satisfactory pace. What a satisfactory pace meant was furthermore never quantified. This lack of quantification provides allows for a flexible interpretation of the debt norm and, therefore, provides the peers’ with some breathing room.

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Source: European Commission, spring 2003, and own calculations.
Note: Data exclude proceedings from the sale of UNMS licenses.

Figure 10: Fiscal improvement leading up the Euro (Briotti, 2004).

5.3.2. Collecting Data

In order to uphold the SGP statistical data is gathered to calculate a government’s deficit and debt to GDP ratios. This statistical data is required for the ex-post assessment of a government’s fiscal performance, more specifically; it shows whether a government has indeed complied with the norms. Eurostat, a Directorate General of the Commission, is charged with the responsibility of gathering this data. However, even though Eurostat is formally charged with this responsibility, it heavily relies on national statistics agencies to collect the data (Sverdrup, 2005). Eurostat oversees that the data is collected in a timely manner and is of the same quality. To this end all national statistics agencies need...
to gather the same data with the same methods and procedures as stated in ESA95, the European System of Accounting. To stimulate this Eurostat organises meetings with the members from the agencies. In some cases Eurostat may visit a national statistics agency to address methodological issues or data quality issues (Eurostat, 2012a, 2013a).

In addition to the statistical data, the Directorate General of Economic and Monetary Affairs gathers information from member states concerning their current and planned economic and fiscal policies. To ensure that the information from the member states is comparable and handed in in a timely manner, they have to hand in so-called convergence or stability program on an annual basis. The content guidelines and format of these programs is identical; the name merely indicates whether the program has been filled out by a Euro or non-Euro member state. Euro countries fill out stability programs, while non-Euro countries fill out convergence programs. Both programmes contain the following information:

- The medium term objective (MTO), which is the budgetary goal of the member state for at least the coming three years. Moreover, they have to describe a year-by-year adjustment path towards the MTO and the annual expected debt and deficit ratio’s leading up to the MTO;
- The assumptions made when constructing the programme (e.g. oil price, GDP growth, export performance, inflation rate, interest rate, employment rate etc.);
- A description and assessment of the policy measures that will help achieve the MTO;
- A sensitivity analysis of how changes in the assumptions influence the feasibility of the MTO;
- Budgetary information covering the previous years, the current year and plans for the coming three years;
- And non-Euro countries also have to describe the relationship between their MTO and price and exchange rates (European Commission, 2013b)

Central in these programs is the so-called “medium-term objective” (MTO) of fiscal policy. This objective was originally defined as “close to balance or in surplus.” The reason for this was to ensure that governments would have sustainable fiscal positions in the long term as well as have room to fluctuate in the short term without exceeding the 3% norm. However, in the first years of the pact this definition of the MTO received a lot of criticism, because the MTO did not consider the circumstances of each individual member state. Having governments with different debt levels aim for the same MTO seemed nonsensical (Morris et al., 2006). Consequently the definition of the MTO was amended in 2005. Member states could now hand in their own country specific MTO’s. They were allowed to diverge from a close to balance or in surplus position as long as the member state had build in a safety margin with respect to the 3% norm and aimed for a swift transition towards sustainable financing (Marzinotto & Sapir, 2012).

Another important part of the stability and convergence programs was the adjustment path towards the MTO. This adjustment path contained a plan with target dates of how the member state was going to reach a “close to balance or in surplus” MTO. However, when the definition of the MTO was amended in 2005, the interpretation of the adjustment path was amended too. In short it meant that the adjustment path now entailed a commitment from the member states to improve the underlying
fiscal balances by at least 0.5% of GDP instead of having each member state reach planned targets. The amendments in 2005 furthermore stated that effort of a member state to improve its fiscal balances could be less in bad times, but should be greater in economic good times. Economic good times where hereby defined as “periods where output exceeds its potential level, taking into account tax elasticities” (Code of Conduct, 2012, p. 6). In the event that a member state did deviate from its adjustment path it also had to explain why in their program. The amendment furthermore specified that a member state could deviate from the MTO or adjustment path if it was implementing structural reforms, which had “direct long-term cost-saving effects, including raising potential growth, and therefore a verifiable positive impact on the long-term sustainability of public finances” (Code of Conduct, 2012, p. 7).

In essence, sub-state actors organise the supply of information. Their finance or budget ministries construct the annual stability and convergence programmes, whilst the national statistics agencies gather the statistical data needed to verify past fiscal performance. Member states determine what information its peers will review; it is thus not the case that each member state gathers its own information about all of its peers. This is probably due to transaction costs advantages and objectivity and harmonisation issues. By allowing each member state to organise their own supply of information and giving each member state a year to do so, provides the member states with a certain amount of room to behave within the peer arrangement.

Another remark can be made when looking at the organisation of data collection and Majone’s argument for transnational regulatory networks, described in the theoretic framework, and that is that Eurostat and the national statistics agencies appear to form such a transnational regulatory network. However, whether there is mutual trust, a high level of professionalization and a common regulatory philosophy is unknown at this stage.

5.3.3. JUDGING DATA
When the Commission (more specifically the Directorate General of Economic and Monetary Affairs) receives the programmes from the member state and the statistical data from Eurostat, they can start their assessment. This assessment focuses on the MTOs and evaluates the appropriateness of the MTO, the current position of the member state in relation to their MTO, and the validity of the economic assumptions (European Commission Economic and Financial Affairs, 2012; European Commission, 2013b). The programmes are used for an ex ante assessment, which analyses the current and coming years. The statistical data from Eurostat is used to perform an ex post assessment of the previous years, which checks whether a member state did actually comply with the norms in previous years. Based on both assessments the Commission publicises its assessment about each member state (European Commission, 2013b). Besides that, the Commission formulates a recommendation for the Council as to what action would be appropriate for the Council to take.

These recommendations state whether the member state is in compliance with the norms, is on a path that deviates from the MTO or exceeds the norms. In the event that a member state complies with the norms the Commission will recommend the Council to take no action. However, if the member state deviates from the development path the Commission can advise the Council to issue an
“early warning”. Furthermore, the Commission as of 2005 can also directly give a member state that deviates from its development path policy advise on the broad implications of their fiscal policies (European Commission, 2011). In the event that a member state is not in compliance with the norms, the Commission will issue an advice to the Council to start an Excessive Deficit Procedure (EDP). If an EDP has already been launched, the Commission will assess whether the member state has put in enough corrective effort. This assessment is also made public and will result in a recommendation to the Council, where the Commission advises the Council to either abrogate the EDP or step up the EDP.

All in all, the judgement of the Commission can be classified as discretionary, because each judgement is not an automatic gun, but results in a recommendation to the Council. Even though the Council must take these recommendations seriously and cannot simply deviate from these recommendations, it does provide the peers with a certain amount of room to form their own opinion and determine a sanction.

5.3.4. SANCTIONS
Upon recommendation from the Commission, the Council can decide with a qualitative majority vote whether a member state fulfils the SGP criteria. In essence, the Council has three types of sanctions: recommendation, early warning and fiscal penalty. What sanction a member state receives depends on the type of violation and whether this violation is detected in the ex-ante or ex-post assessment.

If the ex-ante assessment shows that the MTO and adjustment path towards the MTO have been violated, the Council can give a member state country specific recommendations to prevent the member state from running excessive deficits. Furthermore, if the ex-post assessment shows that a member state significantly deviated from their planned path towards the MTO, the Council can give the member state an early warning. This is also referred to as the ‘early-warning procedure’ (European Commission, 2011). Thus, only soft sanctions can be handed out for violations of the ex-ante assessment.

If the ex-post assessment shows that a Euro-member is in violation of the 3% deficit to GDP ratio or does not have a debt to GDP ratio that is diminishing at a satisfactory pace, the Council can decide to start an excessive deficit procedure (EDP) against a member state as outlined in article 126 of the Treaty of the Functioning of the European Union (TFEU). In the EDP the Council has up to 4 months (before the amendments in 2005 this was 3 months) to give the Euro-country a recommendation after detection of the violation. The Euro-country then in general has a year to implement the recommendations, however, if the member state falls under the category special circumstances the implementation deadline can be extended (Morris et al., 2006). After this period the Commission and the Council evaluate the effort of the member state in question. In the event that a member state has corrected the excessive deficit, the EDP is ended. If a member state has not corrected their excessive deficits, the Council can decide to send a member state a notice, which often contains revised recommendations and extends the implementation deadline. However, if a member state has not implemented any corrective action at all, the Council can impose a non-interest-bearing deposit on a member state. This deposit can turn into a fine if the member state shows another two-year period of
non-compliance (European Commission, 2013c). In other words, member states only consider a fiscal penalty after three years of non-compliance with the peer arrangement.

![Sanction pyramid of the SGP](image)

**Figure 11: Sanction pyramid of the SGP**

The sanctions that the peers have to discipline one another and the procedure used to apply them provide the peers again with a certain amount of room to behave within the peer arrangement. A violation of the arrangement is mostly met with recommendation and warnings. Fiscal sanctions are only given after several years of non-compliance. This means that the actual threat of sanctions is always several years away and that peers have a wide time frame to decide how they want to balance their national fiscal interests with the collective interest of the SGP.

When comparing the sanctions to Ayres and Braithwate (1992) sanction pyramid (see figure 11) another question can be raised and that is whether the current pyramid of the SGP has enough shadow of hierarchy. This comparison shows that the peers mostly have soft sanctions to discipline each other (recommendations and warnings) and only one hard sanction. Ayres and Braithwate (1992) argue that regulators need several hard sanctions to able to put enough pressure on regulatees to comply with the norms. The fact that the SGP offers the peers only one hard sanction suggests that they can’t put enough pressure on each other to comply with the norms. Moreover, the fact that this hard sanction is only considered after several years of non-compliance suggests that this pressure is non-existent in the first few years of violation.

### 5.3.5. PEERS VERSUS REGULATORY TASKS

The analysis of the regulatory tasks clearly shows that the execution of the regulatory tasks involves several actors. A first glance might suggest that the Commission and the Council perform their first tasks independently; a closer look shows that the tasks are an interplay between the member states and the Commission. The Commission, for instance, interprets the norms, whilst the member states determine what these norms are. Moreover, the Commission relies on national ministries and statistics agencies for the execution of the regulatory task of data collection. The Council on the other hand might be responsible for choosing an appropriate sanction; it does have to base its decision on the
recommendations from the Commission. In essence, the enforcement of the SGP involves cooperation between supranational actors and national actors.

The regulatory tasks also showed that each task offers the peers a certain amount of room to behave or influence the execution of the SGP. Table 3 on the next page describes how each task offers peers certain degrees of freedom to influence the enforcement of the SGP or to play with their fiscal behaviour and balance their national interests with the collective interests.

Table 3: Room offered to peers by each task

<table>
<thead>
<tr>
<th>Room offered to peers</th>
<th>Norm Setting</th>
<th>Collecting Data</th>
<th>Judging Data</th>
<th>Sanctioning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Able to play with debt levels due to flexible interpretation of the 60% norm</td>
<td>Freedom to collects its own data for the SGP</td>
<td>Judgement does not turn into automatic sanction. Room for peers to interpret the information</td>
<td>Wide timeframe to correct fiscal behaviour. Fiscal sanction only considered after several years of non-compliance</td>
<td></td>
</tr>
</tbody>
</table>

5.4 REGULATORY STRATEGY

With each regulatory task described, the regulatory strategy of the SGP can be described. When comparing the four regulatory strategies to the regulatory system of the SGP, then it would seem that its regulatory strategy has elements of a command regulation with discretionary punishment, but also has elements of self-regulation (see Figure 12).

Figure 12: Regulatory Strategy of the SGP

It is similar to command regulation with discretionary punishment, because the SGP sets a clear command to keep the deficits of member states below a certain threshold. The SGP furthermore entails a control because it monitors and enforces the command. The sanctions can furthermore be seen as discretionary punishments, because they are determined according to the severity of the violation. However, the regulatory strategy of the SGP could also be described as self-regulation, because the member states have decided to regulate one another themselves. The commission only has a supporting role in the enforcement of the SGP. That been said, the regulatory strategy of the SGP can only become clear by studying the actual functioning of the peer arrangement. The case analysis should therefore provide more insight into the regulatory strategy of the peer arrangement.
5.5 **The institutional context of the SGP**

Before moving onto the functioning of the peer arrangement in the crisis, it is also important to consider the institutional context of the peer arrangement. Both regulatory and institutional theory states that this context is important, because it can constrain the performance of enforcement. Moreover, it can provide an understanding of the institutions that play a role in the peer-to-peer interactions. Note that paragraph 5.2 already described some formal institutions that are part of the institutional context of the SGP, namely the no-bail-out clause and the separation of fiscal and monetary policy (see figure 13). To get an overview of the institutional context of the SGP, the theoretic framework argued to use the institutional framework of Koppenjan & Groenewegen (see Figure 5). The theoretic framework also mentioned that the different theories within international relations and European studies can find different institutions important in each layer. As a result three different levels of analysis are considered in each layer, namely the system level, the national level and the individual level. Therefore, each layer will describe how it dealt with these three levels of analyses. The institutional analysis will start with the bottom layer (layer 1) and will then work its way up.

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**Figure 13: Institutional context discovered so far**

**Layer 1: The multi-actor network of the SGP**

This layer specifically focuses on the actors that are involved in the SGP. Regulatory theory mentions that enforcement involves a network of actors, these actors can be supranational actors and governments, but can also involve domestic actors and individuals. In other words, all three levels of analysis can be relevant in this layer, although it can be difficult to point out important individuals without having described the peer interactions during the crisis. As a result, the system and national level were both taken into account in this layer. Furthermore, this layer considered the actors directly or indirectly involved in the functioning of the SGP, their interdependencies and their powers. Moreover, it considers how the multi-actor network of the peer arrangement might have changed over time. The following factors showed to be important for the functioning of the peer arrangement in the SGP when just analysing the member states:
The Set-Up of the SGP

- The amount of (Euro) member states changes over time: When the SGP was initiated in 1997 there were fifteen member states in total: Belgium, Germany, France, Italy, Luxembourg, the Netherlands, Denmark, Ireland, the United Kingdom, Greece, Portugal, Spain, Finland, Sweden and Austria (Hay & Menon, 2007). Three from these member states, Denmark, the United Kingdom, and Sweden, did not adopt the euro and, therefore, do not fall under the EDP. In 2004 the EU was joined by Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia (Hay & Menon, 2007). The last additions were Romania and Bulgaria in 2007. From these latest additions the countries Cyprus, Estonia, Slovakia and Slovenia have adopted the euro and therefore they also can receive fiscal sanctions under the EDP. Thus currently there are 27 member states of which 17 have adopted the euro. Table 4 provides an overview of when each of the 17 Euro countries adopted the euro as their currency. For peer monitoring this means that the group of peers has evolved from the initiation of the SGP in 1999 until now and that this should be taken into consideration when performing the case analysis of the crisis. The size and formation of the group of peers might have an effect on the functioning of the peer arrangement in the SGP.

Table 4: Timeline of Euro adoption (Commission, 2013a)

<table>
<thead>
<tr>
<th>Year</th>
<th>Who adopted the euro when?</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>Belgium, Germany, Ireland, Spain, France, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland</td>
</tr>
<tr>
<td>2001</td>
<td>Greece</td>
</tr>
<tr>
<td>2002</td>
<td>Introduction of euro banknotes and coins</td>
</tr>
<tr>
<td>2007</td>
<td>Slovenia</td>
</tr>
<tr>
<td>2008</td>
<td>Cyprus, Malta</td>
</tr>
<tr>
<td>2009</td>
<td>Slovakia</td>
</tr>
<tr>
<td>2011</td>
<td>Estonia</td>
</tr>
</tbody>
</table>

- Member states have differing bargaining power: The amount of votes a member state has in the Council depends on the amount of citizens it has. The more citizens, the more votes the country gets. Table 5 on the next page shows how the voting power has been divided amongst the member states from 1999 until the crisis hit in 2009. In general there are four large member states (France, Germany, UK and Italy) followed by medium to small size member states of which Spain and Poland are only slightly smaller than the four large member states, but the rest is significantly smaller (Heipertz et al., 2010). This means that in this specific peer arrangement, peers do not have an equal say. Consequently, they have differing powers to act. This also means that some member states will have to look for more coalition partners than others to block or enforce a sanction. This means that no member state by itself can enforce compliance.
Table 5: Council votes per Member State over time (Hay & Menon, 2007, p. 178/179)

<table>
<thead>
<tr>
<th>Blue = member states that are not subject to fiscal penalty</th>
<th>Fourth enlargement 1995</th>
<th>Fifth enlargement 1 May 2004</th>
<th>Nice Treaty 1 November 2004</th>
<th>Sixth Enlargement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>5</td>
<td>5</td>
<td>12</td>
<td>12</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>5</td>
<td>5</td>
<td>13</td>
<td>13</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>2</td>
<td>2</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>France</td>
<td>10</td>
<td>10</td>
<td>29</td>
<td>29</td>
</tr>
<tr>
<td>Germany</td>
<td>10</td>
<td>10</td>
<td>29</td>
<td>29</td>
</tr>
<tr>
<td>Italy</td>
<td>10</td>
<td>10</td>
<td>29</td>
<td>29</td>
</tr>
<tr>
<td>UK</td>
<td>10</td>
<td>10</td>
<td>29</td>
<td>29</td>
</tr>
<tr>
<td>Denmark</td>
<td>3</td>
<td>3</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>Ireland</td>
<td>3</td>
<td>3</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>Greece</td>
<td>5</td>
<td>5</td>
<td>12</td>
<td>12</td>
</tr>
<tr>
<td>Spain</td>
<td>8</td>
<td>8</td>
<td>27</td>
<td>27</td>
</tr>
<tr>
<td>Portugal</td>
<td>5</td>
<td>5</td>
<td>13</td>
<td>12</td>
</tr>
<tr>
<td>Sweden</td>
<td>4</td>
<td>4</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Finland</td>
<td>3</td>
<td>3</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>Austria</td>
<td>4</td>
<td>4</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Poland</td>
<td></td>
<td>8</td>
<td>27</td>
<td>27</td>
</tr>
<tr>
<td>Hungary</td>
<td>5</td>
<td>5</td>
<td>13</td>
<td>12</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>5</td>
<td>12</td>
<td>12</td>
<td></td>
</tr>
<tr>
<td>Lithuania</td>
<td>3</td>
<td>7</td>
<td>7</td>
<td></td>
</tr>
<tr>
<td>Slovakia</td>
<td>3</td>
<td>7</td>
<td>7</td>
<td></td>
</tr>
<tr>
<td>Cyprus</td>
<td>2</td>
<td>4</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>Estonia</td>
<td>3</td>
<td>4</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>Latvia</td>
<td>3</td>
<td>4</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>Slovakia</td>
<td>3</td>
<td>4</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>Slovenia</td>
<td>3</td>
<td>4</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>Malta</td>
<td>2</td>
<td>3</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Romania</td>
<td></td>
<td></td>
<td></td>
<td>14</td>
</tr>
<tr>
<td>Bulgaria</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No. of member states</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total number of votes</td>
<td>15 in total, 12 with euro</td>
<td>25 in total, 22 with euro</td>
<td>25 in total, 22 with euro</td>
<td>27 in total, 24 with euro</td>
</tr>
<tr>
<td>Qualified majority (as % of total vote)</td>
<td>87</td>
<td>124</td>
<td>321</td>
<td>345</td>
</tr>
<tr>
<td>Blocking minority (as % of total vote)</td>
<td>62</td>
<td>88</td>
<td>232</td>
<td>258</td>
</tr>
<tr>
<td>Votes for EDP</td>
<td>26</td>
<td>37</td>
<td>90</td>
<td>88</td>
</tr>
</tbody>
</table>

- **Sovereignty important interest of peers:** the European Union is a politically sensitive power play between supranational bodies (e.g. the Commission, the Court of Justice) and intergovernmental bodies (e.g. the Council) (Hay & Menon, 2007). To stimulate European integration national powers have been transferred to supranational bodies of the EU, as many areas require coordination at the EU level. That been said, member states also value their sovereignty. Sovereignty was also an important interest when member states were negotiating the design of the SGP. Having already transferred their monetary policy to the ECB during the set-up of EMU, member states wanted to keep fiscal policy under national jurisdiction. That is why member states couldn’t agree with the original draft of the Pact entailing fully automatic monetary sanctions for violations of the norms without any interference from the Council.
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(Stark, 2001). Instead member states agreed to determine sanctions according to the legislative framework of the EU (Bagus, 2010). This way the member states interest in sovereignty was safeguarded. However, in addition to that the interest in sovereignty also played an important role in the exchange of information. As a result Eurostat and the Directorate General of Economic and Monetary affairs had little means to interfere with the data collection of the member states. The Directorate General of Economic and Monetary affairs was only allowed to re-estimate a member states forecast in the event that recent developments showed them to be too optimistic (Strauch, 2004). Moreover, Eurostat was only allowed to determine legislation of data collection. This means that Eurostat and the Directorate General of Economic and Monetary affairs have little control over the quality of data from each state (Everson et al., 1999). Overall this shows that the interest in sovereignty can be very important and can have a big influence on the design of formal institutions (layer 2 and 3) in the EU and possibly also on the development of the crisis.

➢ **Peers interests constrained by domestic politics:** Governments are elected during national elections. During their election period they are confronted with public opinion, the opposition, but also intra-party competition (Heipertz et al., 2010). How they deal with these forces determines their popularity and the length of their election period. As a result, these three elements determine a governments interests and decision-making room, which in turn can also influence a member states interest in the SGP. The domestic political environment of member states can thus have an impact on how a peer takes part in the peer arrangement of the SGP.

➢ **Differing national statistic agencies results in differing quality of information:** The amount of resources that national statistics agencies have differs per member state (Schout, 2013). This has consequences for the speed of data collection as well as the accuracy of data. In essence, this means that the information that member states exchange in the SGP can be of a different quality. It also shows that the criterion of a high level of professionalization from Majone’s theory about transnational regulatory networks is not present.

Besides that, the following factors showed to be important when analysing EU bodies and other third parties:

➢ **Budgetary interdependency within the European Union:** Both Eurostat as well as the Directorate General of Economic and Monetary Affairs depend on the Commission for its resources, which in turn depends on budget that the Commission receives from the member states (Everson et al., 1999). Moreover, how these resources are divided amongst the directorate generals depends on the priority of policy areas. As a result, the Directorate Generals internally compete to increase the priority of their policy areas. How Eurostat and the Directorate General of Economic and Monetary Affairs deals with this internal competition influences their resources and therefore their ability to play their role in the SGP.

➢ **Regulatory lighthouses:** third parties also have an interest in the functioning of the SGP and the fiscal discipline of individual member states. First of all, the ECB has an interest in the SGP, because monetary policy is easier to safeguard when the member states retain some fiscal discipline. The ECB can openly criticise the functioning of the SGP, which can
influence the financial trust in the Euro. This criticism can, thus, put pressure on the member states and can incentivise peer monitoring. Besides that, credit rating agencies can also influence peer monitoring. Because they agencies give government bonds ratings, they can give member states an idea of the fiscal position of their fellow peers. Moreover, they can influence interest, which can stimulate a member state to retain some form of fiscal discipline.

In short, the institutional analysis of layer 1 shows that the enforcement of the SGP involves a regulatory network of supranational, trans state, state and sub state actors. Moreover, it shows that the degree of goal sharing and cohesiveness among the member states is very much dependent on the national actors and national political context. It, however, provides little information about the peer-to-peer interactions, and therefore confirms the necessity for a case analysis.

Layer 2: Formal & informal institutional arrangements

As figure 13 already showed, the peer arrangement of the SGP is part of this layer. However, there are two more factors that are important in this layer of which one was identified by studying the EU and macroeconomic policy and the other was found by studying national fiscal policy:

- **Peer pressure via the Broad Economic Policy Guidelines:** Another important part of the macroeconomic policy of the EU is the Broad Economic Policy Guidelines (BEPG). As opposed to the SGP it only offers member states the possibility to give each other recommendations to adjust their economic policy. It is however another arrangement in which member states can pressure each other. An example of where the BEPG was used to pressure a member state to change its economic policy was Ireland in January 2001 (Heipertz et al., 2010). The Council gave Ireland a recommendation to tighten its fiscal discipline to prevent increasing inflation. This shows that member states use the BEPG to regulate each other financial behaviour.

- **Differing fiscal policies between member states:** Each member state may forms its own fiscal rules and regulations. National fiscal policies of member states are not harmonised. As a result there are different expenditure rules, revenue rules and institutional set ups to execute and control fiscal policy. Some member states even have no fiscal rules (European Commission, 2012b). This means that within each member state there can be different national arrangements organising the fiscal behaviour of central and regional governments.

To sum up, this layer shows that the peer arrangement of the SGP is not only surrounded by institutions from other layers, but also by institutions in the same layer. Moreover, the institutions can be European institutions as well as national institutions. The peer arrangement case thus does not only involve a complex network of actors, but also a complex system of national and European formal arrangements. Figure 14 summarizes the findings from layer 1 and 2. It also mentions some institutions in layer 3 as formal arrangements in layer 2 have a legal basis. Therefore, this legal basis is already mentioned in layer 3 in figure 14.
## The Set-Up of the SGP

<table>
<thead>
<tr>
<th>System level</th>
<th>National level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Layer 4</td>
<td></td>
</tr>
<tr>
<td>Layer 3</td>
<td></td>
</tr>
<tr>
<td>Layer 2</td>
<td></td>
</tr>
<tr>
<td>Layer 1</td>
<td></td>
</tr>
</tbody>
</table>

**Figure 14: The institutional surrounding of the SGP so far**

### Layer 3: Formal institutional framework, rules and regulations

When analysing layer 2, several institutions were already identified for layer 3 (see figure 14), which focuses on the formal institutional framework, rules and regulations. However, more factors are important in this layer:

- **Principle of subsidiarity and proportionality**: The principle of subsidiarity and proportionality was adopted to regulate the power of the EU (Toth, 1992). The principle of subsidiarity means that the EU can only act in policy areas that do not fall within its exclusive competence “only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community.” (TEU, art 3b). The principal of proportionality means that EU institutions can only perform the actions, which are necessary to achieve the goals of the treaties (TEU, art 5.). These principles are again the result of the member states interest in sovereignty.

- **Co-decision of the European Parliament**: When the Treaty of Lisbon was adopted in 2009 (EurActiv, 2009) the European Parliament got the right of legislation, which means that they can either consent to or block a decision (Tacaks, 2013). Before that the European Parliament only had an advisory role in the process of legislation (EurActiv, 2009). This meant that from 2009 onwards the ECOFIN Council would need consent from the European Parliament to make changes to the SGP or other legislation.

- **Monetary Policy dependent on fiscal policy**: The ECB is responsible for the stability of the Euro, which is much easier to achieve when member states retain some fiscal discipline (Morris et al., 2006). The functioning of monetary policy is therefore dependent on the functioning of the SGP. If the SGP fails to function properly it is likely to constrain the effectiveness of monetary policy as well.

- **Some peers reject a European constitution**: In 2004 member states wanted to introduce the Treaty Establishing a European Constitution, however, France and The Netherlands rejected the Treaty in 2005. The rejection of the constitution is one of the moments in European
history that shows how citizens in member states can have different interests with respect to the EU (Tacaks, 2013) and can impact the formal design of the European Union. For the peer arrangement in the SGP this means that citizens can also have an impact on the formal arrangements of the SGP and any changes to them.

- **Differing national political systems:** Each member state has its own political system with its own checks and balances. Some member states have a central organised government, while others have a decentral organised government (Korsten et al., 1995). How the government is organised influences the balance of power in a nation, which in turn can influence the power of the heads of state whom take part in the Council. As a result, commitments of certain members in the Council can carry more weight than others.

Like layer 2, layer 3 shows that European institutions as well as national institutions are important. For instance, it illustrates changes to the European political framework, i.e. co-decision power of the European Parliament, and interdependencies within the European policy frameworks, i.e. monetary and fiscal policy. But it also shows that the national political system can have an effect on the European political system, e.g. the rejection of the European constitution or the influence of the balance of power in a nation on the power of heads of state in the Council.

**Layer 4: Embeddedness**

The final layer of the institutional framework focuses on the norms, values, traditions and culture surrounding the SGP. As Williamsons framework showed this layer changes least frequent of all the layers (between every 100 and 1000 years). As in the other layers, this layer needs to consider European as well as national institutions:

- **European embeddedness versus national embeddedness:** All member states have been a sovereign nation for several centuries and have their own historical background, religion, traditions, norms and values. Compared to the centuries that these countries were an independent sovereign nation, membership of the European Union is a relatively new phenomenon. Member states have been part of the EU for at most several decades (Hay & Menon, 2007), making it difficult to say whether membership in the EU is even part of the social and cultural embeddedness of a nation.

- **Tradition of goal conflict:** Europe is embedded in a society that has different cultures, political systems and views of Europe. It was established on a shared fear of war and poverty, but does not have a history of sharing the same values and political goals (Severin, 2006). Europe, therefore, appears to be embedded in a tradition of conflict.

Overall this layer shows that there is a very strong sense of national culture. Because these cultures differ between nations, the EU and therefore the peer arrangement in the SGP is embedded in an environment of conflicting cultures, values and political goals.
5.6 CONCLUSION

The formal set-up of the regulatory tasks and the institutional context of the SGP provides several insights into peer monitoring as applied in the SGP. It primarily answered sub questions: (1) what was the institutional set-up of the peer arrangement in the SGP and (2) what was the context of the institutional set-up of the SGP? However, the description of the peer arrangement and the institutional context also provided some insights into sub question 3 and 4: what is the ability of peers to regulate one another and what is the willingness of peers to regulate one another?

The analysis of the peer arrangement in the SGP answered sub question 1 and showed that the regulatory task is a complex procedure involving different actors with each task. First of all, it showed that the Commission supports the peers by executing the tasks of interpreting the norms, collecting data and judging data. Having these tasks executed by the Commission has a transaction cost advantage (as opposed to having all 27 member states perform their own comparison and judgement of data), but also means that data can be harmonised, i.e. is collected and compared with the same procedure and methods, and is compared by an independent party. Overall this means that the member states do no perform all four regulatory tasks themselves.

The peer arrangement also showed that each task offers the member states certain degrees of freedom to influence the enforcement of the SGP or to play with their fiscal behaviour and balance their national interests with the collective interests. The flexible interpretation of the debt norm offers the peers room to play with their debt levels, the set-up of data collection offers the peers room to organise their own information that is exchanged in the SGP. Moreover the discretionary character of the judgement from the Commission gives the peers the opportunity to form an opinion for themselves and determine a sanction. Finally, the procedure of sanctioning offers peers a wide time frame to adjust their fiscal behaviour as the implementation deadlines are quite long and a fiscal penalty (their only hard sanction) is only considered after several years of non-compliance.

That been said, the regulatory task of sanctioning also provided some insight into sub question 3, namely what is the ability of peers to regulate one another? First and foremost it shows that peers have three different types of sanctions they can use to enforce compliance, namely: recommendation, warnings/notices and fiscal penalties. However, this also showed that peers mostly have soft sanctions and only one hard sanction. According to Ayres and Braithwate (1992) sanction pyramid this indicates that the peers have a shortage of severe sanctions and, therefore, lack the shadow of hierarchy to pressure each other to comply with the norms. As the fiscal sanction of the SGP is only considered after several years of non-compliance this shadow of hierarchy is even further decreased.

In addition, the peer arrangement also says something about the willingness of peers to regulate one another. Namely, the existence of a formal peer arrangement shows that peers do have some sense of urgency to regulate one another. That been said, the fact that the arrangement offers the member states a certain amount of flexibility to pursue their own national interests shows that peers also have a willingness to be able to make their own decisions and determine their own fiscal goals.

The institutional analysis answered sub question 2 and showed that the context of the peer arrangement is a complex web of national and European institutions. It also provided some useful insights into the
ability of peers to regulate one another. First of all, it showed that the member states also have the opportunity to pressure each other outside the SGP via the BEPG. Within the BEPG the member states can comment on each other’s economic policy decision and fiscal position. Second, the analysis showed that the amount of member states have different abilities to put pressure on one another, because they have different voting power in the Council. Besides that, there is a distinction between sanctions applicable to Euro countries and non-Euro countries. Fiscal sanctions in the EDP only apply to Euro-countries and only Euro countries can take votes on these types of sanctions. Third, the institutional analysis pointed out that the information that member states exchange with one another is not always of the same accuracy. This suggests that peers do not always necessarily have accurate information about each other’s fiscal behaviour.

The institutional analysis gave some insight in the willingness of member states to regulate one another. It showed that member states have a very strong interest in safeguarding their sovereignty. The principle of subsidiarity and proportionality are good indicators of the importance of sovereignty for member states. In fact, peer involvement in the SGP was a compromise between member states due to a fear of loss of sovereignty over fiscal policy. This shows that fiscal policy was to primarily maintain a matter of national concern and not a matter of European concern.
6. THE PACT IN A PERIOD OF CRISIS

Now that the SGP has been analysed as it was before and at the beginning of the crisis, the research project can take a closer look at the peer-to-peer dynamic during the crisis. As was discussed in chapter 4 this will be done by describing the events of the crisis and by comparing three peers: the Netherlands, Greece and Ireland. By doing so, this chapter will provide insights into the interactions between peers, but also characteristics and behaviour of peers.

To start off paragraph 6.1 will describe the general considerations a government makes when determining fiscal policy and what issues it can face. Paragraph 6.2 explains how the financial crisis spread through the EU and how member states reacted to each other’s fiscal behaviour and why. Paragraph 6.3 will then assess the peer dynamics during the crisis. Paragraph 6.4 will continue by analysing the standpoints, risk taking behaviour and reactions of the Netherlands, Greece and Ireland during the crisis. Paragraph 6.5 will finish with a conclusion.

6.1 FISCAL CONSIDERATIONS OF GOVERNMENTS

Retaining some form of fiscal discipline in a nation has certain advantages. First of all, fiscal discipline makes it easier to execute monetary policy, which primary aim is to safeguard stability. A second advantage is that it increases the scope in which governments can use fiscal policy to stabilize domestic demand. If a government already faces high deficits, a further deficit increase can fuel fear about the fiscal position. This fear is less likely to increase when governments increase deficits from low deficits or a surplus position. A third reason to avoid excessive deficits and debt is that it can increase inflation and interest rates, which in turn can discourage private investment. A fourth argument to maintain a strong fiscal position is that increases in debt also increase the interest payments. This means that money that could be used to invest in the nation now has to be used to pay for debt.

This been said, paragraph 5.3.2 showed that it is not unusual for governments to run high deficits and debts. Theory explains this as the result from transaction costs and short sighted behaviour (Morris et al., 2006). In first instance, governments are internally often faced with all sorts of principal agent relationships that are confronted with information asymmetry, moral hazard and adverse selection. This can result in less than optimal fiscal decisions. Moreover, voters often don’t fully comprehend the government’s budget constraints and how these change over time. This makes higher governmental spending and/or fewer taxes attractive in the eyes of voters, which incentivises politicians to make unsustainable fiscal decisions. This incentive becomes even stronger leading up to elections (Buchanan & Wagner, 1977). Frequent governmental elections can furthermore aggravate this short-sighted behaviour. Parties that do not expect to get re-elected will have less interest in the future consequences of their fiscal decisions, they can even choose to increase debt and deficits so that the opposition will have to make unpopular decisions, which in turn will decrease the oppositions future popularity amongst voters. Furthermore, politicians in some cases can be influenced by lobby groups or can be connected to certain sectors, which can motivate them to bargain for certain forms of public spending that are not in the interest of the fiscal position of the nation (Von Hagen & Harden, 1995). Moreover, government can see public debt as a means of transferring money from tomorrow’s
wealthy citizens to today’s poor citizens. As the future generations do not have voting power, it can be politically attractive to place the fiscal burden on future generations.

Of course there are also governments whom are willing to improve their fiscal position, but bump into other difficulties. Public organisations, for example, can use the public perception about spending needs to their advantage so that they can secure a higher budget from the government than needed (Niskanen, 2007). Besides that, fiscal adjustment plans often need readjustment after time (Kydland & Prescott, 1977). As with most plans they require adaption due to the development of different uncertainties. However, this also means it can be difficult for governments to meet their desired fiscal targets.

6.2 Dealing with the Crisis: from Lehman to Euro Plus Pact

This paragraph will describe the developments in the EU from the beginning of the crisis in 2008 until the end of 2010, when member states agreed to a permanent rescue fund and decided to improve the SGP in some form or another. This timeline was chosen, because it gives a good overview of how peers to peer interaction, i.e. how they reacted to each other’s fiscal behaviour and why. Besides, it describes why Greece and Ireland (two of the cases) eventually received a bailout and why.

First response to the crisis: National decision-making and call for flexible SGP

After the SGP was revised in 2005 (see Appendix C), Europe experienced a strong period of economic growth. Many countries were subject to an EDP in 2005; however, as the economic growth improved so did the public finances of these member states. Except for Hungary and the Czech Republic, all member states were in compliance with the SGP and reported decreasing deficits. It was marked as a period of consensus and will to manage fiscal discipline. Some warned for a looming financial crisis (Kleinknecht, 2007; Stiglitz, 2010), but member states agreed that they were economically on a good track. However, a crisis was indeed developing in the US and it quickly became clear that it would spread to Europe. On the evening before the collapse of Lehman Brothers, all the ministers of Finance came together to discuss whether a crisis like that in the US could be avoided in Europe (EUObserver, 2008a). They devised a plan to avoid an outcome like the US by agreeing to a plan to harmonise banks financial results by 2012 and putting the central banks on alert (EurActiv, 2008a). The next day, however, when Lehman went bankrupt, the ECB had to quickly make €30 billion available due to the rapidly declining stock market, followed by another €70 billion the next day (EUObserver, 2008b). A few days later several heads of state pointed out the need for EU collaboration. They also stated that there would be no need for capital injections into banks as was the case in the US. Soon governments started discussing the possibility of an international financial regulatory system (EUObserver, 2008c).

However, as the US stock market continued to plunge, the crisis became more and more real in Europe. Governments needed to take action now, not deliberate on measures for the future. The crisis especially started to hit member states with lots of exposure to risks in the US, i.e. the Netherlands, UK, Ireland, Germany, Belgium and Luxembourg. European leaders wanted to take joint action against the crisis, but the suddenness and speed of events as well as the complexity of the
problem, made it difficult to quickly respond collectively (Heipertz et al., 2010). This resulted in governments making their own decisions about how to save their national banking system.

Ireland was the first government to make a move without European consent. The Irish government announced that it would carry all the losses of its banks for the next two years (Ireland’s Ministry of Finance, 2008). Ireland had attracted many financial institutions over the years that were now suffering because of the collapse of the housing market. The German and UK government strongly opposed Ireland’s decision to safeguard all deposits in Irish banks, as the Irish economy is heavily interconnected with all the other economies in Europe. They feared that it would cause a large transfer of capital to Ireland, which in turn would hurt other banks (BBC News, 2008a; European Commission, 2008). Member states thought that Ireland’s solution for its banking problem was in conflict with the idea of European integration and thought it should have been met with a collective response. Soon after, on the fourth of October, Sarkozy (who was then President of the EU) held a meeting with the leaders from France, UK, Italy and Germany to discuss a plan for collective response. The meeting, however, ended with no results (BBC News, 2008b). France had proposed a bailout fund for the EU, but Germany strongly opposed the idea. Quickly after this meeting both the German and Dutch government went home to round up agreements to save a financial institution. Germany rescued Hypo Real Estate from bankruptcy and secured bank deposits and the Netherlands nationalised its part of Fortis (EUObserver, 2008d). Ireland was no longer the only member state making its own decisions on how to save its banking system. Soon thereafter EU leaders agreed on guidelines for national banking bailouts, which did not describe much more than what member states were already doing to save their financial system (EurActiv, 2008b).

On the same day of that meeting between France, UK, Italy and Germany, a Summit of the European G8 members was held in which the leaders asked the Council to invoke the exceptional circumstances clause of the SGP (EurActiv, 2008c). This indicates that there was a willingness amongst the G8 to relax fiscal regulation. The Council honoured this request to some extent. The subsequent Council meeting decided that fiscal policies of member states should still remain within the Pact’s rules, however, they also stated that the interpretation of the rules should reflect the current exceptional circumstances (Presidency of the European Union, 2008). The Commission also stated that the Pact’s rules should be respected, but that the member states should use the flexibility of the Pact to deal with the impact of the crisis (New Europe, 2008). As a result, EDP’s were still started for each member state that exceeded the 3% norm and could not show that the violation was temporary, but references were made to the economic exceptional circumstances and long deadlines were given to correct the excessive deficit.

**Rising third party and peer pressure on Greece**

As the crisis continued, more and more countries started to record deficits. The amount of countries subject to an EDP had almost doubled. There was however initially little indication of peer pressure (Heipertz et al., 2010). Member states had different reactions to their EDP’s; some immediately implemented measures to bring down the deficit others did not. By April 2009 the Commission started investigating the deficits of Ireland, Spain, France and Greece (Commission, 2013b). Especially,
Greece received a lot of attention as its government had recently promised €0.5 billion to striking farmers (Reuter, 2009), while credit rating agencies were dropping its rating. Ireland on the other hand had announced plans to implement spending cuts of up to 10% of GDP (The Wall Street Journal, 2009). It appeared that Greece and Ireland were responding to their deficits in opposite ways.

Greece, however, changed its response by the end of 2009 when it announced its deficit would be around 12.7% as opposed to the earlier estimated 3.7%. Member states reacted to this announcement with a lot of shock (Katsimi & Moutos, 2010). The Finance ministers immediately got together and started pressuring Greece to increase its pension age so that it would cut down spending. However, instead of increasing pension, Greece decided to increase taxes to bring up its revenue. In the meantime Greece’s interest rates were increasing and the credit rating agency Fitch continued to drop Greece’s status to BBB+(Bloomberg News, 2012; Bruegel, 2012). At that point, the European crisis hit a critical point. Up until then the ECB had only accepted bonds as collateral for loans with a minimum rating of A-(Bagus, 2010). If the ECB would decide to stop accepting Greek bonds, it would have severe consequences for Greece’s ability to meet its financial obligations. Nobody would want to buy Greek bonds anymore, which would cause more financial distress on the market. The ECB, however, decided to temporarily drop its minimum requirement to BBB until the end of 2010 (ECB, 2013), so that people would still be interested in buying Greek bonds.

Short after the ECB had decided to relax its rating requirements, the ECB casted doubt on the accuracy of Greece’s deficit data (Bagus, 2010). This caused the credit-rating agency S&P to drop Greece’s long term rating to A− and put Spain, Portugal and Ireland on a negative outlook. In response to this downgrade, Greece announced tax increases, spending cuts and a freeze on state employees’ salaries to bring its deficit down to 8.7% of GDP (Bloomberg News, 2012). The state workers union immediately responded by announcing strikes on the 10th of February (RTE News, 2010). It appeared that the Greek government was being pulled on both sides. Fellow member states, the ECB and credit rating agencies were pushing Greece to get its fiscal situation under control, whilst national citizens were rebelling against every tax increase and spending cut.

**Peers as scapegoat for Greek government**

By the end of January 2010 the pressure on the Greek government intensified even more. Financial markets were selling Greek bonds at a quickened pace and the Deutsche Bank warned for the disastrous effects of a Greek default (Reuters, 2010a). Again the Greek government decided to implement further measures to bring down the deficit and announced its plan to decrease the deficit to 3% by 2012 (Bruessel, 2012). The Commission openly stated to support these plans, which helped the Greek government pass some of the blame for the unwelcomed tax increases and spending cuts to the EU (Bloomberg, 2010). The Greek government could now tell their citizens that the EU was making them implement these measures and that they had no choice in the matter. By February 2010, however, Greece bumped into the next problem: the public was informed that Goldman Sachs had in the 90s helped the Greek government at that time cover up the extent of its deficits so that it could enter into EMU. The Greece had not only handed in inaccurate data over the years, it lied about its qualifications to adopt the Euro. Greece had never been in compliance with the 60% debt to GDP and 3% deficit to
GDP norms (see Table 6). Again member states were shocked to learn that they had been exchanging such incorrect data. The ECOFIN Council quickly responded by imposing an adjustment plan on the Greek government to bring down its deficit (European Commission, 2010).

Table 6: Fiscal performance of Greece (Eurostat, 2013b)

<table>
<thead>
<tr>
<th>Year</th>
<th>Surplus/deficit</th>
<th>Deficit</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>-4.5</td>
<td>103.7</td>
</tr>
<tr>
<td>2002</td>
<td>-4.8</td>
<td>101.7</td>
</tr>
<tr>
<td>2003</td>
<td>-5.6</td>
<td>97.4</td>
</tr>
<tr>
<td>2004</td>
<td>-7.5</td>
<td>98.6</td>
</tr>
<tr>
<td>2005</td>
<td>-5.2</td>
<td>100</td>
</tr>
<tr>
<td>2006</td>
<td>-5.7</td>
<td>106.1</td>
</tr>
<tr>
<td>2007</td>
<td>-6.5</td>
<td>107.4</td>
</tr>
<tr>
<td>2008</td>
<td>-9.8</td>
<td>112.9</td>
</tr>
<tr>
<td>2009</td>
<td>-15.6</td>
<td>129.7</td>
</tr>
<tr>
<td>2010</td>
<td>-10.7</td>
<td>148.3</td>
</tr>
<tr>
<td>2011</td>
<td>-9.5</td>
<td>170.3</td>
</tr>
<tr>
<td>2012</td>
<td>-10</td>
<td>156.9</td>
</tr>
</tbody>
</table>

**Peers reluctant to bail Greece out, but left with no choice**

This second unpleasant surprise about Greece’s fiscal situation worsened Greece’s fiscal position to the point that Greece started looking for financial support. The first proposal for financial support came from German and French private banks, which both owned a lot of Greek bonds. They proposed to each lend €7.5 billion to Greece, but Germany was against it fearing that it would be in violation of article 103 of the Maastricht Treaty (by then article 125 of the Lisbon Treaty) (Bagus, 2010). Merkel publically stated that the Treaty ruled out any possibility of a member state being bailed out by other member state and that a Greek bailout was therefore out of the question (Deutsche Welle, 2010). As a result, the EU started to demand a further deficit reduction from Greece. Again the Greek government honoured the demand and introduced higher sales tax, tobacco tax and a reduction of salary payments to civil servants (Bagus, 2010). In return for these extra measures Greece asked that member states come up with some kind of financial support as €20 billion of Greek bonds would soon mature. Greece stated that without support it would have to default on its obligation, which would damage many economies of member states. In fear of a Greek default the ministers of Finance started discussing the possibility of a bailout of Greece (Reuters, 2010b). This meeting, however, led to no immediate results. Merkel stated that investors should not get their hopes up and rely on a bailout. Zapatero and Sarkozy were, however, arguing for the creation of a European Economic government, which would have a rescue fund to bail out governments and banks (Bagus, 2010).

On the 25th of March the member states in cooperation with the IMF had finally agreed on a bailout for Greece (European Council, 2013). Greece would receive a loan of €30 billion from EMU countries and another €15 billion from IMF. The funds became available just in time for Greece to meet its financial obligations. Besides that, the ECB announced that it would extend its acceptance period of bonds with a minimum rating of BBB. In the meantime, this bailout had increased the political tension in Greece. Civil servants kept striking and the EU announced a further upward revision of Greece deficit to GDP ratio for 2009. This in turn resulted in decreased credit ratings for Greece; S&P even decreased Greece’s rating to junk status (Bloomberg News, 2012; Reuters, 2010c). Moreover, S&P downgraded the ratings from Portugal and Spain by one or two notches (Bloomberg News, 2012). It became clear that the first bailout package would not be sufficient. On the 2nd of May 2010 the Euro-countries agreed to a second bailout package of €110 billion euro (BBC News, 2010; EurActiv, 2010a). The no-bail-out clause was now officially broken. On top of that, the ECB announced to accept any Greek bonds no matter what its rating (Bloomberg News, 2012). In return for
this Bailout and ECBs policy adjustment, Greece agreed to implement more austerity measures. It cut public wages and pensions and also increased sale tax to 25%.

System crisis trumps the creation of bad incentives for fiscal behaviour

Within days of Greece’s second bailout package and ECB’s announcement to except any Greek bond, yields on Portuguese, Spanish and Greek bonds started to rise steeply. The rise was so bad, that trading in European bonds almost came to a complete standstill (ECB, 2010). Especially two large European banking groups, who had invested a lot in Mediterranean bonds, had troubles refinancing themselves. Therefore bankers were asking that ECB to start buying bonds from financially troubled governments directly. Direct purchases of bonds by the ECB meant that fiscal and monetary policy would no longer be separated.

On the 9th of May the Euro Finance ministers, Merkel, Sarkozy and Berlusconi held a meeting to discuss the severity of the situation and to negotiate an action plan (European Council, 2013). They had only just bailed out Greece and the financial market had already nearly collapsed. More measures were needed. Both Sarkozy and Berlusconi wanted to create a European rescue fund for troubled European governments, but Merkel strongly opposed arguing that such a fund would mean that richer nations would start paying the bill of fiscally irresponsible nations. Finland, Austria and the Netherlands both agreed with Germany (Bagus, 2010). However, there were now more member states with fiscally worrisome positions. On top of that, the fiscal situation of Portugal and Spain was deteriorating, which was worrisome for all member states. Whilst Greece was a relatively small country, Spain was very large. The Eurozone’s financial exposure to Spain was therefore much larger. Especially French and German banks held a lot of public and private Spanish debt, meaning that a Spanish default would have severe consequences for many nations. At the same time a default of Portugal would have severe consequences for Spain (Bank of International Settlements, 2010). It was, thus, in each member states interest to avoid a default of Spain and Portugal. As a result, the member states eventually agreed to a rescue fund that would hold €750 billion euro, which would be managed by the European Financial Stability Facility (EFSF) (EuRactiv, 2010b; European Council, 2013). The Commission would provide the first €60 billion euro, the member states up to €440 billion euro and the IMF up to €250 billion euro. The contribution of each member state would be determined based on its capital in the ECB. In return for this bailout fund, member states with deficits promised to decrease their deficit. Portugal, Spain, France as well as Italy committed to cutting their deficits.

The day after the EFSF was established the ECB also announced that they would directly start purchasing bonds on the open market (Bloomberg News, 2012). Whilst in the past the ECB would only receive government bonds from banks in exchange for loans, it would now start buying bonds directly from governments. Fiscal and monetary policy was now officially not separated any more. In essence, this decision and the rescue fund meant that much of the original set-up of the EMU was now changed. As member states previously might have assumed that they were insured against fiscal defaults of each other, member states now explicitly knew that they were insured by the wealthier member states. In other words, incentives for moral hazard were now even more present than before.
From call for flexible SGP to call for strict SGP

As the no-bail-out clause and separation of fiscal and monetary policy rule were removed, member states started to focus their attention on the SGP (EurActiv, 2010c). Realising that incentives for unsustainable fiscal behaviour were now even more present than ever, the member states focused on the one thing left to stimulate fiscal discipline. As opposed to 2005 when France and Germany had formed a coalition to make the Pact more ‘flexible’, the member states were now discussing new forms of penalties (Bagus, 2010). Up until now the Pact could only hand out recommendations, warnings and in the case of several years of non-compliance a fiscal penalty. Now member states were talking of blocking EU development funds and removing voting rights (EurActiv, 2010c). The EU Commission furthermore proposed that member states would coordinate their budgetary plans before they were approved or rejected by their national governments. This way information exchange between member states would be improved, they could exchange and comment on each other’s plans and get a better sense of where each member state stood. However, as some of the measures implied Treaty changes and reductions of sovereignty, member states found it difficult to agree on any changes (EurActiv, 2010d).

Peers shift in focus to Ireland

As time passed the crisis continued, both Spain and Greece implemented measures. Greece started privatizing several public companies and Spain refinanced important parts of the market. However, banks in both countries could at this point only borrow money from the ECB, which in turn affected the balance sheet of the ECB and the value of the Euro. To help calm the market a stress test was orchestrated for the European Banking System (Blundell-Wignall & Slovik, 2010). This test was supposed to show people what would happen to banks in the event of a (partial) default of a member state and what the current position was of the bank. The test showed that many banks passed the test. However, as this test was based on many unrealistic assumptions (Blundell-Wignall & Slovik, 2010), it was purely viewed as a marketing tool and not as a serious test. As a result, it did not calm markets, so member states had to remain on alert.

The test also passed all Irish banks, but only a few months after the test yields on Irish bonds started to soar. The Irish government had been estimated to have put up to €60 billion euro in its financial system to carry the losses of its banks. Investors were starting to worry about an Irish default and stopped buying Irish bonds. The ECB was thus the only remaining party to buy Irish bonds (Bagus, 2010), making Ireland very dependent on the EU.

Besides that, Germany announced during the European Summit on 29th of October 2010 that the rescue fund, which had an initial lifespan of three years, could not count on extended support from Germany if private holders of government debt were not going to participate in future bailouts of member states (Spiegel Online, 2010). As Germany was the biggest contributor to the EFSF, this caused financial distress on the market. Investors were afraid that they would have to start paying for defaults of member states. Investors wanted to get rid of their bonds as quick as possible, especially from the PIIGS (a term that refers to the countries Portugal, Ireland, Italy, Greece and Spain) (EurActiv, 2010e). This increased the yields on the PIIGS bonds again and put the focus on Ireland.
who had now surpassed Greece with the highest deficit to GDP ratio. Ireland had a deficit of 32.5% of GDP and debt of 80% of GDP (Bloomberg News, 2012).

**Peers pressure Ireland into bailout**

As the pressure increased on the PIGGS, so did the pressure from the member states on Ireland to request financial support from the EFSF. Whilst the Greek bailout was initiated by Greece itself, the EU mostly stimulated an Irish bailout. England, France and Germany both had a lot of banks that had invested in Ireland (Kalbaska & Gątkowski, 2012). Moreover, the member states thought that an Irish bailout would alleviate pressure on Portugal (EurActiv, 2010e), which was still an important country to save due to its interdependencies with Spain. Irish citizens were, however, very much opposed to a bailout, they realised that a bailout would mean that the taxpayer would have to pay for the debts created by banks. For this reason Ireland was hesitant to request a bailout. Ireland, however, had very little bargaining power at the time. Their banking system was completely dependent on the ECB for loans and Germanys plan to withdraw from the EFSF only promised a further increase in interest rates. Requesting a bailout was the only way to get out of the mess. To reduce interference from Irish citizens, elections in Ireland were even postponed until after the bailout agreement was completed (EurActiv, 2010f; The National, 2010). Ireland agreed to a €85 billion euro bailout package.

**Permanent rescue fund and continued SGP discussion**

As Ireland received its bailout package, Germany continued its threat of withdrawal from the EFSF to fight for a stricter SGP. It proposed that sanctions be implemented automatically, that voting rights be withdrawn for member states in violation of the norms and that investors carry some of the losses from government debt. Germany was still convinced that a permanent fund would incentivise governments to show less fiscal discipline and would have tax payers from wealthy nations pick up the bill for fiscally irresponsible nations (Bagus, 2010).

However, by 2010 the European Union had an average deficit to GDP ratio of 6.5%, only three member states had a deficit below the three percent norm (Eurostat, 2012b). Thus, there were more countries in favour of implementing a permanent rescue fund than not (which a few months later would officially be named the European Stability Mechanism) (Commission, 2013c; EurActiv, 2010b; European Council, 2013). However, in return for Germany’s approval of the permanent fund, the member states agreed that the bailouts could only be approved with a unanimous vote (European Council, 2013). This gave countries opposing a permanent rescue fund at least the right to veto bailouts. Moreover, Germany got member states to agree to a Pact for Competitiveness (later referred to as the Euro Plus Pact), which would introduce a strengthening of the SGP (Bagus, 2010). However, what this Pact would exactly entail was at that point still unclear. Besides the permanent rescue fund, the Council agreed to lower Greece’s interest rate on the bailout package by 1 percent an extend its payback period from 3 years to 7.5 years (Bruegel, 2012). Irelands bailout conditions were not altered, as Ireland wanted to keep its corporate tax at 12.5%.
6.3 AN ANALYSIS OF PEER DYNAMICS DURING THE CRISIS

The response to the crisis as described in the previous paragraph gives a good impression of how member states reacted to each other’s fiscal decisions and positions. It also shows how important the context was in the developments of the crisis. Initially when the crisis started member states were very much focused on their own problems. Taken by surprise by the speed of contagion and the size of the impact, governments had to respond quickly, giving member states little time to negotiate some form of collective approach to the crisis. Member states initially criticized Ireland for bailing out its banking system, but member states quickly dropped this critique when they were confronted with similar problems of their own. Not having experienced such a crisis before, member states even argued for a flexible application of the SGP. The member states subject to an EDP more than doubled from 2008 to 2009 (most of these are still on-going), using the fiscal flexibility of the Pact to carry the losses of the impending crisis (Commission, 2013b; Marzinotto & Sapir, 2012). It appeared that when several member states were in a fiscally difficult situation the willingness to regulate decreased a lot compared to when just one member state faced tough times.

It was only when credit rating agencies started dropping the rating of several member states and when member states noticed that Greece was not implementing any measures to improves its deficit that member states decided to pressure Greece to act (Council of the European Union, 2009). Credit rating agencies were thus a benign gun that had a positive effect on the member states willingness to act. However, at that point member states (and most of Greece) were still clueless as to the extent of Greece’s financial trouble. By the time this came to light, the situation had already developed to the point where Greece would need some form of financial support. This increased the willingness of peers to pressure each other even more and lead to more demands tax increases and spending cuts. This also had an effect on the task of collecting data as Eurostat now had the support to increase its methodological visits to Greece (Schout, 2013). Member states were now more than ever interested in accurate data about Greece and opened the discussion as to whether Eurostat’s powers should be extended to prevent such inaccuracies from happening again. Overall, the beginning of the crisis shows that the crisis increased the willingness of peer to regulate one another and made them reconsider their ability to regulate one another.

That been said, the next phase of the crisis shows that the peers agree to bailouts and eventually even agree to a bailout fund, two decisions that seem to incentivise negative effects of moral hazard even more and appear to be opposite to what one might expect from peers. There are several explanations for this turn of events. First, member states did not have the means to enforce compliance. When Greece’s actual fiscal situation was discovered the only severe measure that member states had to enforce compliance with was a fiscal penalty. But as Greece was already so close to bankruptcy it made no sense to penalise them with a fiscal sanction. It would only cause more political turmoil in Europe, which wasn’t in the interest of any of the peers (Schout, 2013; Tacaks, 2013). This basically left member states with peer pressure and recommendations to coach Greece back on the right path to fiscal discipline.
Second, member states and the ECB were put under increased pressure by the financial system. When it became clear that more austerity measures would not be enough member states were basically left with two options: (1) a default of Greece and exit from the Euro, and (2) a bailout of Greece. None of the two options were desirable. The first option meant their economies would have to take another blow, which could have all sorts of side effects, like increased defaults of financial institutions and unemployment. The second option meant that some member states would start paying the bill of other member states, which would decrease the position of the healthier member states, but would also increase domestic political resistance. Citizens of fiscally healthier member states did not relish the idea of their tax money going to fiscally irresponsible member states, whilst citizens from fiscally unhealthy member states did not welcome the terms and conditions of the other member states. However, as private banks from many member states owned Greek debt, member states were convinced to agree to a bailout of Greece. In addition, the ECB was convinced to adjust its monetary policy to accept bonds. The financial system had made the member states realise their economic interdependency and had made a bailout of Greece in their self-interest.

Third, the bargaining power in the Council was no longer just determined by the member states with the most votes, but was now determined by the fiscal position of the peers. In the past the execution of the SGP was mostly determined by interest of the member states with the most votes (see Appendix C). However, by the time Greece received its bailout there were more member states with a worrisome fiscal position than member states with a sustainable fiscal position. This caused a shift in power in the Council and ultimately resulted in the peers implementing a bailout fund.

In return for this bailout fund, the fiscally healthy member states were promised an improved SGP, which opened up the discussion to give each other more means to discipline each other. Moreover, it provided the member states with veto power on governmental bailouts, giving the fiscally healthy member states some bargaining power in the future developments of the crisis.

Concluding, it appeared that the involvement of credit rating agencies had a positive effect on the functioning of peer monitoring. However, there were also factors that constrained the performance of the peer arrangement, namely:

- The member states had no prior experience with such a crisis, which initially lead to a national response and flexible application of the SGP, which was not compatible with the rapidly developing crisis.
- Information asymmetry presented member states with constant surprises, making it difficult to judge the situation at hand and choose an appropriate regulatory strategy for each peer.
- Member states had little means to enforce compliance; they only had recommendations and warnings. Fiscal penalties did not make sense as the member states in question were already close to bankruptcy.
- The interdependency between national financial institutes made it in the member states best interest to bail each other out. In addition, these financial institutes pressured the ECB to adjust its monetary policy.
Peer monitoring and its capacity to decrease negative effects of moral hazard

- The increasing amount of member states with excessive deficits and debts lead to a shift in bargaining power in the Council and lead to the implementation of a rescue fund for member states.

On the other hand, the crisis did get the peers discussing and considering improvements to the current peer arrangement, indicating that willingness to regulate one another had increased overall.

**Peer dynamics versus theoretic views on Europe**

The events of the crisis, like the peer arrangement and institutional analysis, show that the functioning of peer monitoring involved a complex web of different actors. To understand peer monitoring all levels of analysis described by international relations and European integration theories are relevant. Each level of analysis provided important key players that were part of explaining the peer dynamics.

The system level provided insights into the behaviour of the peers, the influence of the Commission, the ECB and credit rating agencies. The national level provided insight into the influence of national banks, like the Deutsche Bank, on the crisis, but also the influence of domestic political pressure on the behaviour of member states. Finally, the individual level highlighted the impact of individuals like Merkel and Sarkozy. It is thus unclear what level provides the better explanation of the crisis and the functioning of the peer arrangement.

**6.4 The peers: Greece, The Netherlands & Ireland**

When looking at the description of the crisis and the three peers, a first remark can be made about their general position within the peer arrangement. It appears that both Greece and Ireland were subject to a lot of peer pressure, whilst the Netherlands was one of the countries executing pressure. The Netherlands agreed with Germany’s stand against a European rescue fund and was in favour of stricter fiscal discipline, whilst Ireland and Greece were both in favour of a rescue fund.

Moreover, there are also differences in how Greece and Ireland received a bailout. Greece’s bailout was agreed with much reluctance, while Ireland’s bailout was stimulated by the other member states. By then the fiscal situation of many countries had worsened and the member states were trying to contain the crisis as quick as possible. The European rescue fund was already established, making it easier to respond to government’s requests for financial support. Like the bailout of Greece, member states had more interest in stabilizing Ireland’s fiscal situation than having it default. Moreover, Ireland had shown strong fiscal performance in the past and seemed to be a party who understood the importance of fiscal discipline and fiscal reporting, making it a more preferred candidate for a bailout (Schout, 2013). And as Ireland was in a fragile position it had no other option but to request a bailout, despite the strong discontent towards a bailout amongst the Irish citizens.

**Difference in problems between Greece, The Netherlands and Ireland**

That been said, this description of member states interactions does not give an indication of the risks that member states had taken, which made them run into financial trouble in the first place. The Netherlands and Ireland had developed similar risks over time; both countries had a considerably large
banking system and housing bubble (Duca, Muellbauer, & Murphy, 2010). Both countries experienced a burst of their housing bubble and a certain amount of turbulence in their financial system. However, Irelands banking system was also much larger than that of the Netherlands. It had a very low corporate tax rate (12.5%), which over time had attracted many banks. During Irelands boom these banks had made a lot of profit by providing credit, which in turn lead to a housing bubble (Conefrey & Fitz Gerald, 2010). As a result, the US financial crisis caused more losses in Ireland than in the Netherlands. Furthermore, the countries had a slightly different approach towards the crisis. Whilst Ireland immediately promised to cover all the losses for the coming two years, the Netherlands bailed out a few specific banks.

Greece’s problems were caused by completely different factors than its size of its banking system and the development of its housing prices. Greece’s problems primarily started due to its government spending and it loss in competitiveness. When Greece entered into EMU it quickly saw its competitiveness with other markets declining due to its inflexible labour market (Bagus, 2010). At the same time the participation in EMU meant that Greece could acquire loans with a low interest rate. As a result, the Greek government started borrowing money to artificially create welfare in the country. Public spending on the unemployed, civil servants and pensioners increased (Katsimi & Moutos, 2010). At the same time there were many holes in the Greek tax system, so that government revenue was lower than it should have been (Katsimi & Moutos, 2010).

Availability of information versus actual events
All in all, it appeared that there were different degrees and different kinds of risk taking between member states. But as these factors were never explicitly described in a stability and convergence programme, it was difficult for member states to fully realise the extent of risk exposure of each member. That been said, it is also interesting to notice that past deficit behaviour is little indication of a member states probability for financial problems (EurActiv, 2010c). Ireland had never before been in violation of the norms, but did run into trouble, while the Netherlands had violated the 3% norm in 2004, but didn’t run into any trouble. Even if the member states had used the 60% norm as an important indicator Ireland would still have been in compliance with the SGP. Perhaps it would have put Greece on a risk alert as it always had a high debt ratio. But as Greece’s data has a history of being adjusted to be more appealing it is hard to tell if this would have worked.

Table 7: Deficit and debt performance of Ireland and The Netherlands over time (Eurostat, 2013b)

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<tbody>
<tr>
<td>Surplus/deficit</td>
<td>0.9</td>
<td>-0.4</td>
<td>0.4</td>
<td>1.4</td>
<td>1.7</td>
<td>2.9</td>
<td>0.1</td>
<td>-7.4</td>
<td>-13.9</td>
<td>-30.8</td>
<td>-13.4</td>
<td>-7.6</td>
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<tr>
<td>Debt</td>
<td>35.2</td>
<td>32</td>
<td>30.7</td>
<td>29.5</td>
<td>27.3</td>
<td>24.6</td>
<td>25.1</td>
<td>44.5</td>
<td>64.8</td>
<td>92.1</td>
<td>106.4</td>
<td>117.6</td>
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<tbody>
<tr>
<td>Surplus/deficit</td>
<td>-0.2</td>
<td>-2.1</td>
<td>-3.1</td>
<td>-1.7</td>
<td>-0.3</td>
<td>0.5</td>
<td>0.2</td>
<td>0.5</td>
<td>5.6</td>
<td>5.1</td>
<td>4.5</td>
<td>4.1</td>
</tr>
<tr>
<td>Debt</td>
<td>50.7</td>
<td>50.5</td>
<td>52</td>
<td>52.4</td>
<td>51.8</td>
<td>47.4</td>
<td>45.3</td>
<td>58.5</td>
<td>60.8</td>
<td>63.1</td>
<td>65.5</td>
<td>71.2</td>
</tr>
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</table>
6.5 **CONCLUSION**

The case analysis of the case analysis and the peers Greece, the Netherlands and Ireland provide many insights into the performance of peer monitoring. These insights especially answer sub questions: (1) what is the ability of peers to regulate one another? and (2) what is the willingness of peers to regulate one another?

The peer-to-peer dynamics and peer characteristics described in this chapter show several things about the ability of peers to regulate one another with respect to the tasks of data collection and sanctioning. First of all, the story of Greece showed that peers can hide information about their actual fiscal situation from the other peers for several years. Moreover, the comparison of the Netherlands, Greece and Ireland showed that the information that peers exchange does not necessarily reflect the actual financial risks taken by peers. Secondly, the crisis showed that peers had relative means to enforce compliance from one another. A fiscal penalty was too severe as the member states in question were already close to bankruptcy. This left the member states with recommendations and warnings to pressure each other to adjust their fiscal behaviour, whereby the biggest penalty that peers had to pressure each other was the threat of not being willing to provide a bailout. The credit rating agencies, however, had the biggest shadow of hierarchy overall as they determined the ratings of governmental bonds and influenced the overall trust in the Euro. This initially helped the peers make the member states with unhealthy finances realise the severity of their situation, but eventually gave the peers and the ECB little choice but to adjust their policy and allow bailouts.

The crisis also gives some indication of the willingness that peers have to regulate one another. Before the crisis and at the beginning of the crisis this willingness seemed low, as the peers had made the pact more flexible in 2005 and responded to the crisis by asking for a flexible interpretation of the SGP. The history of the Euro and the SGP had not given the peers any reason to be eager to regulate one another. This changed when the credit rating agencies started dropping the rating of several member states; this spiked the willingness to regulate one another and resulted in an increased amount of peer pressure on some member states. Furthermore, mounting domestic political pressure and interference from national institutions made it for peers impossible to not be willing to regulate one another. The willingness amongst peers to prevent a bailout switched to an overall willingness to allow bailouts, when the peers realised how interdependent they were and when more peers had worrisome financial conditions than healthy financial conditions.

Last but not least, the crisis also provides insights into the responsiveness of the peer arrangement. As stated in the previous chapter the peers did not have a pyramid of sanctions as Ayres and Braithwaite prescribe, however, the crisis also showed that the peer arrangement initially lacked the ability to respond to context of crisis. By initially choosing to approach the crisis nationally, shows that the peers were slow to acknowledge how government finances were exposed to the financial crisis, which in turn would affect the whole group of peers. This confirms Black & Baldwin’s argument to take the context into account when studying regulation.
7. Proposition Results

Chapter 5 and 6 formed the empirical part of this study, which provided insights into the peer arrangement itself, the context of the arrangement, the characteristics of peers and the peer dynamics. With these insights this chapter can continue with answering the propositions as defined in paragraph 4.2.2:

1. Peers have a sense of urgency to regulate one another
2. Peers have information about each other’s behaviour
3. Peers may interfere with each other’s business
4. Peers have formal and informal means to act
5. Peers have enough degrees of freedom to adjust regulation to the situation at hand

Ultimately these propositions will provide an overall overview of the capacity of peers to decrease the negative effects from moral hazard.

To structure the findings paragraph 7.1 will discuss the findings for each proposition based on the analysis of the peer arrangement and institutional analysis. Paragraph 7.2 will thereafter continue by discussing the findings for each proposition based on the case analysis. Both paragraphs will discuss the propositions in the order listed here above. Paragraph 7.3 will then provide an overview of the ability and willingness of peers to regulate one another. After that, paragraph 7.4 will discuss what this means for the capacity of peer monitoring to reduce the negative effects from moral hazard. Finally paragraph 7.5 will discuss the validity of the propositions.

7.1 Findings Based on the Institutional Set-up of the SGP

This paragraph describes the results for each proposition that were found with the analysis of the peer arrangement and its institutional context.

1. Existence of peer arrangement indicates sense of urgency

The peer arrangement and institutional analysis initially indicated that peers did have a sense of urgency to regulate one another. Member states seemed well aware of their history of accumulating debt and running high deficits and knew that with the creation of the EMU fiscal coordination would be needed. For this reason they did not only agree to a formal peer arrangement in the SGP, they also adopted the no-bail-out clause and separated fiscal policy from monetary policy.

A closer look at the peer arrangement, however, showed that the arrangement was the result of a compromise between member states. The original design of the SGP entailed automatic sanctions, but member states valued their sovereignty to such an extent that they preferred sanctions to be determined by the Council. In addition, the regulatory tasks of the SGP provided the peers with certain degrees of freedom to influence the enforcement of the SGP or to play with their fiscal behaviour and balance their national interests with the collective interests. More specifically, the flexible interpretation of the debt norm offered the peers room to play with their debt levels, the organisational set-up of data
collection allowed peers to organise their own information, the discretionary character of the judgement from the Commission gave the peers the opportunity to make their own assessment, and finally the agreed procedure of sanctioning provided peers with a large window to adjust their fiscal behaviour. All in all, the formalisation of the peer arrangement suggests that peers did have a sense of urgency to regulate one another, but that giving each other some fiscal flexibility to pursue national interests was also important.

2. Peers have a formalised exchange of information
By agreeing to the SGP, the peers also agreed to exchange certain information with each other. The description of the regulatory tasks showed that member states hand in convergence and stability programs on an annual basis. These plans report on past fiscal performance as well as fiscal plans for the coming three years. Moreover, it contains the assumptions made, the policy measures that will help achieve the three-year objective, and a sensitivity analysis of the plan. In addition to that, the national statistics agencies provide Eurostat with fiscal data on each peer, which is used to verify a peers past performance. Overall, this exchange of knowledge indicates that peers do have information about one another. On the other hand, the institutional analysis showed that the quality of data can differ between the member states, as statistical revisions have shown to uncover past violations of the norms by some member states. The majority of member states, however, appear to hand in accurate data and that is why overall the peer arrangement suggests that peers have information about one another.

3. Means to act determined by majority coalition of peers
The analysis of the regulatory tasks shows that member states in the SGP can discipline each other by handing out recommendations, early warnings/notices and fiscal penalties. In other words, peers have two soft sanctions and one severe sanction at their disposal. The procedure of the SGP furthermore showed that the fiscal sanction can only be considered by the peers if there have been several years of non-compliance. This sanction procedure, combined with the fact that peers only have one sanction to pressure each other into compliance, indicates that peers lack the shadow of hierarchy to enforce compliance. Moreover, fiscal sanctions are only applicable to Euro-countries. This means that there is also a difference between Euro peers and non-Euro peers with respect to their means to sanction.

Furthermore, all means are only handed out when a qualified majority is reached in the Council (for fiscal penalties the Euro-countries need to reach a qualified majority). As peers have different voting power in the Council, this coalition can consist of differing amount of peers. Peers with little voting powers will have to look for more coalition partners than peers with more voting power. This means that individual impact of a member state can differ between member states; however, each member state will always need to build a coalition within the Council.

The institutional analysis showed that the peers also have different formal channels through which they can discipline one another, namely through the BEPG. The BEPG is, however, based on soft law and only offers peers the possibility to send each other recommendations.

Besides that, member states agreed to a data collection system where Eurostat (the agency charged with the task of data collection) has limited means to act when it has suspicions about the
quality of data within member states. The reason for this is that member states value privacy and sovereignty, which compete with the creation of a transparent and centrally regulated statistics agency. As a result, data collection powers were always somewhat restricted in their actions.

4. Willingness to take part in the SGP
Like the formal set-up of the SGP indicates that member states have a sense of urgency to regulate one another, so does the participation of the member states in the execution of the SGP indicate that peers are willing to interfere in each other’s business. All member states hand in their stability and convergence programmes and Council meetings are held to determine whether sanctions are needed.

5. Peers have enough degrees of freedom to adjust regulation to the situation at hand
The third propositions already suggested that member states have little degree of freedom to adjust regulation to the situation at hand. Member states can only sanction each other according to a set procedure. Furthermore, when comparing the sanctions in the SGP to the responsiveness principle of Ayres and Braithwate (1992), member states appear to have a relatively low range of sanctions and limited shadow of hierarchy. Moreover, the fact that sanction takes place according to a set procedure limits the speed in which peers can react to each other’s behaviour. In addition, the procedure makes sure that sanctions are only applicable to the already agreed norms and to be gathered information. This means that peers have no flexibility when it comes to adjusting norms and collected data. In essence, the rules and procedures of the SGP are constructed in such a way that all member states go through the same procedure. It ensures that all member states are treated as equals, but it limits the ability of peers to regulate on a case-by-case basis.

7.2 Findings based on the case analysis
This paragraph discusses the results that were found for each proposition based on the analysis of the crisis and the comparison of Greece, the Netherlands and Ireland.

Peers sense of urgency: timing is everything
While the execution of the SGP might suggest that there is a constant urgency to regulate one another, the case analysis shows that the sense of urgency changes over time. The analysis showed that when the Pact became a serious threat for several member states they quickly fought for a flexible application of the SGP. This happened in 2004 when France and Germany formed a coalition to abrogate the EDP against them, despite the Commission’s recommendation to give them a notice, and got the member states to agree to a revision of the SGP. This revision meant that member states would be allowed to take more time to correct their deficits. Member states also asked for a flexible application of the Pact when the crisis emerged in 2008. Member states decided to make their own national decisions on how to react to the crisis and asked the Council for a flexible application of the Pact. These two developments indicate that the sense of urgency was low in the years leading up to and in the wake of the crisis. This changed, however, when the credit rating agencies started dropping ratings of certain member states. In other words, third party interference brought the peer’s sense of urgency back in full
swing. These dropping ratings made the financial trouble of some member states much more serious for everybody, because their economies were so intertwined. The involvement of credit rating agencies, thus, incentivised member states to regulate one another.

**Mismatched and hidden information**

The analysis of the crisis showed that Greece had been hiding their actual fiscal situation between the years of 1997 and 2009. Before this came to light, Greece had been found to only violate the norms twice. It turned out, however, that Greece had always been in violation of the norms. In fact, they had not even met the necessary Maastricht criteria to adopt the euro. This was possible, because Eurostat had limited means to enquire about the quality of data from member states. Eurostat can only set out regulations as to what information should be collected by member states and with what method they should collect this data. To this end Eurostat can go on a few technical visits per year, which focuses on methodology issues rather than data accuracy issues. This indicates that member states can hide their actual fiscal position from one another or at least can delay the process of other member states finding out.

That been said the case analysis of Greece, The Netherlands and Ireland showed that the collected data does not fully cover the risks of member states. Ireland never violated any norms up until the crisis, but did run into trouble, whilst the Netherlands did violate the norms in the past and did not run into any trouble. This suggests that there is a mismatch between the norms that were being enforced and the risks that were being taken. The case comparison showed that the biggest risk factors in member states were: the amount of private debt, the development of housing prices, the size of the banking sector, the development of labour costs, unemployment costs and the export position of a country. These factors were, however, not part of the program that the member states exchanged with one another. Some of these factors impacted the deficit and the debt ratios directly, whilst others only impacted a countries deficit and debt ratios after state intervention. In other words, the deficit and debt levels are output measurements of risk behaviour; they do not monitor the entire development of risks within a nation.

**Peers have means and third party pressure**

The set-up of the SGP already showed that member states have limited means to discipline one another, the analysis of the crisis even showed that fiscal penalties are too severe to hand out. By the time that the fiscal penalty became the next enforcement step in the SGP, the member state was already in such financial trouble that it did not make sense to use it. This would only enhance the economic damage for all member states and increase the political tension. The deteriorating financial situation of some member states, however, did give the peers a new mean to discipline each other and that was the threat of not wanting to give financial aid. For some time this gave them the necessary power to get a member state to implement austerity measures. Besides that, the credit rating agencies had a mean to pressure a member state to implement austerity measures, as they determined the rating of each member state. With each downgrade, a member state was forced to implement more measures to prevent further downgrades. The involvement of credit rating agencies, thus, did not only increase the peers sense of urgency to regulate one another, they also provided the peers with some shadow of
Peer monitoring and its capacity to decrease negative effects of moral hazard

hierarchy. That been said, one could also argue that involvement of credit rating agencies lead to over enforcement, leaving the member states (and the ECB) with the two extreme choices of letting Greece go bankrupt or agreeing to bailouts.

Willingness to interfere depends on self-interest of peers
As the previous proposition already showed, peers can have an interest in reduced interference. This resulted in changes to the SGP in 2005 making it more flexible, i.e. to allow each other more exceptions and more time to correct violations. Moreover, in 2008 when the crisis started to take its course member states asked for a flexible interpretation of the Pact so that member states could decide their own course on how to deal with the crisis without any interference. In other words, member states did not criticize national policies and customs of others, because they did not want to be criticised for its own way of handling things either. The willingness to interfere changed when credit rating agencies started to cause alarm bells and problems for ECB operations. It all of a sudden became in the peers interest to peer pressure each other into implementing austerity measures. As more peers ran into financial trouble, it also became in the peers interest to bail each other out rather than just penalise each other.

Legitimacy versus regulatory adaptability
The case analysis showed, as the previous paragraph already suggested, that peers had little means to discipline one another, as fiscal penalties were politically and financially undesirable to hand out. This left peers with recommendations and threats of declining financial support to pressure each other. Moreover, the case analysis showed that the peers had difficulty adapting their procedures and norms to the rapidly developing crisis.

7.3 An Assessment of Peer Monitoring in the EU
Now that all five propositions have been answered, a better overview can be established of the member states overall ability to regulate one another and willingness or sense of urgency to regulate one another. Table 8 on the next page provides an overview of the findings for each proposition as discussed in the previous two paragraphs and table. Table 9 on page 81 provides an overview of the willingness, ability and adaptability of peers.

The ability of peers to regulate one another was examined by studying the member states ability to collect data and the member states means to act (proposition 2 and 3). The findings to both propositions showed that peers did indeed have information and means to regulate one another, but that there were still some problems. The collection of data faces two main problems, namely data is not always accurate and the collected data does not cover all the fiscal risk factors of member states. The analyses showed that data can be less accurate due to the set-up of a member states data collection system or because a member state wants to hide certain information from its fellow member states. The reason that the collected data does not always cover all the risk taking activities of a government is that
the SGP is not easily adaptable. Each alteration to the peer arrangement requires negotiations between the peers. In essence this means that there is information asymmetry between the member states.

The member states ability to sanction one another also faces barriers. The set-up of the SGP showed that member states have not a wide enough variety of sanctions to discipline each other, especially when it comes down to harder sanctions. Moreover, these sanctions can only be handed out according to the procedure of the SGP, which does not always coincide with the speed of development of the situation at hand. In addition, the qualified majority in the Council always determines sanctions. This means that when many member states are in violation of the norms the ability to sanction decreases as the violating member states can block the sanction.

Table 8: Overview of the proposition findings

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<thead>
<tr>
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<th>The institutional set-up</th>
<th>Case analysis</th>
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<tr>
<td>1. Peers have a sense of urgency to regulate one another</td>
<td>Yes, Peer have agreed to an arrangement to regulate one another, but still offers peers some flexibility to pursue national interests</td>
<td>Changes over time. Initially peers had an interest in relaxing peer regulation due to domestic interests. The willingness decreased during the crisis after the involvement of credit rating agencies.</td>
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<td>2. Peers have information about one another</td>
<td>Yes. Peers had in annual programs and national statistics agencies exchange data with Eurostat.</td>
<td>No. Peers can hide information from each other and the information that is exchanged does not fully cover the risk profile of a member state.</td>
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<tr>
<td>3. Peers have formal and informal means to act</td>
<td>Yes, but they don’t have a wide variety of sanctions and they lack the shadow of hierarchy. They also need a quality majority vote to implement a sanction</td>
<td>Yes, but only two of the three sanctions can be used. Thus the variety of sanctions is even smaller.</td>
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<td>4. Peers may interfere with each other’s business</td>
<td>Yes, peer comment on each other’s programmes and give recommendations if necessary</td>
<td>Changes over time. When it’s in everyone’s interest to mind their own business then they do, if not they interfere.</td>
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<tr>
<td>5. Peers have enough degrees of freedom to adjust regulation to the situation at hand</td>
<td>Lack of pyramid of sanctions and the rules and procedure of the SGP suggest no</td>
<td>No, the rule based framework for the peer arrangement could not be adapted to the rapidly changing circumstances of the crisis. Negotiations about changes to the Pact take time.</td>
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The willingness of peers to regulate one another was examined by studying the member states sense of urgency to regulate one another and their willingness to interfere with each other’s business (proposition 1 and 4). Proposition 3 already showed that the willingness to interfere with each other’s business depends on the dominant interest in the group. Furthermore, the case analysis showed that this interest can change over time, when there are many sinners the willingness is lower than when there are just a few sinners. However, the case analysis also showed that the willingness to regulate can be brought on by credit rating agencies.

As the willingness to sanction one another depends on the dominant interest in the group of member states, so does the sense of urgency to regulate one another. When a majority of member states benefits from a flexible application of the SGP, they bargain for a flexible application, putting their
Peer monitoring and its capacity to decrease negative effects of moral hazard

domestic interest above their European interests. This, for instance, happened at the beginning of the crisis when several member states were confronted with financial problems and they asked for a flexible interpretation of the SGP. This way they could give each other the room to solve their own problems. It was only when credit rating agencies put certain member states on amber alert that they started interfering with each other’s business again. Peer monitoring was in the interest of each member state, as they realised that they posed an immediate threat to their own domestic stability.

A separate proposition was formulated to test the degree of freedom that peers had to adjust regulation to the situation at hand. As this proposition is more a prescriptive criteria for regulation and not an actual task, it was not directly coupled to the ability and willingness of peers. That been said, proposition 3 already provided some insight into the degrees of freedom that peers have when performing the tasks of sanctioning (in theory referred to as responsiveness). It showed that the limited amount of sanctions and procedure for sanctioning limited the peers’ responsiveness. However, the fact that the peer arrangement involved an overall rule based framework for each task also made it difficult to adapt the other tasks to the situation at hand. There appears to be a trade-off between legitimacy and flexibility of the institutional set-up. In order for the peer arrangement to be legitimate it needs a framework that treats each peer the same, this however reduces the adaptability of the framework to the situation at hand. The crisis, for instance, showed the inability of the procedure to deal with the rapid developments of the crisis. Whilst the crisis developed each day, member states required much more time to negotiate any changes to the procedure. This shows how important legitimacy is to the peers. It is very likely that without an agreed procedure the peers would not take part in peer monitoring.

Table 9: The ability, willingness and adaptability of Peers

<table>
<thead>
<tr>
<th>Ability</th>
<th>Limited, due to information asymmetry, lack of hard sanctions and inability to speed up the procedure to match it to the situation at hand.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Willingness</td>
<td>Changes with the dominant interest of the group or can be brought on by third party involvement (credit rating agencies).</td>
</tr>
<tr>
<td>Degree of freedom</td>
<td>Limited due to the institutional set-up of the peer arrangement and importance of legitimacy of the institutional set-up</td>
</tr>
</tbody>
</table>

7.4 THE CAPACITY TO DECREASE NEGATIVE EFFECTS OF MORAL HAZARD

With all the propositions answered, it is time to answer the first part of the main question, namely: “What is the capacity of peer monitoring in the SGP to decrease the negative effects from moral hazard between the member states?”

As the theoretic framework explained, both information asymmetry and goal conflict are necessary conditions for moral hazard or adverse selection to occur. Theory argues that peer monitoring can mitigate these conditions, because peers have similar knowledge and expertise and know how to interpret the given information. Moreover, they are willing to regulate one another, because they share risks together. However, as the answers to the propositions show, these assumptions are not necessarily true.
First of all, member states do not necessarily have access to accurate knowledge of each other. Statistical revisions have shown that member states can overestimate their fiscal position and in some cases can even hide their fiscal position. Moreover, the information that member states look at does not necessarily give a complete picture of member states financial risk behaviour. These problems of selective data collection and inaccuracy are the result of the current institutional set-up of the SGP, which was chosen by the peers themselves. It appears that the set-up is the result of a trade-off between sovereignty on the one hand and transparency on the other hand. Whilst peers might have the ability to interpret each other’s behaviour, they are also interested in keeping information private from each other due to sovereignty principals. These conflicting interests lead to information asymmetry between the member states.

Second of all, the willingness to regulate each other does not necessarily need to be there due to risk sharing. Peers also have other interests and as a result the willingness fluctuates over time. The willingness is low when there are enough member states that benefit from a flexible application of the SGP. In other words, when there are enough sinners the dominant interest in the Council will be to not regulate each other as much. This means that the task of sanctioning can at times be replaced with political bargaining games. As a result, member states are not always willing to regulate one another.

As one of the conditions for peer monitoring is never met and the other condition is only met at times, the capacity of the peer arrangements in the SGP to decrease the negative effects of moral hazard is limited. The interest in preventing moral hazard or adverse selection in the EU has a lower priority than the interest in sovereignty and domestic political needs, which makes it difficult for member states to mitigate the conditions for moral hazard or adverse selection.

7.5 Validation Results

With any research it is important to discuss the validity of the found results. For this type of research approach it is important to discuss the construct validity, the external validity as well as the reliability. To ensure construct validity this research project used three types of sources as recommended by Yin (2003), namely interviews, archives and documents. Moreover, one of the interviewees reviewed the draft report to avoid any confusion for the reader. Furthermore, the report was set up in such a way that an external observer can examine the research process from the initial research question to the final results of the project and if need be can repeat the research project.

External validity concerns the degree in which the results can be generalised. Generalisation of the results in this research project is difficult for it studies peer monitoring in a specific context. For this reason the answers to the propositions cannot be used for each case of peer monitoring. To increase the external validation of the results it would be advisable to test the propositions in other cases of peer monitoring. Because the propositions were derived from theory the propositions can be easily applied to other cases where peer-monitoring plays a role. Besides that, consideration should be put into whether the results are applicable to the EU as a whole or not. This study focused on three member states specifically. Each member state was analysed according to the same replication logic, but not all member states were studied. That been said, the case study also involved an analysis of the crisi
Peer monitoring and its capacity to decrease negative effects of moral hazard

which gave an overall impression of the peer dynamics. It showed that peers overall can hide information from each other and that the willingness to regulate each other depends on the dominant interest in the Council. Member states always need to form a coalition to actually discipline each other. It is unlikely that these findings would have been different if other member states had been chosen to analyse peer-to-peer dynamics.

The reliability of the case study also needs to be discussed. First of all, performing the case study according to the case study protocol was to ensure reliability. This protocol is depicted in Figure 6. That been said, a remark must be made about step six of the protocol. More specifically, the interviews that were used to support the findings. Most empirical data was retrieved from documents and archives, not from interviews. People involved in the SGP or the EU were approached for an interview, but did not or could not take part in an interview because the research topic was still sensitive. One could argue that the research project would have been more reliable if interviews had been held with people involved in the SGP. On the other hand, this research project is based on an extensive amount of documents and archives that discuss the supporting findings for the propositions as well as the contradictory findings in order to make the findings more reliable for the reader.
PART III
ABILITY TO CHANGE
Peer monitoring and its capacity to decrease negative effects of moral hazard

8. ABILITY TO CHANGE

The proposition results showed that the current peer monitoring arrangement is unable to prevent moral hazard or adverse selection. Moreover, the case analysis showed that the incentives for moral hazard or adverse selection have only increased during the crisis with the abolishment of the no bail out clause and the abolishment of the provision separating monetary and fiscal policy. As a result, the functioning of the SGP has become even more important. Therefore, this chapter will discuss how the peer arrangement can be improved to decrease the damage from moral hazard.

The first paragraph will start by summarising the current barriers facing the peer arrangement. Paragraph 8.2 will discuss which of these barriers has the biggest impact on the performance of the peer arrangement and how it can be improved.

8.1 THE MAIN BARRIERS

When listing the findings for each proposition several barriers were identified that constrain the performance of the peer arrangement in the SGP. These barriers were as follows:

- Member states do not have accurate and enough information to judge each other’s financial behaviour and exposure to risk. This is predominantly due to the institutional set-up of the exchange of information between member states. It only allows for the exchange of certain types of information and depends on national ministries and statistics agencies to supply information. This means that member states can provide inaccurate data due to hidden action or sloppiness.

- Member states do not always have a sense of urgency or willingness to regulate one another. The sense of urgency to regulate one another can be low due to the burden of history (although this currently is not a problem anymore) or the interests of member states. When the majority of member states are interested in a flexible application of the norms the willingness to regulate one another dies down. In other words, the long-term interest in peer monitoring can suffer due to short term interests of the member states.

- Member states have limited means to sanction one another. This is partly because the member states only have one hard sanction to discipline each other, which is furthermore so severe that it is never applied. This leaves member states with only soft sanctions to discipline each other. Another reason why member states have limited sanctions is because member states can only discipline each other when they have formed a majority coalition in the Council. This means that a member states’ means to sanction depends on the alignment of interest in the group.

- Member states have difficulty adapting the peer arrangement to the situation at hand. In order to convince the member states to take part in the peer arrangement it needs to be legitimate. In other words, the member states need to be treated as equals, i.e. according to the same rules and procedures. At the same time this makes it difficult to adapt the peer arrangement to the situation at hand. Changes to the rules and the procedure cannot be implemented without consent from all the member states. Therefore, any change to the arrangement takes time and is not quickly adjustable to new situations.
8.2 ADDRESSING THE CORE ISSUE: SHORT TERM INTERESTS OF PEERS

Most of the identified barriers originate from the set-up of the peer arrangement. Both the limited means to sanction, the insufficient and inaccurate exchange of information as well as the lack of regulatory flexibility are all result of the current design of the peer arrangement. The other barrier, the fluctuating willingness to regulate one another, is caused by the interests of peers. That been said, these interests not only result in a fluctuating willingness to regulate one another, they also influenced the current institutional design of the peer arrangement. In other words, it was the interests of peers that lead to the current organisation of information exchange and the means to sanction. Yes, they agreed to a peer arrangement, but they also made sure that this arrangement offered them enough room to pursue their own national interests. This means that all the barriers have the same root cause: the interests of the peers.

In general, a distinction can be made between short-term interests and long-term interests of peers. Having fiscal regulation is, for instance, the result of the peer’s long-term interest in a financially stable European union. In the short term the peers are, however, interested in pursuing their own national interest, which can conflict with the peers long-term interests. The trade-off between these long and short-term interests influences the design and functioning of the peer arrangement. In this case the short-term interests appear to be have the upper hand as the peers utilise the room of the peer arrangement and their regulatory powers to pursue their own interests. As a result, regulatory procedures are replaced with political games.

Considering that the main source of issues in the functioning of the peer arrangement stems from the myopic behaviour of peers, the argument can be made that peer monitoring cannot function without vertical regulatory involvement. Whereby a vertical regulatory arrangement refers to a party whose sole objective is to enforce regulation and can therefore provide the proper checks and balances between regulatory interests and peer interests. A counter argument could be that such a vertical regulator (the Commission) is already involved in the peer arrangement as it supports the execution of the peer arrangement by interpreting the norms, aggregating data and judging data. However, this role is mostly of a supportive nature and only offers a limited degree of checks and balances between the short-term interests of peers and the long-term interest of fiscal regulation. Thus, in this paragraph ‘involvement of vertical regulation’ refers to checks and balances between regulator and regulatee interests as well as executive support.

Checks and balances in peer monitoring examples in literature

All three examples of peer monitoring as mentioned in the theoretic framework have certain checks and balances in place to limit the impact of myopic behaviour of regulatees on regulation. First of all, the example of Stiglitz (1990) indicates that the execution of peer monitoring is backed by the threat of intervention by the bank (in that case the vertical regulator). More specifically, if the farmers fail to pay back their loans and fail to monitor each other, the bank will freeze their loan and possibly seize their

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2 As you may recall, Stiglitz (1990) described an example were local farmers collectively applied for a loan at Grameen bank and then monitored each other’s behaviour. Brousseau and Glachant (2011) made an argument that network industries need regulators that stimulate peer monitoring in order to coordinate and exchange knowledge within the industry. Finally, Nier & Baumann (2006) described how peer monitoring by investors can discipline bank’s risk taking behaviour.
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goods. As a result, this threat of intervention prevents peers from letting their self-interests get the best of them.

Secondly, in the example of Brousseau and Glachant (2011) peers have a supportive role in the execution of regulation. This is contrary to the peer arrangement of the SGP where the vertical regulator has a supportive role. Network industries (the peers in that example) only facilitate the exchange and judgement of information. Norm setting and sanctioning is thus in hands of the vertical regulator and not subject to the self-interests of peers. Moreover, the vertical regulator can always threat to intervene and collect and judge data itself. Again his threat of intervention can stimulate peer monitoring as the alternative of not having anything to say in the regulation of their industry is worse than having some influence in the regulation of their industry.

In the third example of Nier & Baumann (2006), peer monitoring is not even executed by the regulatees (the banks), it is done by their neighbours (the investors). Hence, regulatees can’t even pursue their self-interests via peer monitoring. Like, the previous example the peers support the execution of vertical regulation, as investor behaviour should provide the vertical regulator with a signal of how banks are behaving, i.e. to what degree are they exposing themselves to risks.

Overall, in all three examples actors other than the regulatees have the upper hand in the enforcement of regulation, especially in the regulatory tasks of norm setting and sanctioning. This way regulation does not suffer from the myopic behaviour of regulatees. In essence, these examples support the argument that peer monitoring cannot work without proper checks and balances between regulatory interests and interests of regulatees.

Improving the checks and balances in the SGP: a rigid process

Based on the descriptions of the checks and balances in the above-mentioned examples, one could conclude that the party whom has the upper hand in the tasks of norm setting and sanctioning eventually determines what interests are pursued by regulation. This could mean that the peer arrangement in the SGP could be improved by giving the Commission the power to hand out sanctions and determine norms (the current peer arrangement already provides the Commission with the power to interpret the norms). This way member states can still contribute to regulation during the exchange of information, but they will no longer have the opportunity to pursue myopic behaviour during the tasks of norm setting and sanctioning.

However, this solution is easier said than done. Changes to the EU often come with heavy negotiations that take a lot of time. There are many member states, which all have different interests. In order to get this change adopted, all member states would need to be convinced of the change. This can take a lot of time, but is necessary to make the adoption legitimate. That been said, it can be very difficult to get the member states to agree to any proposal in the first place, especially one giving the Commission the upper hand or shadow of hierarchy in the regulatory task of norm setting and sanctioning. As the institutional analysis showed member states value their sovereignty and, therefore, are reluctant to transfer any of their national powers to supranational bodies. Besides that, member states with excessive deficits and debts will be even less eager to accept this transfer of power, as they currently benefit from flexible regulation, not more strict and objective regulation. The case analysis on the other hand showed that member states providing considerable contributions to the ESM are in
pursuit of better regulation. The fact that they are now financing the operations of financially irresponsible member states combined with the fact that there is no separation of monetary and fiscal policy and no clause prohibiting bailouts, has got them to start a negotiation on how to improve the SGP. However, it is unlikely that these member states will get the other member states to agree to an adoption that gives the Commission the power to hand out sanctions and determine norms, it will most likely result in a compromise. That been said, member states have promised to implement a Pact strengthening the SGP. Moreover, the interests of European citizens and financial institutions make it impossible for the member states to not make any improvements to the current regulatory arrangement. This means that some improvements reducing the impact of member states’ self-interests can be expected.

Considering the events of the crisis it is likely that these improvements will address the exchange of information as well as the ability to sanction. An improvement to the exchange of information is to be expected, as many actors were shocked that a member state could hide its actually fiscal position from the other member states for such a long time. This has increased the interest in transparent information amongst citizens as well as certain member states. Moreover, the mismatch between the gathered information and the actual risk exposure has increased the interest in a broader exchange of knowledge. For these reasons it is quite possible that the scope of information exchange will be broadened and that Eurostat will receive more competencies to deal with national statistics agencies. What eventually gets adopted depends on how the member states, given the events of the crisis, will make the trade-off between national privacy and sovereignty on the one side and transparency on the other side.

An improvement to the task of sanctioning is to be expected, as the SGP is currently the only legal provision disciplining fiscal behaviour of member states. In order to stabilise the confidence on the financial market and address the concerns of citizens and certain member states, it is important that the SGP is perceived as credible. For this reason it is plausible that member states will negotiate additional sanctions as well as changes to the checks and balances between member states and regulation. Given that these checks and balances are crucial for the credibility of the regulation there will most likely be some transfer of power to the Commission. How much power is transferred to the Commission will depend on the trade-off between fiscal sovereignty and credible regulation. This trade-off will probably not give the Commission the upper hand in the regulatory tasks of norm setting and sanctioning as desired. However, any change that reduces the influence of member states’ self-interests is an improvement to the current peer arrangement, considering that member states currently use their regulatory powers to play political games rather than execute regulatory procedures.
9. DISCUSSION

Now that suggestions have been made to improve the peer arrangement in the SGP, it is time to discuss the findings of this research project and identify recommendations for future research. This chapter will start by discussing what the findings of this research project mean for the understanding of peer monitoring, the main goal of this research project. Moreover, this paragraph will discuss the limitations of this study. Finally, paragraph 9.2 will present the recommendations for future research.

9.1 DISCUSSION AND CONTRIBUTION OF FINDINGS

By means of an institutional analysis and case study this research report aimed to answer the question: “What is the capacity of peer monitoring in the SGP to decrease the negative effects from moral hazard between the member states?” The findings of this research project showed that the core conditions for moral hazard and adverse selection were not being mitigated by the presence of peer monitoring, despite the expectations derived from literature. Therefore, the capability of peer monitoring to decrease the negative effects of moral hazard for the case of the SGP was limited.

It appeared that interdependencies between member states did not necessarily result in a willingness to monitor each other and did not reduce information asymmetry. This was mainly due to the national interests of peers, which often resulted in a low willingness to regulate one another and lead to barriers in the institutional design of the peer arrangement. The design of the peer arrangement allowed the member states to use their regulatory powers to pursue their national interests, which lead to information asymmetry as well as under enforcement of fiscal regulation. The case study showed that this changed after the credit rating agencies started downgrading ratings of member states. However, at that point the financial situation of certain member states had already decreased to such an extent that peer monitoring could do little to improve the situation. In fact, it became the member states interest to bail each other out.

Overall, this might cast doubt on the value of peer monitoring, as the assumptions made in theory do not appear to be true. However, to really understand the value of peer monitoring, it can be wise to compare this case of peer monitoring to the case described by Stiglitz, as Stiglitz’s example did show positive results. A comparison of the example of Stiglitz to the case of the SGP shows that the situation of these two examples is very different. First of all, Stiglitz describes small groups of peers, which have been formed by the peers themselves. The case of the SGP involves a very large group of peers that has been established over a long period of time for many different reasons, not just for the sake of peer monitoring. Secondly, the case of Stiglitz describes a situation where peers live in close proximity of each other. This offers these peers the ability to judge another’s situation by literally looking over their fence. This is certainly not the case for the peer arrangement in the SGP. Thirdly, in the case of Stiglitz the peers are farmers, whilst in the case of the SGP the peers are member states. Farmers are non-political individuals, whilst member state are a gathering of different groups of actors both political and non-political. Finally, the design of the peer arrangement between the two cases differs. For instance, in the example of Stiglitz the banks have a shadow of hierarchy over the peers, whilst in the example of the SGP the member states hold the shadow of hierarchy themselves.
It is most likely that these differences explain why the execution of peer monitoring in the example of Stiglitz is better able to decrease the negative effects from moral hazard. Therefore, Stiglitz’s argument, that peer monitoring can help reduce problems of moral hazard or adverse selection, remains untouched. It merely underscores how important the characteristics of the peer arrangement are for the functioning of peer monitoring. In essence, this means that this study contributed to the understanding of peer monitoring by showing what characteristics can hamper the effectiveness of peer monitoring.

Besides that, this study also gave insights into the relationship between regulatory tasks and peer monitoring. This case study showed that the involvement of peers in regulatory tasks leads to the replacement of regulatory procedures with political games. This was especially problematic for the tasks of norm setting and sanctioning, as these tasks determine the regulatory objective and pressure on the regulatees. This research project argued that in the case of the EU more involvement of an independent vertical regulator is needed to provide the necessary checks and balances between the interests of fiscal regulation and the national interests of member states. Ideally this case should combine peer monitoring and vertical regulation. This way regulation can benefit from the peers ability to interpret information and benefit from the objectivity of a vertical regulator. However, if peer monitoring and vertical regulation can be combined and how peer monitoring and vertical regulation can be combined is still unclear at this point.

Limitations of the study findings
As the validation of this research project already stated, this project researched only one case of peer monitoring. This means that the characteristics that were found to be important for the functioning of peer monitoring in this case do not necessarily apply to other cases of peer monitoring. Other cases could identify different factors as important. Moreover, a certain characteristic might hamper peer monitoring in the one case, whilst it might contribute to peer monitoring in the other. Thus, because the characteristics and the effects of characteristics can differ per case so can the value of peer monitoring. This also means that other cases might require a different organisation of the regulatory tasks. Some cases might also require a balance between vertical regulation and peer monitoring, while other cases might not require such a balance at all.

Another factor that limits the results of the study is the scope of the project. This study focuses on moral hazard between member states, however, as many principal and agent relationship can be found in practice, so can many more forms of moral hazard. For instance, the case analysis of the crisis showed that moral hazard also occurred between banks and national governments. It was the risk taking behaviour of banks that lead to government intervention in many member states, which eventually increased the financial distress of governments. By ignoring other forms of moral hazard and purely focussing on the moral hazard between member states, one could argue whether the improvement of regulation in the SGP would really solve moral hazard issues in the EU.

A final factor that limits the results of the study is the fact the findings were gathered during a specific period of time. More specifically, the findings were gathered during a period of crisis. As the sovereign debt crisis is not an event that happens every few years it is difficult to say whether the findings would be the same if the peer arrangement had been studied for a different time period.
(although without the crisis one would not have observed the inconsistency between theoretic expectations and real world events and there would not have been a study on the subject of peer monitoring in the first place). Therefore, these findings also apply to a specific period of time.

9.2 **Recommendations for Future Research**

The findings of this research project as well as the limitations of the research project, provide several points of departure for future research. First of all, it is recommended to perform more peer monitoring case studies. Additional case studies can help understand what characteristics can influence the functioning of peer monitoring and how these characteristics can influence the functioning of peer monitoring. This could give insight into what influences the willingness to regulate one another and what can decrease issues of information asymmetry. Moreover, additional case studies could provide more insights into the relationship between regulatory tasks and peer monitoring. Are some tasks more suitable for peer monitoring than others or does this depend on the characteristics of the case? Further research could possibly lead to a framework that can provide guidelines on what roles to give peers and what roles to give vertical regulators, given the characteristics of the sector subject to regulation. Moreover, additional case studies could provide more insights into the relationship between regulatory tasks and peer monitoring. Are some tasks more suitable for peer monitoring than others or does this depend on the characteristics of the case? Further research could possibly lead to a framework that can provide guidelines on what roles to give peers and what roles to give vertical regulators, given the characteristics of the sector subject to regulation. Finally, additional case studies could give insight into the relationship between regulatory design on the other hand? Is responsiveness intrinsically flawed or does a certain combination of peer monitoring and vertical regulation allow for more responsiveness than others.

From a practical perspective it is recommended to perform further studies on the cause of the financial crisis, as this was one of the main reasons why certain governments ran into financial distress. In order to prevent another sovereign debt crisis in the EU regulation on the behaviour of member states as well as financial institutions needs to be studied and understood.
10. Reflection

This chapter is the final chapter of the research project. It reflects on the theory used in the research project, the research approach used and the process of the research project. The first paragraph will reflect on theory, paragraph 10.2 will reflect on the research approach and finally paragraph 10.3 will reflect on the research process.

10.1 Reflection on Theory

This paragraph reflects on certain parts of theory that was used in this research project. The first two sessions reflect on moral hazard and how this relates to the discipline of economics and public administration. The last section reflect on transnational regulatory networks and what this means for the suggested improvements.

Is moral hazard unobservable?

The dependent variable in this research project was the negative effects of moral hazard, whereby moral hazard was defined as follows: Moral hazard is unobservable behaviour of an actor from which the risks are dispersed between that actor and other actors. This definition was based on definitions found in literature. However, as most of these definitions stem from the discipline of economics and this research project was conducted with a public administration perspective, the question can be raised whether moral hazard is really unobservable. Economists state that moral hazard is unobservable, because the agent has more knowledge than the principal. This research, however, showed that the relationship between the principal and the agent does not take place in isolation, but takes place in a network of actors. Furthermore, whilst the principal might have difficulty observing the agents behaviour, other parties in the network might have less or no difficulty observing the agents behaviour. For instance, in this case of peer monitoring credit rating agencies observed and acknowledged behaviour of certain member states earlier than their group of peers. In essence, this means that unobservable behaviour is relative; it depends on who is observing the behaviour.

Managing good and bad moral hazard?

Another remark can be made when considering the phenomenon of moral hazard as described by economists and when considering the phenomenon of moral hazard from a public administration perspective. Economists describe moral hazard as a value neutral concept that can result in welfare gains and losses. Whether moral hazard is good or bad depends on whether the losses outweigh the gains or whether the gains outweigh the losses. If the gains outweigh the losses then moral hazard is good and should be left alone, when moral hazard is bad incentive structure for moral hazard should be taken away or reduced.

From a public administration perspective the question on whether moral hazard is good or bad is more complicated, because it takes entrepreneurship into account (economists, especially neoclassic economists, do not do this). In public administration theory the art of entrepreneurship is to undertake new things. Any new venture involves certain investment risks, but it can also push society forward...
and bring economic growth. This means that without risk there are no gains. Thus, whilst economic theory might make a distinction between good and bad moral hazard, the public administration perspective could argue that a clear distinction between good and bad moral hazard is not possible. Positive effects of moral hazard never come without the negative sides of moral hazard and are difficult therefore, to weigh up against each other. This raises another question and that is whether negative effects of moral hazard can be managed? If the gains of moral hazard do not come without the losses, it is safe to say that the reduction of moral hazard losses does not come without the reduction of moral hazard gains. This indicates that the management of moral hazard involves a balancing act between the negative effects of moral hazard and the positive effects of moral hazard, not just the prevention of negative effects of moral hazard.

**Improving peer monitoring through transnational regulatory networks**

The research project argued that the exchange of information is likely to be a point of improvement, therefore, it can be interesting to consider how Majone’s (2000) transnational regulatory networks would argue to change the exchange of information. As the theoretic framework described, transnational regulatory networks are networks whereby the European regulating agencies are central nodes in a network of national regulators and international organisations. Based on the institutional analysis one could argue that the regulation of statistical data takes place in such a transnational regulatory network, whereby Eurostat is the central node in a network of national statistics agencies. To improve the regulation of statistical data and therefore the exchange of information, Majone (2000) prescribes three important criteria: trust and cooperation within the network, a high level of professionalism and a common regulatory philosophy. Considering the events around Greece it is doubtful whether these three criteria are present. Majone is therefore likely to argue that these criteria need to be stimulated in any improvements of the exchange of information. In lign with this reasoning an increase in the competencies of Eurostat could have a detrimental effect on the functioning of regulation, as it is a sign of distrust. Yet the analysis of peer monitoring shows that more centralisation is needed. This shows that within the discipline of regulation, different ideas can exist on how to improve the functioning of regulation.

**10.2 Reflection on research approach**

This project started with a literature study to get a basic understanding of moral hazard, peer monitoring and regulation. This literature study gave good insight in the knowledge gaps of peer monitoring. It showed that little detailed knowledge was available on the subject of peer monitoring and that more context dependent information was needed. The theoretic study therefore provided an important argument for a case study approach. Moreover, this theoretic study also provided insights as to how one could analyse the “context” of peer monitoring by using an institutional framework, multi-actor network analysis and sanction and regulatory strategy pyramids. These tools allowed for the analysis of the complex situation of the SGP. Finally, the theoretic study also allowed for the
formulation of propositions. These propositions helped structure the findings and answer the main research question, but also made it easier to analyse other cases of peer monitoring and compare them.

The choice for an exploratory case study and institutional analysis is also still considered to be a good choice. The institutional analysis provided a lot of insights in the system and nature of the peer arrangement. The case study provided a lot of insights into the interests of peers, the interactions between them and the overall interactions between the actors in the system. Whilst a single case study might not be desirable from a generalisation perspective, the case study was needed as the literature study showed that little detailed knowledge was available on the subject of peer monitoring. In essence, the combination of the approaches allowed for the detailed analysis of the peer-monitoring situation of the SGP and helped understand why peer monitoring appeared to fail in the EU.

The research project also chose to analyse the peer arrangement case of the SGP from a public administration perspective. A public administration perspective allows for the analysis of interests, powers of actors and their interdependencies as well as the regulatory institutions in place and was therefore thought to provide good insights into the functioning of peer monitoring. Overall it seems that this perspective was a good choice as the role of actors and institutions played an important role in understanding how peer monitoring in the SGP worked.

10.3 REFLECTION ON THE RESEARCH PROCESS

Overall, I would say that the research process went quite smoothly. It took some time to get started, because a lot of the theoretic topics were new for me and I had never done a case study before. However, with a little guidance and many hours of reading I got familiar with the material and no longer felt overwhelmed by the assignment.

The main hurdle in this project was the interviews. First of all, access to interesting interviewees was limited. Dozens of mails and requests via acquaintances were sent out, but often had no result. This probably was due to the fact that it is still a sensitive topic and many of these people are too busy to make time for interviews. Besides that, I also had to consider the element of time. Finding out whom to approach for an interview takes time, on the other hand I wanted to finish the project in five months’ time. Luckily the European crisis is such a popular item that there were enough documents and archives available to answer my research questions. In the end, I interviewed two European Union experts. More interviews would have been nice, but looking at my experience with organising interviews for this project, I fear this can only be accomplished if you have a serious network of contacts within the European Union.

Despite this challenge of interviews I believe the process of the research project went very well. I gained a lot of new knowledge about topics, like moral hazard, finance, the European Union and case study research. Moreover, I learned a lot from constructing a theoretic framework and analysing case study evidence.
Graduating in groups

Another important thing to mention is that this study was executed parallel to two other graduation projects with a similar research project and research topic. The reason for this is that the faculty of TBM wants to test whether graduating in groups could speed up the process of graduating (currently it takes 7-8 months on average to complete the master thesis research project whilst it is supposed to take 5 months) and increase the depth of the study. Although I can’t really judge whether the second goal has been achieved, I can say that all three projects have been completed in five months’ time.

Moreover, as a team member, I found that graduating in a group offers many benefits. The fact that your teammates are studying similar topics makes it easy to have discussions about literature, the research approach, storyline of the report etc. These discussions make it easier to come to grips with the material and maintain a helicopter view on the assignment. In addition, being part of a team helps you stay motivated and makes it a lot more fun. The only disadvantage that being part of a graduation group has is that it requires some coordination effort to keep the research projects aligned. This can take some time. On the other hand, these coordination issues also help you think about your research project and force you to be more specific about what you want to do.
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APPENDIX A

This appendix gives a short background description of the European Monetary Union (EMU). It describes what the reasons were for implementing it and phases in which it was implemented.

ESTABLISHING A EUROPEAN MONETARY UNION

The Treaty of Maastricht initiated the set-up of the Economic and Monetary Union (EMU). It described three phases that would ultimately lead to the introduction of a single European currency, the Euro. The EU desired a single European currency for several reasons (Rijksoverheid, n.d.):

- To end fluctuation exchange rates between EU-countries: Fluctuating exchange rates were an obstruction to international trade. Sudden spikes and drops in an exchange rate give a different meaning to transactions, forcing businesses to hedge themselves against exchange risks, which increases costs. The implementation of a common currency would save money and decrease uncertainty.

- To have a strong communal European currency in the global market: The Euro would become an important currency in the global market, due to its wide area of use. This would be beneficial for the financial sector and European business.

- To simplify the comparison of prices: A common currency would make the comparison of prices within the EU easier. Furthermore, it would simplify travel within the EU.

- To stimulate a stable economy within the EU: The euro would stimulate the development of a stable and sustainable growing economy in the European Union. Citizens of Euro-countries, but also citizens from other EU countries benefit from a strong European economy.

The first phase leading to the introduction of the Euro started in 1990 and aimed to achieve an internal market (Grieco, 1995). Most importantly, it focused on achieving a completely free circulation of capitals. The second phase, starting on the 1st of January 1994, was aimed at coordinating economic policies between member states. Member states had to meet certain convergence criteria (Heipertz et al., 2010) also known as the Maastricht criteria, before they were allowed to enter into phase three. These criteria are as follows:

- Inflation is not allowed to be more than 1.5 percentage points higher than the average of the three member states with the lowest inflation.

- The government deficit to GDP ratio may not exceed 3% at the end of the preceding fiscal year. If this criteria cannot be met it must at least be close to 3%, only exceptional or temporary deficit excesses can be exempted from this criterion.

- The gross government debt to GDP may not exceed 60% at the end of the preceding fiscal year. In the event that the ratio cannot be achieved due to specific conditions, the ratio must have decreased sufficiently and at a tolerable pace.

- Member States have to be part of the exchange rate mechanism (ERM II) for two consecutive years. During this period they should not devalue their currency.
The long-term interest rates are not allowed to be more than 2.0 percentage points higher than the three member states with the lowest long-term interest rates.

The third phase started on the 1st of January 1999 and ended on the 1st of January 2002. This phase focused on the establishment of a European Central Bank (ECB), the fixing of exchange rates and the introduction of the Euro. The countries that went through to the third phase were: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain (Commission, 2013a). Six more countries followed later, namely Cyprus, Estonia, Greece, Malta, Slovakia, and Slovenia (Commission, 2013a).
APPENDIX B

This appendix described the actors involved in the Stability Growth Pact and the European debt crisis. It provides a short description of each actor involved and their powers and interest. These descriptions are especially useful if one does not have an understanding of the EU actor network and needs some more background information to understand it.

DESCRIPTION OF INVOLVED ACTORS IN THE EU CRISIS

The European Commission

The Commission is the executive body of the European Union and is responsible for the day to day running of the EU, the upholding of the Union’s treaties, and international representation of the EU (European Commission, 2012c). To manage the daily operations of the EU there are 27 Commissioners that manage a body of 23000 European civil servants (European Commission, 2012c). These civil servants are divided into several Directorates General (DGs) and services. The DGs deal with specific policy areas while the services are often of a more general nature. In total there are 33 DGs and 11 services. There are two DGs important for the functioning of the SGP, namely Eurostat and Economic and Financial Affairs (Ecofin). Eurostat has the task of gathering all the necessary statistical data for the SGP and Ecofin is in charge of assessing this data and giving policy advise (Heipertz et al., 2010). Because these two DGs are so important they will be discussed separately.

The European Council selects the President of the Commissioners and the President together with the Council chooses the other Commissioners (Hay & Menon, 2007). Every member state has one commissioner that is assigned for a 5-year term. The president furthermore decides what commissioner is responsible for what specific policy area. The elected Commissioners and President then need to be approved by the European Parliament, which also has the power to dismiss the Commission when they are in office (Hay & Menon, 2007). Parliament can, for instance, interview a nominated Commissioner and test his or her expertise on the policy area it is elected for. So overall the Council and the European Parliament both have an influence in the formation of the Commission. José Manuel Barroso is currently the President of the European Commission and Oli Rehn is the Vice-President and commissioner of economic and monetary affairs and the euro.

The Commission has the right to propose new legislation to the European Parliament and the Council of the European Union (Hay & Menon, 2007). This is also referred to as the right of initiative. However, new legislation can only be adopted by the European Parliament and the Council. For the Commission to performs its task as EU policy implementer and budget monitor it requires certain funding. The Commission receives its funding from the treasuries of member states (Hay & Menon, 2007). Table 10 gives an overview of the agreed budget for the Commission from 2007 until 2013. This table shows that the budget has gone up since the European sovereign debt crisis started in 2009.
The Council of the European Union (the Council)
The Council of the European Union is also referred to as the Council. Its composition is based on the policy field that is being discussed, but it is always formed by heads of state from each member state (Hay & Menon, 2007). In the case of the European Crisis, for instance, the national ministers of Finance and Economics come together. This Council of Economics and Finance ministers is also known as the Ecofin Council. The Council is the primary institution in which member states can voice their views and can negotiate with other member states on each policy area (Hay & Menon, 2007). In general the council is responsible for several important tasks, namely the coordination of the broad economic policies of EU member states, signing international agreements on behalf of the EU, helping the development of a joint foreign and defence policy and stimulating cooperation between courts and police forces of member states. In the case of fiscal policy the (Ecofin) Council is responsible for deciding whether a member states needs recommendations, a warning or financial penalty (European Commission Economic and Financial Affairs, 2012; Heipertz et al., 2010). Thus, the Council is the ultimate decision making body within the fiscal policy of the EU.

When the Commission proposes new legislation, the Council and the European Parliament have to approve it. Hence, the Council has legislative power. The Council and the European Parliament furthermore need to approve the EU’s budget. Decisions within the Council are made based on a qualified majority vote (Hay & Menon, 2007). This means that the amount of votes per member state are based on the amount of citizens the country has. In total there are 345 votes divided over member states, Table 11 on the next page shows the amount of votes per country.

For a decision to pass at least 255 of the 345 votes need to be in favour. A member state can, however, always ask to check whether the vote represents the minimum of 62% of the total EU population (Hay & Menon, 2007). If the vote does not meet this criterion the proposal cannot be adopted. In the event that a vote regards a sensitive topic, the vote can only pass with a unanimous vote. Consequently, the vote can be vetoed by one single member state.

Because the Council is formed by ministers from the member states, they only meet several times a year. The frequency of meeting is different per Council type, in general the Ecofin Council meets once a month (European Commission Economic and Financial Affairs, 2012). Furthermore, the

---

**Table 10: Budget European Commission per year (Everson et al., 1999)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Budget (in billion euro)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>120.7</td>
</tr>
<tr>
<td>2008</td>
<td>120.3</td>
</tr>
<tr>
<td>2009</td>
<td>116.1</td>
</tr>
<tr>
<td>2010</td>
<td>141.5</td>
</tr>
<tr>
<td>2011</td>
<td>142.0</td>
</tr>
<tr>
<td>2012</td>
<td>147.2</td>
</tr>
<tr>
<td>2013</td>
<td>150.9</td>
</tr>
</tbody>
</table>
Council has a president, that changes every half-year. The President is in charge of setting the agenda and making sure that the meetings run smoothly.

<table>
<thead>
<tr>
<th>Countries</th>
<th>Votes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany, France, Italy &amp; UK</td>
<td>29</td>
</tr>
<tr>
<td>Spain &amp; Poland</td>
<td>27</td>
</tr>
<tr>
<td>Romania</td>
<td>14</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>13</td>
</tr>
<tr>
<td>Belgium, Czech Republic, Greece, Hungary &amp; Portugal</td>
<td>12</td>
</tr>
<tr>
<td>Austria, Bulgaria &amp; Sweden</td>
<td>10</td>
</tr>
<tr>
<td>Denmark, Ireland, Lithuania, Slovakia &amp; Finland</td>
<td>7</td>
</tr>
<tr>
<td>Cyprus, Estonia, Latvia, Luxembourg &amp; Slovenia</td>
<td>4</td>
</tr>
<tr>
<td>Malta</td>
<td>3</td>
</tr>
</tbody>
</table>

The Ecofin Council
As mentioned earlier the Ecofin Council is the Council of the European Union that is formed by the national Economics and Finance ministers. Budget ministers are also present when budget issues are discussed. The Ecofin Council focuses its attention on the areas of economic policy coordination, economic surveillance, the monitoring of Member States’ budgetary policy and public finances, the euro, financial markets and capital movements, and economic relations with third countries (Hay & Menon, 2007). Decisions are mostly made based on a qualified majority; fiscal matters are however decided by unanimity. Member states that do not have the euro as their currency lose their vote in the Council when issues relating to the euro and the EMU are discussed (European Commission, 2013a). The Ecofin Council is also the Council that works with the European Parliament to debate and adapt the budget of the European Union.

The European Parliament
The European Parliament represents the European citizens and is directly elected by EU-voters for a five-year term (Hay & Menon, 2007). At the moment consists of 754 members. As mentioned the European parliament like the Council has the right of legislation, which means that it can pass laws and adopt the EU’s budget. Moreover, the Parliament has the important task of monitoring the democratic functioning of other EU institutions (especially the Commission) (Hay & Menon, 2007). It can examine reports produced by the Commission and can question Commissioners. Furthermore, the Parliament has a committee that monitors and evaluates the spending of the EU. So overall, the European Parliament is not directly involved in the execution of the SGP. However, they can question commissioners if they fear that the SGP is not being performed properly and need to approve any new legislation concerning the SGP.
The European Council
The European Council consists of the heads of state of each member state, the President of the European Commission and the President of the European Council (Hay & Menon, 2007). According to the Treaty of Lisbon, the European Council is in charge of setting the general political direction and priorities of the EU. It also deals with complex or sensitive issues that have to be solved at a high level of intergovernmental cooperation. Decisions are made based on consensus unless the Treaties state otherwise (Hay & Menon, 2007). Normally the European Council meets twice every six months, however, if needed the President can summit a special meeting. Like the Council, the European Council is an institutional body in which the member states can express their views on European policy.

Eurostat
Eurostat is one of the Directorates-General from the European Commission. It provides the statistical information to the institutions of the European Union and stimulates harmonization of statistical methods across all member states (Sverdrup, 2005). With the creation of the EMU, it has become responsible for the collection of reliable data to enable the monitoring of the Stability Growth Pact. It also helps develop statistical systems in candidate countries that want to join the EU.

National Statistics Bureaus in the EMU
National Statistic Bureaus are charged with the responsibility to gather and process data of national importance. This statistical information is of importance for commerce, governance and scientific research. Besides that, the national statistic agencies have the task of supplying Europe with the necessary statistics (Sverdrup, 2005). The deficit and debt to GDP ratio’s of the member states are thus gathered by the national statistics agencies and then passed on to Eurostat, so they can supply the Commission with the necessary information to monitor the SGP.

European Central Bank
The European Central Bank (ECB) is the central bank for the euro. Its main goal is to maintain price stability within the Eurozone. Hence, it tries to keep inflation low and prevent deflation. To achieve this the ECB has the tasks of defining and implementing the monetary policy of the Eurozone, conducting foreign exchange operations, managing foreign reserves of the European System of Central Banks, and stimulating a smooth operation of the financial market infrastructure (Arghyrou & Gadea, 2012; Grieco, 1995). Besides that, it has the exclusive right to issue euro banknotes. Member states are allowed to issue euro coins with the permission of the ECB. Mario Draghi is the current president of the ECB.

Eurogroup
The Euro group is an informal body of the European Union that ensures coordination of economic policies within the euro area and stimulates conditions for stronger growth and financial stability (European Commission Economic and Financial Affairs, 2012). It is composed of the national finance ministers from member states whose currency is the euro. They normally meet once a month, the day
Peer monitoring and its capacity to decrease negative effects of moral hazard

before the Ecofin meeting. The Commission Vice-President for Economic and Monetary Affairs as well as the President of the European Central Bank attend the meetings of the Euro group. Furthermore, the Euro group is in charge of preparing and following up on Euro Summit meetings. These are meetings where the heads of state of euro countries come together to discuss matters of importance to the euro area. With the introduction of the treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) in January 2013, the Euro Summit is required to meet twice a year.

Credit Rating Agencies

A credit rating agency is an agency that gives certain types of debt obligations and debt instruments credit ratings. These ratings reflect the ability of the debtor to pay back its debt, more specifically, it indicates the ability of a debtor to pay back its interest payments on time and likelihood to default (Standard & Poor, 2012). This debtor can be banks, corporations, national and local governments. Figure 15 shows the different ratings of one of the three major credit rating agencies, namely Standard & Poor (S&P). The other two major credit rating agencies are Moody’s Investors Service and Fitch Ratings.

![Opinions Reflected By S&P's Ratings](image)

Figure 15: The meaning of S&P’s ratings (Standard & Poor, 2012)

**DESCRIPTION OF EXECUTIVE AND LEGISLATIVE POWER**

Figure 16 gives an overview of the relations between the Commission, the European Parliament, the Council, the European Council and the Member States as just described. It shows what parties have
Appendix B

legislative power and what parties have executive power. Furthermore, it shows how the member states are represented in the European decision making process.

**OVERVIEW OF ACTORS INVOLVED IN THE SGP**

This last part of the appendix provides an overview of the involved actors in the SGP. This overview is given in table 10 on the next page. It lists the important actors, but also explains their interests, powers and discusses whether they can be viewed as a homogenous actor.
<table>
<thead>
<tr>
<th>Actor</th>
<th>Description</th>
<th>Homogenous</th>
<th>Interests</th>
<th>Power</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Commission</td>
<td>Executive body of the EU, responsible for the upholding of the treaties, international representation and daily operations</td>
<td>No, each commissioner stands for different policy areas</td>
<td>Smooth and successful functioning of the SGP. Maintain and enhance credibility</td>
<td>Right of initiative and execution</td>
</tr>
<tr>
<td>The Council</td>
<td>Main EU body in which member states can voice their views and can negotiate with other member states on each policy area</td>
<td>No, each member state has its own worries, desires and views for the EU</td>
<td>All are interested in maintaining their sovereignty. However, some are interested in fiscal discipline while other are against it.</td>
<td></td>
</tr>
<tr>
<td>The member states</td>
<td>Countries that are member of the EU. Their voting power in the Council is determined based on the amount of citizens the country has.</td>
<td>No, each member state has its own national culture, political system, fiscal framework etc.</td>
<td>Differs per member state. In general they have an interest in maintaining their sovereignty. Some have an interest in the relaxation of the SGP, whilst others have interests in stricter rules.</td>
<td>Voting power in the Council, voice in the European Council, financial power (for some more than others, depending on economic performance)</td>
</tr>
<tr>
<td>The European Parliament</td>
<td>Represents the European citizens, is directly elected by EU citizens. Monitors the democratic functioning of other EU institutions</td>
<td>No, formed by different European parties</td>
<td>Making the interests of EU citizens known. Safeguarding democratic functioning of EU.</td>
<td>Right to legislation and right to question commissioners</td>
</tr>
<tr>
<td>The European Central Bank</td>
<td>Responsible for monetary policy</td>
<td>Yes</td>
<td>Maintaining a stable currency</td>
<td>Right to determine monetary policy within the EU</td>
</tr>
<tr>
<td>The European Council</td>
<td>Formed by heads of state. Sets the general political direction and priorities of the EU</td>
<td>No, member states have their own EU priorities</td>
<td>Determining the proper course for Europe</td>
<td>Right to determine annual strategy of the EU and important policy areas</td>
</tr>
<tr>
<td>DG Eurostat</td>
<td>Responsible for gathering the necessary data for EDP from MS, harmonising statistical standard among countries, is part of the Commission</td>
<td>Yes</td>
<td>Providing objective qualitative data and stimulating harmony amongst national statistics agencies</td>
<td>Right of information. Can schedule certain technical visits.</td>
</tr>
<tr>
<td>DG Economic and Monetary Affairs</td>
<td>Responsible for gathering the convergence &amp; stability programs, is part of the Commission</td>
<td>Yes</td>
<td>Providing recommendations to the Council and MS w.r.t. the SGP</td>
<td>Right of execution</td>
</tr>
<tr>
<td>National statistics agencies</td>
<td>Gather statistical data on own nation</td>
<td>Yes</td>
<td>Providing objective qualitative data</td>
<td>Informational power (can differ depending on resources)</td>
</tr>
<tr>
<td>Credit Rating Agencies</td>
<td>Determines the credit rating of different types of bonds from different governments</td>
<td>Yes</td>
<td>Giving a rating that represents the level of risk bonds can have</td>
<td>Financial market power can influence liquidity of bonds.</td>
</tr>
</tbody>
</table>
APPENDIX C

This appendix analyses the performance of the Stability Growth Pact (SGP) up until the crisis. It provides a short background on how member interacted in the SGP up until the crisis.

A SHORT ANALYSIS OF THE PACT THROUGH TIME

When the SGP was implemented in 1999, member states were still busy with achieving MTO’s that were close to balance or in surplus (Buti, Franco and Onega, 1998). Then European Union counted 15 members states. By 2000 the deficit to GDP ratio had been reduced to 1.0 % for the Euro area as a whole. After that, however, the deficit started to increase again, reaching 3.0 % in 2003. This quickly put the SGP to the test. From the implementation of the SGP until the amendments in 2005, several countries ran excessive deficits. Portugal in 2001, Germany and France in 2002, the Netherlands and Greece in 2003, and Italy in 2004. Statistical improvements would later show that the 3% norm was breached even more frequently than known at the time, especially by Greece, Portugal and Italy. There were also member states that did comply with the norms: Belgium, Spain, Ireland, Luxembourg, Austria and Finland. The EDP did not apply to the UK, Denmark and Sweden.

The deficit violations before the revisions in 2005 were brought to the attention of the Council by recommendation from the Commission. Throughout most procedures the Council adopted the recommendations form the Commission, however, in other cases the Council deviated from the Commission’s recommendations. The first one was in 2002, when the Commission recommended the Council to give Portugal and Germany an early warning as stipulated in the preventive arm of the pact. The Council however decided that an early warning would be unnecessary seen as Portugal and Germany had already stated to be willing to reduce their deficits. The second deviation was in 2003 when both France and Germany had entered into an EDP. Both countries had until 2004 to correct their excessive deficits, however, as 2004 came closer the Commission discovered that both parties had taken insufficient action to reduce their deficits. Consequently, the Commission advised the Council to send notices to France and Germany and to give them another year to implement correcting actions. Nevertheless, the Council took an opposite direction than the Commission and decided that the EDP for both countries should be ended. France and Germany had created a big enough coalition to block further sanctions. France and Germany had both agreed to correct their excessive deficits by 2015 and therefore an EDP was no longer needed (ECOFIN Council Conclusions, 2003). In reaction to this conclusion the Commission decided to bring these conclusions in front of the European Court of Justice (ECJ). The ECJ annulled the Council conclusions and stated that the Council could not replace the rules and procedures as determined in the Treaty with “political conclusions” (Doukos, 2006).

During the ECJ ruling discussions were being held about changing the SGP. The member states main critique of the pact was that it was a formal “one size fits all” procedure that did not consider the individual economic situation of each member state. As a result, the SGP was amended in 2005. The amendments allowed for the member states to hand in country specific MTO’s, stipulated several escape clauses under which the member states would be allowed to violate the norms and extended procedural and correction deadlines (see paragraph 5.3 Regulatory Tasks). Under this new
more flexible SGP deviations between the Commission and the Council were no longer an issue. Member states now had a longer time to correct their deficits.

When these amendments were implemented the member states France, Germany, Greece, Portugal as well as Italy were already undergoing and EDP. However, after these amendments all five countries set on a path to abrogate the EDP and period of consensus followed.

Table 13 shows the actual deficit/surplus to GDP ratio of each member state. It shows that the data as depicted here can differ to data available at the time. For instance, Greece was continuously in violation of the norms whilst the Commission up until the crisis thought that Greece was only twice in violation of the norms.

Table 13: Annual deficit/surplus ratios of member states (Eurostat, 2013b)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>EU (27 countries)</td>
<td>-1.5</td>
<td>-2.6</td>
<td>-3.2</td>
<td>-2.9</td>
<td>-2.5</td>
<td>-1.5</td>
<td>-0.9</td>
<td>-2.4</td>
<td>-6.9</td>
<td>-6.5</td>
<td>-4.4</td>
<td>-4.0</td>
</tr>
<tr>
<td>Euro area (17 countries)</td>
<td>-1.9</td>
<td>-2.6</td>
<td>-3.1</td>
<td>-2.9</td>
<td>-2.5</td>
<td>-1.3</td>
<td>-0.7</td>
<td>-2.1</td>
<td>-6.4</td>
<td>-6.2</td>
<td>-4.2</td>
<td>-3.7</td>
</tr>
<tr>
<td>Euro area (16 countries)</td>
<td>-1.9</td>
<td>-2.6</td>
<td>-3.1</td>
<td>-2.9</td>
<td>-2.5</td>
<td>-1.4</td>
<td>-0.7</td>
<td>-2.1</td>
<td>-6.4</td>
<td>-6.2</td>
<td>-4.2</td>
<td>-3.7</td>
</tr>
<tr>
<td>Belgium</td>
<td>0.4</td>
<td>-0.1</td>
<td>-0.1</td>
<td>-0.1</td>
<td>-2.5</td>
<td>0.4</td>
<td>-0.1</td>
<td>-1.0</td>
<td>-5.6</td>
<td>-3.8</td>
<td>-3.7</td>
<td>-3.9</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>1.1</td>
<td>-1.2</td>
<td>-0.4</td>
<td>1.9</td>
<td>1</td>
<td>1.9</td>
<td>1.2</td>
<td>1.7</td>
<td>-4.3</td>
<td>-3.1</td>
<td>-2.0</td>
<td>-0.8</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>-5.6</td>
<td>-6.5</td>
<td>-6.7</td>
<td>-2.8</td>
<td>-3.2</td>
<td>-2.4</td>
<td>-0.7</td>
<td>-2.2</td>
<td>-5.8</td>
<td>-4.8</td>
<td>-3.3</td>
<td>-4.4</td>
</tr>
<tr>
<td>Denmark</td>
<td>1.5</td>
<td>0.4</td>
<td>0.1</td>
<td>2.1</td>
<td>5.2</td>
<td>5.2</td>
<td>4.8</td>
<td>3.2</td>
<td>-2.7</td>
<td>-2.5</td>
<td>-1.8</td>
<td>-1.8</td>
</tr>
<tr>
<td>Germany</td>
<td>-3.1</td>
<td>-3.8</td>
<td>-4.2</td>
<td>-3.8</td>
<td>-3.3</td>
<td>-1.6</td>
<td>0.2</td>
<td>-0.1</td>
<td>-3.1</td>
<td>-4.1</td>
<td>-0.8</td>
<td>0.2</td>
</tr>
<tr>
<td>Estonia</td>
<td>-0.1</td>
<td>0.3</td>
<td>1.7</td>
<td>1.6</td>
<td>1.6</td>
<td>2.5</td>
<td>2.4</td>
<td>-2.9</td>
<td>-2.0</td>
<td>0.2</td>
<td>1.2</td>
<td>-0.3</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.9</td>
<td>-0.4</td>
<td>0.4</td>
<td>1.4</td>
<td>1.7</td>
<td>2.9</td>
<td>0.1</td>
<td>-7.4</td>
<td>-13.9</td>
<td>-30.8</td>
<td>-13.4</td>
<td>-7.6</td>
</tr>
<tr>
<td>Greece</td>
<td>-4.5</td>
<td>-4.8</td>
<td>-5.6</td>
<td>-7.5</td>
<td>-5.2</td>
<td>-5.7</td>
<td>-6.5</td>
<td>-9.8</td>
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APPENDIX D

This appendix describes the interviews conducted during this research project. The interviews were semi-structured, meaning that they started open and the interviewee used a checklist of questions to structure the interview to recover all the necessary information. This checklist will be displayed first, followed by a summary of each interview.

INTERVIEW QUESTIONS

Proposition 1: Member states have information about each other
Member states agreed with the Stability and Growth Pact (SGP) that they would hand in an annual programme with their fiscal performance from the past years and their expectations for the following three years. Besides that, Eurostat collects statistical data on the fiscal performance of each government to monitor the 3% deficit to GDP norm and the 60% debt to GDP norm.

1. An interesting question would be to know whether the Commission only looks at each programme or whether the member states also look at each other’s programmes? Or do the member states only look at the programmes of the member states that have exceeded the norms?

2. Is other data that is not covered in the programmes assessed as well? Do the member states look at other information that could display about their risk taking behaviour, fiscal activities and ambitions? Do the member states analyse each other national fiscal framework and quality of information gathering?

3. If the Commission and the member states gather and use different sources of information about each other, then how contradictory are these sources?

And when making a distinction between information gathering and interpreting of information.

4. Can the Commission and the member states create an overview of the fiscal behaviour of (their peers) member states based on the gathered information? And do the member states and the Commission have the necessary knowledge to form an opinion about the individual member states?

Proposition 2: Member states have a sense of urgency to regulate one another
Member states agreed to coordinate their fiscal plans in the SGP. This shows that member states at the time did have some sense of urgency to regulate one another. On the other hand member states have asked for a flexible interpretation of SGP. Thus, what is now really the sense of urgency to regulate one another and what factors play an important role (e.g. historical past, self-interests etc.).

Note: There can be a difference in sense of urgency to regulate between the Commission and the member states. Moreover, amongst the member states there can be a difference sense of urgency.
Proposition 3: Member states may interfere with one another
On the one hand member states can send each other recommendation via the Council in the event that a member state is in violation of the agreed norms. On the other side the Council has never handed out a sanction when a member state does not adjust its fiscal position within the agreed time. This raises the question to what degree member state actually interfere with one another?

1. Is there a difference among member states? For example, does a member state only interfere with a member state with the same size, the same or opposing interests etc.?
2. Or is it uncommon to interfere with each other’s business, because of principles of subsidiarity and proportionality or because it can hurt international relations and can invite criticism upon yourself?

Proposition 4: Member states have formal & informal means to act
There is a formal moment when member state can decide in the Council whether to hand out recommendations, warnings or fiscal sanctions. Is this the only moment when a member state can act or are there more moments (think of other meetings, network conferences etc.)? What is the effect of these informal and formal intervention? What factors can limit this intervention?

Proposition 5: Member states have enough degrees of freedom to adjust regulation to the situation at hand
Is there a large enough variety of measures in place to encourage compliance with the standards set? If so, can these measures be applied properly and does this differ between member states? If one extends the implementation deadline of recommendations for one member state then do the deadlines need to be extended for other member states too?

INTERVIEW SUMMARY
Interviewee: Adriaan Schout
Date: 11 April 2013
Function/Background: International relations, works at institute Clingendael
Interview conclusions:
This interview gave a lot of insight in the relations between member states and EU institutions:

- **Information**: Eurostat and the Commission have acknowledged the difference in quality of national data for years. However, they have limited means to do anything about this. Member states also want to maintain their sovereignty/privacy. Moreover, it is not a situation where you can look over the fence and see what is going on. There was this idea that some member states would learn from other member states and implement a same system of data collection. However, there is always enough going on domestically so how much time is a member state really busy with learning from other member states?

- **Sense of urgency to regulate**: this is limited because members of the Council also have other political interest at stake. Domestic importance eventually influences will to regulate.
Peer monitoring and its capacity to decrease negative effects of moral hazard

- **Ability and willingness to sanction:** Soft sanctions (recommendations/warnings) are fine, but when it comes to the point where the next step is to pose a financial sanction it doesn’t happen. It makes no sense to give a bankrupt country a fiscal penalty.

- **Responsiveness:** Is very difficult, there is no such thing as a case-by-case analysis of appropriate regulation when peers decisions could affect their own (future) interests.

- **No shared norms and values:** If you want to govern in a network you need shared norms, values and goals, but they are not present. Member states have different traditions of governing and different interests.

- **Irish bailout different than Greek bailout:** Greek bailout is very worrisome. They have a different tradition of fiscal policy and data collection system. They really need to modernise. There are now German, Dutch, French etc citizens there to help this process, it is however still uncertain whether you can force a country to modernise. Ireland however is very different. They are trustworthy, because they do value fiscal discipline and qualitative data collection. There is less worry of what will happen to the money we lend out to Ireland. It is less of a gamble.

- **France (and southern states) against increased regulation:** With the crisis we also see a trend towards more centralised governance. The Commission is gaining slightly more power, reversed quality majority voting etc. However, France is currently frustrating this process. France does not like strict regulation and the ECB.

Interviewee: Tamara Takacs  
Date: 24 April 2013  
Function/Background: EU-law expert, works at Asser Institute  
Interview conclusions:  
This interview gave a lot of insights in the institutional context of the SGP and the means that member states have to act and gather information:  

- **Background on EU:** The amount of member states increased tremendously during the lifespan of the pact, which also increases the amount of interests and goals that need to be coordinated. This takes time, which make sudden events like a financial crisis.

- **SGP is a rule-based framework:** Regulation needs to be executed according to the rule-based framework. This gives little room for responsiveness.

- **Co-decision power of Parliament:** In 2009 the European Parliament received co-decision power from the Lisbon Treaty. This makes it slightly more difficult for the Council to ratify the SGP and make it more flexible. On the other hand lots of things have now been changed since the crisis (six pack, two pack).

- **Principle of subsidiarity and proportionality:** These are two important principles that limit the power of the EU. They show how important sovereignty is for member states. When the EMU was created member states already had to give up monetary policy, they did not want to give up fiscal policy as well.
Appendix D

- Fiscal sanctions difficult: especially the fiscal sanction is difficult to hand out. Fiscal damage was already so big that fiscal sanctions would not help achieve any more compliance; it would only hurt the group even more. Moreover, fiscal sanctions would have only added to a politically sensitive environment already, causing even more unrest.

- Regulation via the Council vs. via the Commission: Fiscal sanctioning is determined by the Council and not via the Court of Justice, which for example is the case for environmental law. This has two disadvantages first of all you have a situation where sinners have to evaluate sinners. Second of all, you have a situation where member states have to judge each other but where member states also need to think of diplomatic etiquette and international relations. This can make it difficult to openly critique one another. In the event of environmental law, for example, a member state can raise the alarm with the Commission without letting anybody else know. This way a member state can save face, but can also address its concerns. However, these advantages are not as important as sovereignty. And it is because of these type of dilemmas that Europe is a power play between supranational and intergovernmental governance.
Peer monitoring and its capacity to decrease negative effects of moral hazard