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Article 1

Title:	De facto differentiation in the European Union – Circumventing rules, law, and rule of law
Publication:	*The Routledge Handbook of Differentiation in the European Union*
Abstract:	Differentiation has become a common feature in European integration and attracts considerable scholarly attention. The vast majority of academic literature focuses on formal (*de jure*) differentiation, in which opt-outs or other derogations are codified in EU law. This chapter elaborates on the as yet understudied and ill-defined phenomenon of informal (*de facto*) differentiation which is not recognised or supported by EU law. Combining knowledge from several disciplines of EU studies, this chapter conceptualises *de facto* differentiation and distinguishes three distinct types: *de facto* differentiation by non-compliance, cooperation outside the EU legal framework, and unilateral opt-ins to the acquis. These theoretical foundations are subsequently discussed in an illustrative study of three cases in Economic and Monetary Union, comprising all three types of *de facto* differentiation. Ultimately, the contribution of this chapter is a conceptual framework of *de facto* differentiation that invites further research in this area.

Introduction

As a consequence of increasing socio-economic and political heterogeneity among its member states, the European Union (EU) has to cope with divergent policy preferences in its pursuit of 'ever closer union.' The remedy of choice has often been to engage in various forms of differentiated integration which has become an integral part of EU governance and attracts considerable scholarly attention (Dyson & Sepos, 2010; Leuffen et al., 2013; Schimmelfennig & Winzen, 2020). More recently and in particular in light of Brexit, research has begun to turn to differentiated disintegration (Schimmelfennig, 2018; Leruth et al., 2019a). The prevalence and multi-directionality of differentiated processes of European integration has led to a more comprehensive concept of differentiation, seen as a key feature of European integration (Gänzle et al., 2020).

This chapter contributes to this broadened scope by addressing a distinct form of differentiation that has long been overlooked. The vast majority of academic literature discusses formal arrangements of differentiation in primary and secondary EU law (Leuffen et al., 2013; Duttle et al., 2017). Understudied in comparison remain informal arrangements of differentiation that are not codified in EU law. This scholarly neglect is surprising, considering the high relevance of the policy areas affected. For example, in Economic and Monetary Union (EMU), both Sweden's *de facto* opt-out and the unilateral adoption of the euro by Kosovo and Montenegro constitute differentiation that is not recognised by EU law. Moreover, the original Schengen Agreement was conceived as an intergovernmental treaty and, signed by only five member states, created differentiation outside the EU legal framework.

More research is needed to fully grasp this distinct type of differentiation in the EU. As yet, we know little about its origins and ramifications for EU integration. The key objective of this contribution is to lay the groundwork for a new research agenda that addresses these gaps in knowledge. To that end, the chapter proceeds as follows. In the next section, I review and assess the literature on informal differentiation in the EU. On that basis, I subsequently develop a typology and workable definition. Finally, I present three distinct cases of informal differentiation in EMU and discuss their respective implications from the institutional perspective of the EU.

Informal differentiation in the EU

The idea that differentiation can also be established outside of formal opt-outs is not entirely new. It first entered academic debates after the EU's enlargement by ten new member states in 2004. In view of limited resources, constrained administrative capacities, and the widely different institutional traditions among the predominantly post-communist new member states, Andersen and Sitter (2006) called for including informal aspects of differentiation in the study of differentiated integration. Inspired by organisational theory and Europeanisation literature, the authors sought to connect the dots between the dynamics of integration and variation in the actual impact of EU policy across sectors and states. Their main

contribution is a typology[8] of differentiated integration in secondary law, which includes three types of informal arrangements of policy opt-outs. Most notable among these is the concept of deviant integration, whereby differentiation is established by circumventing EU law. Essentially based on some form of non-compliance, this type of differentiation was conceived to be the result of limited state capacity and/or strong domestic resistance against the implementation of a certain EU policy.

Few scholars of EU integration have since heeded their call. Notable exceptions include Dyson and Sepos (2010: 4) who mentioned informal arrangements in their definition of differentiated integration. In the same volume, Howarth (2010) listed non-compliance as one aspect of informal differentiation in EU industrial policy and referred to breaches of the EU's limit of state aid as an example. In a similar vein, Holzinger and Schimmelfennig (2012) reference Andersen and Sitter in a side note by acknowledging the possibility that member states may choose non-compliance over negotiating differentiation to avoid costly policy obligations.

Sweden's reluctance to adopt the euro, is often referred to as a *de facto* opt-out in EMU (Adler-Nissen, 2009; Schimmelfennig et al., 2015). Following the result of a referendum in 2003, Sweden has since taken no steps to adopt the euro, despite being obliged to do so under the Maastricht Treaty. The case study of Jensen and Slapin (2012) on 'cascade effects,' in which the opt-out of one state is said to encourage other member states to follow suit, specifically deals with this case.

[8] Andersen and Sitter present four types of integration. 'Homogenous integration' does not depict differentiation, but cases in which EU policy uniformly affects all member states. 'Aligned integration' and 'autonomous integration' are each models in which EU law is specifically designed to provide leeway in the modalities of implementation or to accommodate divergent national preferences, respectively. While both account for variation in the transposition and application of EU law (cf. Zhelyazkova & Thomann, 2021), they do not constitute differentiation if understood as the unequal validity of EU law across member states. In that sense, only the fourth type 'deviant integration' can be considered differentiation because the validity of EU law is *de facto* suspended. In other words, citizens or businesses located in states engaged in deviant integration remain unaffected by the piece of EU law in question.

Surprisingly, the informal nature of Sweden's opt-out was neither discussed nor put in context with their findings.

Using the same case as an example, Leruth et al. (2019b) conceptualise *de facto* differentiation as one of five empirical models of differentiation in the EU. In their study, *de facto* differentiation resembles the concept of deviant integration in that it depicts differentiation based on non-compliance with EU law. Falling short of providing a full-fledged definition for *de facto* differentiation, the article briefly discusses its limitations and risks. Primarily, *de facto* differentiation hinges on tolerance from the EU Commission. Its longevity is, therefore, uncertain because the legal questions raised by such arrangement will sooner or later be addressed. However, the authors argue that *de facto* differentiation may become permanent if the socioeconomic and political conditions for further integration are not met.

The term *de facto* differentiation has also been mentioned in context with Poland and Hungary's ongoing violations of the EU's rule of law principles, albeit only as a sidenote (Schimmelfennig, 2019). Thereby, Schimmelfennig referred to a recent contribution from Kelemen (2019), wherein he assessed the normative implications of differentiation in rule of law. Although acknowledging that Poland and Hungary have already established a national legal basis in violation of the EU's rule of law principles, Kelemen did not further elaborate on whether the current situation constitutes some kind of informal differentiation even now.

Eriksen (2019) views *de facto* differentiation from a spatial perspective that resembles the concept of variable geometry as defined by Stubb (1996). In that regard, Eriksen mentions the Eurogroup, an EU Council subcommittee comprising the finance ministers of eurozone member states, which indeed distinguishes itself from the EU-27 by a different level of integration. Since the financial crisis hit Europe, Eriksen contends that non-Eurogroup states have been 'downgraded to a secondary status,' thus establishing *de facto* differentiation. This assessment is grounded in the analysis of Avbelj (2013) who asserted that measures taken outside the EU legal framework such as the Fiscal Compact have created a new EU-17 that could replace the original EU-27.

Informal arrangements of differentiation receive some mention in the literature but mostly just in passing. As yet, there exists no comprehensive concept that embraces the variety of associated cases. Moreover, terminological ambiguity prevails, and the potentially different causes and implications of this distinct type of differentiation remain opaque. These questions shall be addressed, albeit tentatively, in section four. In the following section, I lay the conceptual groundwork by elaborating on the different types of informal arrangements of differentiation in the EU and by developing a workable definition.

Conceptualising *de facto* differentiation

For terminological clarity and brevity in describing these phenomena, I adopt the term *de facto* differentiation. Although Andersen and Sitter's concept of deviant integration paved the way for this hitherto nascent sub-discipline, it fails to capture the disintegrative direction which is now considered an inherent part of differentiation in the EU. Moreover, deviant integration is rather narrowly defined to describe informal differentiation that stems from non-compliance, whereas the somewhat elusive term *de facto* differentiation still allows for broader conceptualisation.

In order to develop a comprehensive concept of *de facto* differentiation, it is first necessary to clarify the individual constituents of this composite term. This volume understands differentiation as an umbrella term that covers both differentiated integration and differentiated disintegration, as well as their respective modes multi-speed, variable geometry, and *à la carte* (Stubb, 1996). In that vein, Schimmelfennig (2018) offers an inclusive definition of differentiation as processes of an unequal increase or reduction in the centralisation level, policy scope, or membership of the EU.[9] Both EU member states and non-members are included in this concept and represented in the different types of internal and

[9] Of course, the literature offers various other definitions (cf. Gänzle et al., this volume) and settling for one inevitably creates a bias. I adopted the Swiss-German school's strongly legal perspective, as it is most suitable to introduce and discuss a form of differentiation in which the circumvention of the EU legal framework plays a central role.

external differentiation. The addition of the term '*de facto'* essentially describes the informal nature of this particular type of differentiation. In legal studies, the term refers to practices or conditions that exist in reality but are not officially recognised by binding law, in this case EU law. This is what distinguishes *de facto* differentiation from *de jure* differentiation. In that sense, *de facto* differentiation describes cases that fall under the definition of differentiation but are not enshrined or recognised by EU law. That is not to say, however, that the practice is *per se* illegal.

With basic terminology out of the way, it is time to address the two types of *de facto* differentiation identified in the literature. Both involve the circumvention of EU law. This can either be grounded in non-compliance, as in Sweden's opt-out from EMU, or in some form of cooperation outside the EU legal framework, as in the Fiscal Compact. To develop a generalisable typology, this requires further specification. Clearly, not all kinds of cooperation outside the EU and not all acts of non-compliance fall under the definition of differentiation. In the final subsection, I present a third type of *de facto* differentiation that has thus far been ignored.

<u>De facto differentiation by non-compliance</u>

Non-compliance by nature creates a *de facto* suspension of otherwise valid EU law. In the most general sense, this can be considered differentiation because it effectively and unequally reduces the centralisation level or membership in a certain policy area. Although EU law remains uniformly valid, its unequal application creates a situation in which citizens or businesses situated in compliant member states are affected by EU law, whereas those registered in non-compliant member states effectively are not. This is, however, not to say that all cases of non-compliance constitute or lead to *de facto* differentiation.

Non-compliance is a fairly common phenomenon in the EU, as well as in other international organisations. Recent research by Falkner (2018) attests to a 'non-trivial degree of non-compliance with EU policy.' Explanations for the existence of non-compliance in international organisations are dominated by two schools of thought: the management approach and the enforcement approach (Tallberg,

2002). The managerial school assumes that non-compliance is involuntary and due to a lack of administrational capacity, vague wording, or inadequate timetables (Chayes & Handler Chayes, 1993). By that logic, international organisations can manage non-compliance by providing aid in implementation, but their resources are limited as well. In 2017, the EU Commission admitted that its capacities to enforce compliance were limited and that it strategically prioritised cases that obstruct the implementation of important policy objectives or risk undermining the four freedoms (EU Commission, 2017).

In contrast, the enforcement approach posits that non-compliance is intentional and serves states to avoid the costs of compliance (Downs et al., 1996). To enforce compliance, international organisations employ monitoring and sanctioning schemes to increase the costs of non-compliance vis-á-vis the costs of compliance. The EU possesses several enforcement instruments, including the Commission's infringement procedure, preliminary rulings and naming and shaming (Hartlapp, 2007). As member states consider the costs of compliance, international organisations must take into account the costs of enforcement. In the same vein, König and Mäder (2014) contend that the EU Commission considers the likelihood and costs of enforcing compliance before taking action. Moreover, Steunenberg (2010) found that the Commission only acts if supported by the European Court of Justice (ECJ) or other member states.

Whether non-compliance constitutes *de facto* differentiation can be determined by applying a causal and a temporal criterium. In line with the enforcement and management approach, Tallberg (2002) divides the causes of non-compliance in two main categories: non-compliance as a preference and non-compliance due to capacity limitations. In the latter case, non-compliance is unintentional, and, crucially, states have no interest in differentiation. Furthermore, states have no incentive to protract non-compliance, because the Commission's infringement procedure incurs non-compliance costs already during the early stages. Before being met with financial sanctions as the *ultima ratio*, non-compliance can diminish reputation among other member states (Downs & Jones, 2002). In addition, the negative press associated with court cases may incur domestic audience costs (Chaudoin, 2014). Conversely, the picture can be very different if

non-compliance is a choice resulting from a rational evaluation of costs and benefits. Strong resistance from interest groups can incur significant compliance costs, which may entice states to prolong non-compliance and drag out the infringement procedure (Hofmann, 2018). By doing that, states create *de facto* differentiation that remains in effect until the state complies.

Following Schimmelfennig and Winzen (2014), exemptions from EU legal rules qualify as differentiated integration if they last for at least one year. Although explicitly excluded in their contribution, *de facto* differentiation by non-compliance should also be delimited by a temporal criterium. Most registered cases of non-compliance are due to failures of notification or untimely transposition, and most cases are resolved in the early stages of the EU Commission's infringement procedure (EU Commission, 2020a). This resonates with the above-mentioned causal differences between non-compliance due to capacity issues and different preferences. Börzel et al. (2012) further estimate that by the time the EU initiates infringement procedures, member states that first ran into capacity issues should be able to redistribute resources to comply with the respective policy. In contrast, non-compliance due to divergent preferences is more likely to go through more stages of the infringement procedure. As the intervals between the different stages are not uniform, setting the temporal criterium to a specific number of months or years is difficult. Instead, I suggest considering cases of non-compliance *de facto* differentiation if non-compliance endures after the Commission's issuing of a reasoned opinion. At this second stage of the infringement procedure, the culprit state has failed to prove compliance and capacity issues could have already been addressed.

To conclude, it is the wilful protraction of non-compliance that can be considered *de facto* differentiation. The bulk of such cases affects secondary law. In fact, the EU Commission's infringement database is rife with cases in which compliance with secondary law could be restored only after ruling by the ECJ. Some cases are even taken to court a second time, following which incessantly non-compliant states may face financial penalties according to Art. 260 (TFEU). However, Falkner (2018) demonstrates that even less wealthy states are not always deterred by financial penalties and choose to pay rather than comply. Although fewer in

numbers, there are significant examples of *de facto* differentiation established by non-compliance with primary law. This includes Sweden's *de facto* opt-out from EMU, which will be discussed in the following section. Poland and Hungary's *de facto* differentiations in the rule of law or freedom of press technically belong in that category as well. Despite difficulties to pin this down to a specific EU policy, both states have passed national legislation undermining principles outlined in Article 2 (TEU).

De facto differentiation by cooperation outside the EU

Aside from certain areas in which the EU has exclusive competences, e.g. international trade agreements, member states may engage in various types of international cooperation. Neoliberal institutionalists assert that an increasingly interdependent world economy demands cooperation within the framework of international organisations and regimes (Mitrany, 1975; Keohane, 1984). The EU is but one of many international organisations its member states participate in. Membership in other international regimes is not uniformly distributed among EU member states. It is, in fact, rather diverse. Following the neoliberal school, one could attribute this to states' diverse and issue-specific interests (Keohane, 1986). If these interests cannot be accommodated within the EU, member states may be enticed to engage in other bilateral or multilateral regimes that comprise more likeminded allies. The same argument basically underlies the liberal intergovernmentalist interpretation of the emergence of differentiation *within* the EU (Schimmelfennig, 2019).

The diverse international regimes EU member states participate in range from bilateral agreements to membership in various types of international organisations. On the most basic level, states cooperate by way of bilateral agreements concerning specific issues. For instance, France and Germany have a long history in bilateral industrial cooperation. The two states have pooled competencies and resources i.a. to establish Airbus as a global player in the aviation industry or, more recently, to advance research and development in artificial intelligence. One step above that, EU member states increasingly engage in smaller multilateral networks to coordinate policy in specific areas. For example, Denmark, Sweden, and Finland cooperate with other Nordic states in the Hanseatic League, and so do the central

European member states Poland, Czechia, Slovakia and Hungary within the framework of the Visegrad Group. Furthermore, subsets of EU member states are members in international organisations with different degrees of policy coordination and influence. For example, all EU member states except Austria, Ireland, Sweden and Finland are NATO members, only France, Germany and Italy are in the G7, and only France holds a permanent seat in the UN Security Council.

To be clear, while none of the above-mentioned examples are codified in EU law, they do not qualify as differentiation. This is because neither the centralisation level, nor the policy scope or membership of the EU are affected. A positive case for *de facto* differentiation by cooperation outside the EU – in this case its predecessor, the European Communities (EC) – is the 1985 Schengen Agreement between France, Germany, and the Benelux states. The abolition of passport controls for intra-EC border crossings had long been discussed among the then ten member states of the EC. Due to concerns related to national sovereignty, consensus could not be reached among the EC-10. To escape this deadlock, this integration step took the shape of an international treaty outside the EC legal framework. This type of *de facto* differentiation persisted until the Schengen Agreement was incorporated into EU law by the 1997 Treaty of Amsterdam.

<u>De facto differentiation by unilateral opt-ins</u>

Although not mentioned in the literature, *de facto* differentiation can also be established via unilateral opt-ins into the *acquis communautaire* by non-member states. The literature on Europeanisation shows that the European Union affects domestic policy, politics and polities not only among member states, but also beyond its borders (Sedelmeier, 2011). Official and prospective candidates for EU membership adopt EU rules, standards and norms to meet the accession criteria defined by the EU Commission. But even in areas that are unlikely to be integrated into the EU in the foreseeable future, Europeanisation can be observed in specific policy areas (Gänzle & Müntel, 2011).

The partial integration of non-member states into the *acquis* is generally recognised as a form of external differentiation (Leuffen et al., 2013; Leruth et al., 2019b). Third states choose to ‘opt-in’ either unilaterally or because they are

induced to do so by the EU (Holzinger & Tosun, 2019). Most research in that area deals with the latter, either in context with requirements for EEA members or the policy alignment targets of EU neighbourhood policy (Lægreid et al., 2004; Börzel, 2011). While receiving some mention, the '*de facto* interaction' with non-member states or '*de facto* opt-ins' remain understudied (Lavenex, 2015; Cianciara & Szymanski, 2020). Such *de facto* opt-ins are unilateral steps taken without the explicit approval from the EU. In most cases, they take the shape of adopting standards or norms. In some rare cases, unilateral opt-ins allow for free-riding and access to excludable collective goods. For instance, Kosovo and Montenegro have both unilaterally opted into parts of EMU by making the euro their official national currency. These cases will be discussed in further detail in the following section.

In conclusion, *de facto* differentiation manifests in three distinct types. Each involves some way of circumventing the EU legal framework either by: cooperation outside the EU, non-compliance, or unilateral opt-ins from non-member states. Among these types, *de facto* differentiation by non-compliance arguably bears the highest significance, because engaging in such differentiation actively contests the EU's legal authority. Moreover, the numerous cases of lasting non-compliance in secondary law make this type of *de facto* differentiation a far-spread phenomenon. In comparison, the two other types are rather rare.

It was also the ambition of this section to propose a definition of *de facto* differentiation. A comprehensive definition must embrace all three types without becoming generic and, crucially, remain in line with the general understanding of differentiation. Taking this into account, I define *de facto* differentiation as a deliberate and enduring circumvention of the EU legal framework, which leads to an unequal increase or reduction of the centralisation level, policy scope and membership of the EU.

De facto differentiation in Economic and Monetary Union

In this section, I present and discuss three empirical cases of *de facto* differentiation in Economic and Monetary Union (EMU). EMU was established as part of the Maastricht Treaty in 1992 and comprises a set of policies and the adoption of the euro, through which the economic convergence of EU member

states shall be facilitated. Crucially, EMU is a highly differentiated policy area. In addition to the UK's and Denmark's voluntary opt-outs, its three-staged integration process makes EMU one of only few policy areas that contain *de jure* differentiation by design. Only after a member state has moved into the third stage, it is permitted to adopt the euro and, thus, fully integrated. Full participation in EMU is further contingent on meeting five economic convergence criteria: member states must not exceed a pre-defined rate of inflation and long-term interest, stay below the 3% ratio of annual budget deficit to GDP and 60% overall debt to GDP, and participate in the Exchange Rate Mechanism (ERM) which pegs member states' national currency to the Euro.

In the following subsections, I demonstrate that the high degree of differentiation in EMU extends to all three types of *de facto* differentiation. First, I introduce the three cases individually and elaborate on the circumstances under which they emerged and how they are today handled by the involved member states and EU institutions. In the final subsection, I take a more general perspective and discuss the implications of each type of *de facto* differentiation for European integration.

Sweden's de facto opt-out from EMU

Sweden joined the EU in 1995 alongside Austria and Finland. As the Swedish government had not previously negotiated any opt-outs, Sweden became subject to the entire *acquis* which, since the Treaty of Maastricht, obliges all EU member states except Denmark to adopt the Euro once the convergence criteria are met. Although mostly in favour of adopting the euro, the Swedish government was aware of the far-spread public scepticism towards abandoning the krona for the euro and followed a cautious approach.[10] In October 1995, the government appointed a commission tasked to assess the consequences of Swedish participation in EMU. The commission was headed by economist Lars Calmfors and comprised five economists and three political scientists. The report, delivered

[10] The European Commission's polling instrument Eurobarometer found that 54% of Swedish survey participants rejected the common European currency, whereas only 29% spoke out in favour (Standard Eurobarometer 44, 1996).

in October 1996, concluded that the economic arguments spoke against adopting the euro, whereas remaining outside the Eurozone would come at the loss of political influence (Calmfors et al., 1997). Ultimately, the Calmfors commission suggested not to join EMU in the first wave in 1999 but to aim for future membership. In 1997, the Swedish Parliament (Riksdagen) acted accordingly and decided that Sweden would not join the ERM, which left one of the five convergence criteria deliberately unfulfilled. In order to settle the issue, the Swedish government put the question of introducing the euro to a legally non-binding referendum, held in September 2003. With 55.9% of votes against the common currency and 42.0% in favour, the results were clear, and the government subsequently shelved any plans to adopt the euro.

Since then, Sweden has not undertaken any steps towards full participation in EMU and maintains the position that a future adoption of the euro must be decided by referendum. Thus, Sweden has established what is often called a *de facto* opt-out that stands on no legal footing. The Swedish government agency Swedish Institute for European Policy Studies (SIEPS), however, argues that it is the government's understanding that membership in ERM is voluntary (Campos et al., 2016). Conversely, the European Central Bank's (ECB) annual convergence reports consistently stress that 'Sweden has been under the obligation to adopt national legislation with a view to integration into the Eurosystem since 1 June 1998. As yet, no legislative action has been taken by the Swedish authorities […]' (ECB, 2020). From a legal viewpoint, the Swedish government's position appears questionable. Because it is not inability but a deliberate decision not to fulfil the convergence criteria, Sweden's opt-out from monetary union can be considered a violation of its obligations as an EU member (Nergelius, 2019). In that sense, Sweden has established *de facto* differentiation on the basis of non-compliance with primary EU law.

As of today, there are no indications on either side that this informal arrangement of differentiation will soon be dissolved or legalised by way of a formal opt-out. The topic hardly ever comes up in Swedish politics, and recent opinion polls

suggest that the public remains firmly opposed to adopting the euro.[11] Likewise, the European Commission seems to have swept the issue under the carpet and has not taken any actions to enforce the adoption of the euro. A rare exception was former Commission President Jean-Claude Juncker who stressed in his 2017 state of the union address: 'The euro is meant to be the single currency of the European Union as a whole. All but two of our Member States are required and entitled to join the euro once they fulfil the conditions' (Juncker, 2017). In view of the loss of the UK as a strong ally with an opt-out from EMU, Brianson and Stegmann McCallion (2020) caution that Sweden's current status will become more difficult to maintain. Still, Sweden is far from alone in this issue. The Swedish method to put off ERM membership to avoid the adoption of the euro has been imitated by Poland, the Czech Republic and Hungary.

Kosovo and Montenegro's de facto opt-in to EMU

Following the dissolution of the Socialist Federal Republic of Yugoslavia, Montenegro entered a political union with Serbia, which lasted until Montenegrin citizens voted for independence in the 2006 popular referendum. Between 1991 and 1994, the dinar underwent several episodes of hyperinflation, which caused economic distress and an increased use of foreign currencies, mostly US dollars and the German Deutsche Mark (DM). The dinar was subsequently replaced by the novi dinar which was pegged to the DM to achieve price stability. In 1999, the Montenegrin government decided to adopt the DM as a second official currency. This two-pronged system was short-lived, as the DM was raised to Montenegro's sole legal tender in October 2000. This step was not coordinated with the German federal government but facilitated by the already widespread circulation of DM. Almost immediately after the European Union began to issue euro banknotes and coins, the DM was replaced by the euro in June 2002. Similar to the use of the DM, the adoption of the euro was a unilateral decision by the Montenegrin government that had not been coordinated with the EU or the ECB, respectively.

[11] The latest Eurobarometer found that 22% of the Swedish survey participants are 'very much against the introduction [of the euro]' and 40% 'rather against the introduction' (Flash Eurobarometer 487, 2020).

Kosovo adopted the euro as its official currency in January 2002, but on slightly different terms. After the war had ended in June 1999, one of the first regulations passed by the United Nations Interim Administration Mission in Kosovo (UNMIK) targeted monetary policy and allowed the use of DM and other foreign currencies. As in Montenegro, trust in the highly inflationary dinar was low, and the widespread use of the DM prompted its unilateral adoption as the *de facto* legal currency (Korovilas, 2002). This step was not preceded by negotiations with the German central bank (Bundesbank) or the ECB. In view of the EU's impending cash changeover to the euro, the UNMIK authorised to adopt the euro as Kosovo's official currency.[12] Although the adoption of the euro was a unilateral step, the Kosovar central bank maintains that the process was supported by the ECB and EU member states (Tyrbedari, 2006).

The adoption of the euro in Montenegro and Kosovo clearly resembles *de facto* differentiation by unilateral opt-in into the *acquis* that is not recognised by EU law. Moreover, the two states effectively bypass the convergence criteria and other instruments of fiscal policy coordination which, in addition to membership of the EU, mark a necessary preconditions to using the euro. In that sense, Montenegro and Kosovo reap the benefits (and disadvantages) of a policy area that is designed as a collective good with exclusive access to EU member states.

After eighteen years, it is safe to say that the *de facto* opt-ins have turned into a tacit arrangement both Montenegro and Kosovo, as well as the EU seem to be content with. At the cost of monetary policy being made in Frankfurt without taking into consideration the economic conditions of non-EU states (Padoa-Schioppa, 2003), the euro affords Kosovo and Montenegro stable inflation rates and has contributed to economic growth.[13] At the same time, however, this

[12] For more information, see UNMIK Administrative Direction no. 2001/24.

[13] For the 2019 fiscal year, the annual report of the central bank of Montenegro noted a 3.6% growth in GDP. Likewise, the central bank of Kosovo measured real growth of 4.2%. https://bqk-kos.org/wp-

arrangement creates a precedent for EU expansion and might affect both states' prospective accessions. While Kosovo is currently only a potential candidate for EU membership, Montenegro has been an official candidate since 2010. Although the 'unilateral euroisation' was initially a point of contention,[14] the EU Commission's latest report on future Montenegrin EU membership recognises that the use of the euro was decided under 'exceptional circumstances' and does not specifically call for abandoning the chosen path (EU Commission, 2020b). For practical and political reasons, it appears unlikely that Kosovo and Montenegro will be required to abandon the euro only to reintroduce it sometime after becoming EU member states.

The Fiscal Compact

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) is most commonly referred to as the Fiscal Compact, after the title of the third and most significant section of the treaty. The TSCG is an intergovernmental treaty concluded outside of EU law, signed in March 2012 by all EU member states except the UK and the Czech Republic. It formed a major part of the EU's response to the sovereign debt crisis that hit Europe in 2009. The TSCG expands the Stability and Growth Pact (SGP) and contains several measures to ensure and enforce fiscal discipline, establish closer economic policy coordination and institutionalise the governance of the eurozone. All members of the eurozone are bound by these measures, while non-eurozone signatories may

content/uploads/2020/10/CBK_AR_2019.pdf;
https://www.cbcg.me/slike_i_fajlovi/eng/fajlovi/fajlovi_publikacije/god_izv_o_radu/cbcg_annual_report_2019.pdf.

[14] The annex of a COREPER document concerning the signature of the Stabilisation and Association Agreement between the EU Commission and Montenegro reads: 'The Council recalls that unilateral 'euroisation' is not compatible with the Treaty, which foresees the eventual adoption of the euro as the endpoint of a structured convergence procedure within a multilateral framework.' https://data.consilium.europa.eu/doc/document/ST-13831-2007-REV-1/en/pdf.

opt-in.[15] Most notably, signatories must implement into national law – preferably via constitutional amendment – a provision for balanced government budgets and an automatic correction mechanism in case of deviation. The European Commission assumes the task to monitor compliance with the TSCG and shares the right with other contracting parties to bring non-compliant states before the ECJ. If a breach of the TSCG is identified, the ECJ may impose penalty payments of up to 0.1% of the non-compliant state's GDP.

These measures confer additional powers to the EU Commission that significantly expand its competences in monitoring fiscal policy as defined by the SGP (Craig, 2012). For that reason, incorporating the TSCG into EU law would have required amendments to the EU treaties. Because the UK categorically vetoed any such amendments, the TSCG took the shape of an intergovernmental treaty outside the EU legal framework. Thus, the TSCG marks a clear case of *de facto* differentiation by cooperation outside the EU. It reinforces differentiation between the Eurogroup and member states not using the euro and contains in itself multiple layers of differentiated participation in the agreed upon measures. Ultimately, the EU Commission's new powers in monitoring and enforcing fiscal policy mark an unequal increase in the EU's centralisation level that goes beyond the monetary and economic policy instruments of EMU.

Although the treaty foresees adoption into EU law at the latest five years after ratification, no notable steps in that direction have so far been undertaken.[16] At this point, the integration of the TSCG is not a priority of the EU Commission or the member states. Understandably, the current agenda focuses on combatting the COVID-19 pandemic and ameliorating the economic damage it caused. With the explicit support from the EU Commission, many member states have taken up

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[15] Denmark and Romania have chosen to opt-in and to comply with the entire set of measures. Bulgaria maintains a partial opt-in and is only bound to the fiscal measures.

[16] According to the European Parliament, the EU Council has made 'no visible progress' in integrating the TSCG into EU law. https://www.europarl.europa.eu/legislative-train/theme-economic-and-monetary-affairs-econ/file-integration-of-the-fiscal-compact-into-secondary-eu-law.

additional sovereign debt to boost their economies. Hence, initiating legislative steps to ensure fiscal discipline would send a contradictive message and undermine these efforts. In the medium term, however, Brexit poses an opportunity to amend the treaties by adopting the TSCG. The UK had been the most fervent veto player in this regard, and since the Czech Republic's opt-in in 2019, all 27 member states of the EU have now ratified the TSCG.

Discussion

The most basic observation the three cases in EMU invite to make is that they have each endured several years and appear to be ongoing. On the one hand, this demonstrates that *de facto* differentiation is not a recent phenomenon, but rather an ongoing and long-lasting aspect of European integration. On the other hand, this begs the question whether the EU institutions see in *de facto* differentiation an intended means to create more flexibility, a tolerated deviation from the norm, or an undesired by-product of disobedient member and non-member states. At first glance, the two cases concerning the adoption of the euro seem to share being grounded in tacit arrangements between the involved member state(s) and the EU institutions, whereas the EU Commission actively participated in the circumvention of EU law to deepen integration via the TSCG. But to address this question from a more general perspective requires looking at the purpose and potential consequences of each type of *de facto* differentiation.

As the case of the TSCG showed, *de facto* differentiation that stems from cooperation outside EU law may help to escape legislative deadlock. Although not seen as an ideal solution, the EU tends to support such initiatives.[17] This is understandable considering the EU's guiding principle of 'ever closer union.' After all, closer cooperation outside the EU still effectively deepens integration, albeit not for all member states and not under the auspices of the EU. Moreover, the original Schengen Agreement has proven that intergovernmental treaties may

[17] Günther Oettinger, at the time the German EU Commissioner for Budget and Human Resources, noted that the TSCG was a 'good, second-best solution.' https://www.spiegel.de/international/europe/split-summit-the-birth-of-a-two-speed-europe-a-802703.html.

eventually be incorporated in EU law. Nonetheless, such arrangements can be problematic, because integration outside the EU may fuel legal disputes regarding the primacy of EU law vis-à-vis international law. For instance, states charged with penalty payments according to the provisions of the Fiscal Compact might challenge that decision on the grounds that the ECJ and EU Commission have exceeded the capacities bestowed upon them by the Treaty of Lisbon.

Similarly, *de facto* differentiation that stems from unilateral opt-ins appears to be no major concern of the EU. Not only is policy alignment a prescribed step for candidate states and a key objective of EU neighbourhood policy, unilateral opt-ins never did any real harm. This picture may be a bit different, if unilateral opt-ins target collective goods inseparably linked to EU membership. In that case, the EU is wise to assess whether this produces negative externalities for the EU and its member states. In the case of Montenegro and Kosovo's adoption of the euro, their small economies hardly affect EU monetary policy. Moreover, the Balkans' unstable political situation in the early 2000s called for a cautious approach on the part of the EU, that facilitated economic recovery rather than asserting EU law. However, should unilateral opt-ins indeed create negative externalities, the EU's means to intervene are rather limited. The only effective means to ban unilateral opt-ins is by making their discontinuation a binding condition for accession to the EU. But this, of course, only applies to current and prospective candidate states and may counteract the interests of the Union.

De facto differentiation established by non-compliance is an entirely different beast, because it actively and deliberately undermines EU governance. The Swedish refusal to adopt the Euro demonstrates that states use it to unilaterally accommodate divergent policy preferences. Due to the implied legal uncertainty, it can be assumed that states only resort to *de facto* differentiation by non-compliance if *de jure* opt-outs have proven or are assumed to be unavailable. More research is needed here. Because the EU has a natural interest in preserving the legal primacy of EU law, the EU Commission aims to inhibit differentiation created in such fashion. Its resources, however, are limited, and the enforcement of compliance may sometimes also present normative issues. If, for instance, the

EU forced Sweden to adopt the euro, it would undermine the expressed will of Swedish citizens and potentially stoke Eurosceptic sentiments.

To return to the question posed earlier, *de facto* differentiation is hardly ever a perfect solution, not for the EU and rarely for the involved states. In some cases, however, it may be the only way to accommodate insurmountable differences in policy preferences or to proceed integration. Because all three types pose legal challenges and threaten the EU's authority, the EU is best advised to use or tolerate *de facto* differentiation, especially if established by non-compliance, only under certain circumstances. With the powers bestowed upon the EU Commission and ECJ by Articles 258 and 260 (TEU), the EU possesses relatively sharp tools to combat *de facto* differentiation by non-compliance. But, as mentioned in the third section, the lengthy legal procedure may entice states to protract non-compliance and maintain *de facto* differentiation as long as the associated benefits outweigh the costs. In the end, the decision for *de facto* differentiation lies firmly in the hands of individual member states. Unlike *de jure* differentiation, the EU cannot prevent it, but only react once it has already been established.

Conclusion

In this chapter, I sought to anchor informal arrangements of differentiation in the overall framework of differentiated integration in the EU. My contribution is largely grounded in knowledge that had been scattered across various disciplines of EU studies and complemented by simple empirical observations. On that basis, I developed a three-pronged typology subsumed under the term *de facto* differentiation. I demonstrated this theoretical backbone by way of three exemplary cases in Economic and Monetary Union.

In conclusion, I argue that *de facto* differentiation is a distinct feature of European integration, that deserves to be studied in its own right as well as in conjunction with *de jure* differentiation. My brief analysis of three cases in EMU has shown that *de facto* differentiation is not unproblematic, especially if grounded in non-compliance. This chapter, however, only scratched the surface of the various reasons for and consequences of *de facto* differentiation. In that regard, I recognise that relying predominantly on approaches based on rational choice theory creates

bias. Constructivist or historical institutionalist interpretations could certainly offer valuable additional insights. Rather than to tackle all these aspects head-on, it was the intention of this chapter to lay the conceptual groundwork for future empirical research on *de facto* differentiation.

The potential avenues for future research are manifold. Beyond the field of EU integration studies, *de facto* differentiation touches on several related subject areas and calls for more interdisciplinary cooperation. Related to the three subtypes, compliance research can contribute to a better understanding of the motivations and consequences of the long-term manifestation of non-compliance. Insights from Europeanisation studies can further illuminate the spread of EU policies across the Union's borders. Furthermore, *de facto* differentiation ties into research on informal governance, which can help clarify the EU's motivations to participate in, or tolerate, such informal arrangements. What is more, recent trends concerning democratic backsliding in Poland and Hungary can and should be studied from the perspective of *de facto* differentiation. Having effectively and unilaterally established differentiation by applying the norms and values specified in Article 2 (TEU) only partially, this presents a particularly harmful case of *de facto* differentiation that calls into question the EU's authority. Ultimately, more empirical research is needed to address the two main questions associated with *de facto* differentiation: why and how does it come into being; and secondly, how do the EU and the concerned member state(s) handle the legally unstable situation it creates?

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