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Evolutionary Dynamics in Internal Market Regulation in the European Union

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Abstract

The chapter applies a historical institutionalist perspective to analyse the dynamics of market regulation in the European Union. It shows how an institutionalist perspective allows a deep understanding of the feedback loops that affected the preferences of European stakeholders and transformed initially insignificant agreements into profound changes that became visible only with time. Using the internal market for network industries as an example, it shows how European regulation expanded and was transformed from a very limited and often non-binding set of policies to an integrated and wide-ranging framework that sees rules for liberalisation and re-regulation of competition, together with new EU-level regulators. The long-term perspective of historical institutionalism highlights that this incremental but profound change was possible because critical junctures, in particular judgments by the European Court of Justice, allowed the European Commission and its allies to advance new policy proposals with a new default position. This in turn affected the preferences of major member states and created new coalitions. In addition, initial agreements led to the emergence of new actors. Taken together, the feedback loops reinforced the orientation of previous agreements and created changes that most observers would have qualified as impossible three or four decades ago.

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An unusual political system, the European Union (EU) is frequently criticized by policy-makers and often has a negative image in public opinion. It is seen as overly complex, unable to adapt to changing political conditions, imposing centralized rules that are oftentimes inadequate for local conditions and subject to a high degree of squabbling and disagreement among EU member states. Meanwhile, scholars see the EU as slow moving and weak. Its institutional structures are traditionally analyzed as the outcomes of decisions of powerful actors, be these through periodic intergovernmental ‘grand bargains’ (Moravcsik, 1998) or through pressures from transnational firms, the European Court of Justice (ECJ) and the European Commission (Sandholtz and Sweet, 1998).

We focus on internal market regulation to highlight two puzzles about European integration given these two traditional theories. First, the scope of European regulatory authority has expanded considerably in the last three decades in ways that nobody would have predicted in the 1970s. To be sure, much of this expansion built on initial agreements among member states, as intergovernmentalism highlights, and benefitted from spill-overs and the activities of institutional European and private actors, as supranational institutionalism stresses. Yet it has also been led by public bodies, whose institutional features have themselves evolved over time. However, and this is the second puzzle, many of the dramatic changes over time emerged out of formal institutions that should have frustrated policy innovation. In a highly complex political system such as the EU, most formal agreements can only happen on the lowest common denominator, which rarely allows moving substantially away from the

status quo. But seemingly insignificant advances opened the way for substantial incremental change in a variety of areas, we will argue below, most importantly by helping to shift the preferences of powerful actors.

Historical institutionalism provides tools to account for the evolutionary dynamics of internal market regulation and to explain how and why EU institutions have been greatly extended in scope, detail and depth over time. We argue that change has been marked by endogenous processes, as liberalization has stimulated re-regulatory rules and new organizations have sought to extend EU regulation. Although the processes have been slow and marked by bargaining, negotiation and compromise, they have led to a gradual or evolutionary development. We demonstrate how a historical institutionalist approach both helps to reveal these features and to explain them, and hence can in fact offer deep insights into the nature of the development of EU institutions.

The chapter begins by setting out key elements of a historical institutionalist (HI) approach applied to the EU. It then sets out key characteristics of EU institutional development in the field of regulation of economic markets, since these are at the core of the EU. Several of these characteristics differ from both popular views of the EU and several academic analyses. Finally, it looks at how an HI analysis helps to explain the features found.

Analyzing European integration and regulation

Historical institutionalism is a well-developed framework of analysis that focuses our

attention on the influence of past institutional developments on present ones, on crucial junctures and ensuing path-dependence, and on the value of lengthy time periods to capture slow-moving processes (Steinmo, Thelen, and Longstreth, 1992; Hall and Taylor, 1996; Thelen, 1999; Pierson, 2000; Capoccia and Kelemen, 2007). It has demonstrated that preference formation is an endogenous process: actors behave rationally, but that rationality is in part at least a product of the wider institutional context (see Fioretos, Falleti and Sheingate, this volume).

The key insights of the approach were developed to explain patterns within nation states. Yet, the scope for path dependence is likely to be great in the development of EU institutions (cf. Pierson, 1996). All four factors posited by Pierson (2000) for the importance of path dependence in politics apply in spades to the EU. To begin with, the nature of the EU is highly collective: many of the policies produced by the EU involve coordination of multiple participants, especially as inter-dependencies are high. The EU is marked by very dense politics, due to the high number of veto points and players. Equally, the reallocation of powers is likely to reinforce certain actors. Finally, the costs of setting up new institutions can be high, given the high number of actors involved. Developing what this means in a supranational context, this section highlights the institutional features of the EU that make historical institutionalism a particularly relevant perspective for understanding the evolution of EU regulation.

First, a high number of veto players are a crucial feature of EU decision-making. Legislation can only be proposed by the Commission, but then must be passed by a qualified majority (with elements of a supermajority) by the Council of Ministers, and

today most also by the European Parliament. The ECJ can strike down legislation. The Commission itself is divided into Directorate Generals (DGs), headed by Commissioners nominated by national governments and whom the Commission President cannot remove. National governments face their own domestic veto players and points. Coordination among these different actors is therefore key to the success of a policy proposal, but equally difficult to achieve.

This is linked to a second feature: the complexity and opacity of EU legislation, and especially European Community (EC) regulation.¹ The subject matter of regulation is often highly technical. Its legal form can vary, from Directives that member states have to transpose into domestic legislation to Regulations and some Treaty articles that have direct effects in member states. Most EU regulation is implemented by member states by national regulatory authorities, which may be government departments or different kinds of independent regulatory agencies. Still, some areas, such as competition policy, are predominately managed by the Commission. To add complexity, different forms of coordination of national bodies are possible, from networks to European regulatory agencies (Coen and Thatcher, 2008).

Over time, the need for coordination, technical cooperation and integration among multiple organisations have grown. These have resulted in a third feature: interdependencies and inter-linkages between formally separate national institutions and actors. Domestic agencies now connect in order to share information and coordinate their action. Regulatory ideas are frequently shared among strong professional and epistemic

¹ European Community (EC) is used here since most regulation is under the EC 'pillar' of the EU.

communities. By encouraging comparisons and creating competitive contexts, the EU provides a political setting where developments in one member state increasingly affect the evolution of its neighbours.

Fourth, there are multiple and often competing institutional legacies. This explains both the fault lines of individual conflicts, but also highlights that the costs of adaptation to a new EU regime can be unequally shared depending on the respective institutional fit. Each member state has its own specific institutional past. Thus for instance, France's statist institutions and traditions stand in contrast with Britain's economically liberal past and strong position in favour of finance capital, which in turn differ from neo-corporatist features seen in Germany and other Northern European countries (e.g. V. A. Schmidt, 2002; Fioretos, 2011). In addition, there are competing legacies at the EU level: for example, between DGs in the Commission, where some sectoral DGs are more 'interventionist', while others, such as DG Competition, is more economically liberal.

Fifth, supranational law adds an additional layer of complexity and affects both the strategy of actors advocating or opposing policy change and the costs that can be incurred. More specifically, the highly legalized nature of the EU also means that courts, especially the ECJ, provide a source of change (Weiler, 1991; Kelemen, 2011). This possibility is often used strategically by member states or European institutions such as the Commission to push for regulatory reform (S.K. Schmidt, 1998). As Kelemen (2011) highlights in a comparison between the adversarial legalism distinctive of the US and "eurolegalism", European courts now play a crucial role in determining political conflict in ways much comparable to the American system. Regulatory dynamics are no longer

just cooperative and informal, marked by bureaucratic solution-finding. With the increasing possibility for private actors and other stakeholders to take cases to the European courts, litigation strategies profoundly shape regulatory development. This stands in contrast to some Western countries where political institutions have dominated regulation.

These five features – a high number of veto-players, a complex EU regulatory process, interlinkages between national actors, competing institutional legacies and supranational law – have lasting effects on policy change that unfold over time and underscore the relevance of historical institutionalism. Studying the evolutionary dynamics of EU regulation highlights the co-existence of gradual change with some rare moments of rapid transformation caused by critical junctures. We argue that this is attributable to the fact that several defining features of the EU push towards the maintenance of the status quo (veto-players and complexity), while others encourage slow change (interlinkages) and can facilitate profound changes (diverse legacies and supranational law) in specific contexts.

As a general rule, EU policy-making and its regulatory process make ‘evolutionary’ or ‘gradual’ change highly likely, and a rapid change of direction and revolutionary reform rare. Streeck and Thelen’s (2005) modes of institutional change can all be observed in the EU. Layering is a common form of institutional development, as EU governance is multi-level and contains many veto actors who make contribute to new institutions being added to existing ones. Displacement is also an attractive strategy as new organisations

can slowly grow and use their own resources to expand their competencies and territory. The EU's limited resources such as staffing and large budgets encourage 'drift' (i.e. deliberate neglect) and conversion of existing organizations. In contrast, terminating existing organizations can be very difficult, not only due to incumbent organisational interests but also because new legislation must pass through a legislative process with multiple veto points and players.

Yet, as historical institutionalism points out, beyond such bounded change, new and unexpected directions of change can happen due to contingent events, which have been labelled "critical junctures". The EU's political system offers several sources for such contingent events. Its powerful courts provide a non-political source of change. Equally, the youth of many of its institutions and the expansion of its regulation may allow for contingent factors and new and unexpected developments. Finally, the contrasting and varied national institutional legacies may mean that there is more space for choice and contingency than for modern Western nation states. Indeed, interactions over time thanks to EU institutions may lead to actors altering their preferred policy positions, as we will develop below.

Finally, institutional complexity also affects the rationality of actors, who are likely to be subject to multiple and potentially conflicting contexts. Many policy makers are playing at least a two-level game (Putnam, 1988), if not a multi-level one (Woll, 2012). Thus governments, national regulators and firms with powerful domestic bases are operating in both national domestic and EU policy arenas (as well sometimes as international and/or

regional ones), which can lead to shifting alliances across levels.

The development of EU regulation of economic markets

Until the 1970s, EC regulation of markets remained relatively limited. The focus was initially on the elimination of tariff barriers to trade. Later on, competition policy became another major activity, notably regulation of state aid and dumping, which were directly handled by the Commission. However, many economic markets were left to national governments, especially public services, notably network industries such as telecommunications, energy, stock markets and transport (Thatcher 2007). These were mostly state monopolies supplied by government-owned entities.

The EC faced important constraints. The Commission was divided, with some elements in favour of greater competition, largely inspired by German *ordo-liberalism*, but other elements supporting industrial policy, notably in the form of promoting national and European champion firms, who would be large enough to meet feared competition from US or Japan. In any case, however, the EC seemed a weak regulatory body, with few legal powers. Legislative development was limited, especially due to the requirement for unanimity after the Luxembourg Compromise of 1966, which followed De Gaulle's 'empty chair' approach, in which a *de facto* veto was given to all member states of 'matters of very important national interest'. The EC's main activity was the provision of agricultural subsidies.

Thus by the early 1970s, the EU seemed to be destined to be a loose linkage of nations, at best a weak intergovernmental body. However, the 1970s and early 1980s saw a number of ‘critical junctures’ concerning regulation of economic markets. Many arose from judgments of the ECJ (Weiler, 1991; Caporaso and Stone Sweet, 1998; Fligstein, Sandholtz, and Stone Sweet, 2001). The most important was the 1979 Cassis de Dijon case, in which the court ruled that goods legally produced in one member state could be sold in other member states. “In the absence of common rules”, individual member states could set their own rules, but then meeting these empowered firms to export goods and services across the EC and other member states could not impose national restrictions that hindered trade (being caught by Article 28 [30]) except under limited circumstances (e.g. public morality, public policy or health and safety). Hence national rules provided a ‘passport’ across the EC (Nicolaïdis and Schmidt, 2007). In competition policy too, ECJ judgments were important, especially the 1972 Continental Can decision in which the Court offered a ‘backdoor’ entrance for the Commission to control mergers by applying Article 86 on abuse of a dominant position (Bulmer, 1994; McGowan and Cini, 1999). Other similar and unexpected ECJ decisions took place in telecommunications, such as the 1982 BT case, which gave the Commission ability to use its authority to regulate markets despite the absence of legislation.

The 1980s saw major changes in the European Commission. Jacques Delors, its President from 1985 to 1995, despite being nominally a Socialist, took up the notion of the European Single Market and proposed the ‘1992 programme’, in which EC liberalisation would revitalize European economies. He formed an alliance with ‘economic liberals’ in which greater competition led by the EC would be married with re-regulation. At first,

liberalization measures appeared limited. EC legislation opened up parts of the telecommunications and energy markets, but left the bulk under national control (which often meant monopoly supply). Moreover, liberalization was counterbalanced by other 're-regulatory measures' that appeared to protect traditional 'public service'. A Merger Regulation was passed in 1989 giving the Commission jurisdiction over the largest mergers, but its thresholds appeared very high at the time.

The production of EC regulation was slow. Thus the 1989 Merger Regulation took almost twenty years, while telecommunications legislation began with a Green Paper in 1987 but then took almost a decade before the whole sector was liberalized (Bulmer, 1994, Thatcher 2001). Negotiations were tortuous, often pitting 'liberal' states seeking extensions of EC law on competition (usually Britain and Germany) against 'Southern' states (often France and Italy) who supported more scope for industrial policies of favouring selected companies and protecting traditional 'public service' obligations, while the Commission sought greater powers for itself and for deepening economic integration. As a result of judicial strategies of pro-reform actors and shifting alliances that will be analysed below, different actors eventually reached agreement, including on the substantive content of regulation.

Once seriously underway, EC regulation spread. Liberalisation was extended in the late 1990s and 2000s across many economic markets, including their core. Thus by the end of the 2000s, the entire telecommunications, energy, airline and postal markets were opened to competition under EC law (Thatcher, 2007). Moreover, 're-regulatory' measures became not only increasingly detailed but also designed to ensure that competition was

‘fair and effective’, concerning a host of matters from cost-based tariffs to interconnection. Equally, EC merger control was extended by lower thresholds. Moreover, EC legislation began to encroach on national institutional structures, notably encouraging the establishment of independent regulatory agencies (and indeed requiring them in the case of electricity). Today, EC legislation over the internal markets has been greatly extended and runs counter to traditional monopolies and highly politicized interventions by national governments. The extension of EC regulation has involved much bargaining, negotiation and compromise, but even previously hostile countries such as France have accepted the principle of liberalization of markets.

The EC also developed its coordination capacities convening implementation. The 1980s and 1990s saw the establishment of independent regulatory agencies in member states (Thatcher, 2002). These often had detailed powers over enforcement and hence held many responsibilities for implementing EC regulation in practice. Equally, they had incentives for further EC regulation since it increased their powers and also aided them in achieving independence in practice from governments. Initially, informal networks of independent regulatory agencies/authorities were created, either by the agencies themselves or helped by the Commission.² However, over time, more formalized networks were

² Examples of informal fora largely established by the Commission include the European Electricity Regulation Forum in 1998, and one year later the European Gas Regulation Forum (see Eberlein, 2005); examples of informal networks of independent regulatory agencies include the Independent Regulators Group (IRG) for telecommunications in 1997, the Forum of European Securities Commissions in 1997, and the Council of European Energy Regulators in 2000.

established under EC law (Thatcher and Coen, 2008).³

As the Commission (and some national governments) became concerned about consistent implementation, to avoid member states ‘cheating’ by selective implementation of EC regulation, the power of regulatory agencies increased. This created a complex relationship with the Commission, as both it and the networks sought greater EC regulation, but the networks and their IRA members also wished to ensure sufficient distance from the Commission. After lengthy debates, involving both actors, as well as national governments, integrated European Regulatory Agencies (ERAs) were created in 2009-10, such as the European Banking Authority and the Agency for the Cooperation of Energy Regulators (Thatcher, 2011). However, they were given limited formal powers, and faced many constraints, notably dual boards – one for national government representatives and another for agency representatives of independent regulatory agencies. Nevertheless, they the ERA rapidly began to extend their operations. The European Banking Authority, for example, has been an important participant in efforts to reregulate banking in the aftermath of the financial crisis throughout Europe.

By 2012 EC regulation has been transformed in ways that were unexpected in the 1970s. It had been extended in scope and detail, covering many sectors, and including liberalization, re-regulation of competition, and implementation and coordination of national regulatory agencies/bodies. Each stage had been followed by another that built on

³ For example, the Committee of European Securities Regulators, CESR (2001), the Committee of European Banking Supervisors, CEBS (2003), and the European Regulators Group for Electricity and Gas, ERGEG (see Thatcher and Coen, 2008).

the previous one. Development had been slow and incremental, through negotiation and compromise, strategic manoeuvring and sometimes unexpected feedback loops created by moments of critical juncture that shifted the basis of negotiation of all participants. We will analyse these mechanisms in order to clarify the theoretical insights from historical institutionalism in the following section.

Insights from historical institutionalism

The longer time horizon of historical institutionalism offers a very different perspective than those focusing on recent changes or isolated ‘grand bargains’ during Treaty changes. It shows that EC regulation has developed greatly over time, in terms of coverage of different markets, extension of liberalization and provisions for implementation. It offers an immensely valuable lens for understanding a polity that has grown incrementally, with a series of small steps, through limited agreements, but resulted in outcomes that were not foreseen at the start of the process.

Secondly, a longer-term view brings attention to the role of critical junctures in shaping the evolution of EU regulation. The path of the 1960s and 1970s stands in sharp contrast to that of the 1980s onwards. As the previous overview highlighted, critical junctures arose most notably from ECJ judgements and the activism of senior figures in the Commission. Moreover, we can analyse how specific actors exploited critical junctures to orient future developments and forge new coalitions. To begin with, the ECJ acted when normal legislative progress seemed impossible, offering legal alternatives

through application of existing Treaty provisions. In addition, the Commission was able to offer new reform programmes that appeared to serve the interests of national governments and to be of rather limited scope.

Put more theoretically, the critical junctures opened up by court rulings were crucial for two reasons. First, they changed the default position that negotiators could previously fall back on. With new legal interpretation, “business as usual” was often precluded and conservative actors had to determine new policy stances, which oftentimes brought realignments. Second, the European Commission exploited these junctures by proposing new legislation in response to court cases. Proposals that would previously not have passed because a majority of member states might have preferred the status quo, were now able to garner more significant support. This explains many of the most significant changes in network industries such as electricity, telecommunications or air transport (S. K. Schmidt, 1998; Eising and Jabko, 2001; Woll, 2006). The evolution of preferences, endogenous to the process of European integration, are thus a major motor of further institutionalization. Historical institutionalism has long drawn attention to the need to endogenize the political construction of interests into models of change. As Immergut (1998: 20) underlines, “institutions act as filters that selectively favour particular interpretations either of [...] goals or [...] means.” When court judgements or Commission proposals changed default options or provided new institutional fora for negotiation, political actors adjusted their strategies, and sometimes even their overarching goals.

Thirdly, not only the traditional decision-makers, but also new actors triggered positive

feedback processes. Once liberalization began, it generated strong forces for the extension of EC regulation, notably for re-regulation and later concerning implementation through spill-over effects: rules in one domain or part of a domain create pressures for further rules in adjoining domains or to re-regulate the newly liberalized market (Vogel, 1996; Fligstein, Sandholtz, and Stone Sweet, 2001). Moreover, new organizations, such as loose networks of national regulatory agencies, began to press for further powers. Thus, new actors that arose of initial intervention (both at the EU level and at the national level) developed their own interests, joined coalitions and pressed for changes that increase their powers and extend EC regulation. Similarly, once European networks of regulators were created, they then gave rise to further processes of centralization and formalization, which have contributed to the creation of European regulatory agencies. These feedback effects are vital for understanding the EU, as initial, apparently limited changes can develop over time and often incrementally into far-reaching reforms. Historical institutionalism offers powerful insights into such processes.

Although neo-functionalist scholarship has greatly underlined the rise of new transnational actors, HI analyses add to their analyses by pointing to the space for political actors such as the Commission, independent regulatory authorities and networks of such authorities to undertake changes which, thanks to these feedback processes created dynamics that were not foreseen at the outset and that do not correspond fully to the market integration demands of the transnational actors alone. In addition, sometimes even limited institutions that correspond only to the lowest common denominator led to consequential changes in institutional design and market integration that developed their own organisational logics and paths. This does not imply that powerful actors were blind-

sided or did not act strategically, on the contrary! Most decision-makers involved were large and well resourced. Rather than following scripts blindly, they continuously evaluated their interests in the face of changing political contexts and consider different institutional alternatives. They bargain hard to pursue their preferred solutions. Policy preferences had to integrate changing fall-back options and shifting alliances, the arrival of new actors and competitive dynamics unleashed by previous decisions. This leads to surprising changes in the position of countries such as France, for example, who initially opposed liberalization, or the United Kingdom, which initially resisted further integration, including financial services. The interests of some regulatory agencies also evolved, towards accepting greater formalization under EC law. Correspondingly, we can find the main economic actors, the former monopoly providers and other private companies, change their policy stances in response to changing competition dynamics and shifts in the position of their national governments (Woll, 2008).

Fourthly, historical institutionalism points to the evolutionary nature of EC regulatory development. Existing organizations usually survive. They are often converted (with additional powers and formalization) or sometimes new organizational forms may be layered on top. The process of development is fraught with conflict, as different actors jostle and have their interests partially overlap but also partially conflict, leading to relationships of limited cooperation and also conflict. In many ways, the growing institutional complexity that arises from incrementalism and compromise can be compared to developments in American politics, where scholars have labeled the tension between overlapping sources of authority “intercurrence” (see Fioretos, Falleti, Sheingate, this volume). The American government, just like the institutions governing market

regulation in Europe, grow because a multitude of actors seek to preserve their respective authorities over a policy domain and to broker institutions that allow for compromise and co-existence. The rationalisation of practices is the exception.

However, there is one crucial difference between the American and European regulatory development that is linked to the policy cycle and the passage rate of legislative proposals. While the great majority of legislative proposals are abandoned in the US, Commission proposals have a very high chance of being adopted eventually, even if they may undergo considerable changes during long negotiation periods.⁴ This means that one should not overestimate the importance of bargaining, delay and compromise in the EU. Paying too much attention to these features risks missing two crucial aspects that matter for outcomes in the long run: (1) most often, even protracted EU negotiations lead to some sort of agreement and (2) however limited the agreement may seem initially, it is likely to involve greater EC regulation, in particular as it plays out over time.

Conclusion

Historical institutionalism draws attention to several features of EC regulation that are unexpected or downplayed in other frameworks with the help of theoretically-grounded explanatory factors. The long term time horizon sheds light on two parallel and surprising evolutionary dynamics: on the one hand, the forces resisting change that lead to gradual

⁴ Mahoney (2008: 64) estimate that only 10 percent of legislative proposals were passed as bills by the US Congress in 2008, compared to roughly 80 percent of European proposals which eventually turned into directives or regulations.

change and layered institutions, on the other hand, mechanisms that facilitate profound shifts. In particular, the strategic interactions of domestic actors, supranational institutions and new transnational actors and their use of European institutions lead to critical junctures, which create feedback loops and inform further institutional development. Much of this evolution operates through sometimes marginal shifts in actors' preferences, but in the complex interplay of multi-level policy bargaining, these feedback loops can create quite fundamental change over time.

Nevertheless, it is valuable to conclude by highlighting the limitations of an historical institutionalist approach, if only to suggest areas for development. One concerns the definition of actor interests. As anyone doing empirical work on changing preferences will quickly find out, it is almost impossible to distinguish basic interests from altered strategies in pursuit of the same interests. Only in rare cases do actors acknowledge having completely changed their mind about fundamental goals. This may be important if deeper questions of actor objectives are at stake. Equally, it matters for discussions of whether actors' identity is altered by interactions such as bargaining and negotiations, which is at the heart of debates concerning identity in constructivism.

A second issue concerns identification of a path (cf. Deeg 2005). Although changes in direction can be seen after long time periods, greater definition of what constitutes a path would greatly aid in identifying critical junctures and especially the timing of path change, which then would be valuable in analysing actor strategies, coalitions and roles.

Finally, historical institutionalism pays too little attention to informal arrangements that help to balance or off-set formal rules and organizations. On the one hand, formal

institutions may only create policy effects because they are complemented by informal procedures, as Kleine (2013) shows, arguing that formal rules alone would be unacceptable to many stakeholders in the EU and would bring integration to a stand-still. On the other hand, informal governance reinforces learning and feedback effects in ways that are more subtle than the ones previously described. Sabel and Zeitlin (2010) argue that even non constraining agreements, such as the open method of coordination, can create recursive processes, where comparison and learning pushes for a convergence of standards that eventually make formal arrangements possible. A more complete historical institutionalist account of European market integration needs to consider such non-constraining informal procedures on equal footing with formal institutional development.

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