Do Euro Area Institutions Benefit the Small Member States?

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ABSTRACT

In recent years, the pooling of authority among the member states of the euro area has intensified, expanding the remit of the Council, Commission and ECB. While it is commonly thought that large states dominate these institutions, a growing literature emphasizes the ability of small states to pursue their interests too. We explore whether the empowerment of euro area institutions was associated with relative net gains for small member states over large ones, and with relative losses during the euro crisis. We estimate the relationship between the relative amount of resources of different institutions, and the distribution of gains among members, throughout 1999-2016. We find that empowering the Council, the Commission or the ECB provides relative gains to small member states, although not against Germany.

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Introduction

Following Moravcsik (1998) seminal work, it is often argued that the large member states were instrumental in designing the Economic and Monetary Union (EMU) (Bulmer, 2014). According to this Liberal-Intergovernmentalist view, the largest member states, in particular those with the most competitive industry, such as France and Germany, have effectively enjoyed veto powers in the European Union's (EU) intergovernmental bodies (Killermann, 2016), manipulated supranational institutions (Murdoch, Connolly and Kassim, 2018; Puetter, 2012), and are the main beneficiaries from this project. Some scholars go further to argue that the crisis in the euro area has turned Germany into such a central member state in the recent decade as to render it a hegemonic power in this club (Carstensen and Schmidt, 2017; Schoeller, 2017; 2018; Schneider and Slantchev, 2018). However, other scholars note that Germany cannot disregard the interests of its fellow large member states, most importantly France (Howarth and Schild, 2018; Jones, 2018).

What role then, for small states in EMU decision-making? Small states are structurally disadvantaged, endowed with less resources than the large states, their policy autonomy more constrained by globalization (Panke, 2010a; 2010b; Verdun, 2013). However, with small size may come greater social and political homogeneity (Alesina and Spolaore, 2003), allowing a more coherent and agile policy than in large member states (Ornston, 2018). Small states can leverage their bargaining positions if they enjoy policy credibility, and if they have compelling and persuasive policy ideas. Forming alliances, with large or other small states, maintaining the initiative in policy-making and 'prioritization' are also helpful (Panke, 2012). Small states want to ensure effective voice opportunities in any agreed international cooperation (Grieco, 1995).

Small states may prefer to empower institutions that are altogether autonomous from national interests, to lock-in commitments and constrain the ability of large member states to manipulate the club to their advantage (Deckarm, 2017; Hooghe and Marks, 2009; Maes and Verdun, 2005). At the very least, even if the large states delegate authority to such institutions in pursuit of their selfish interests, delegation inevitably leads to agency loss, which in relative terms may benefit the small states, compared with policymaking in intergovernmental bodies. International institutions also save on negotiation resources, which is particularly important to small states. Within the EU, small states can sometimes play the large member states against each other (Golub, 2012; Thomson, 2008), taking advantage of the complicated voting system in the Council (Schure and Verdun, 2008). Groupings such as the new Hanseatic league, the Benelux, and the Visegrad Four may have been effective lobbies (Verdun, 2018). Small EU member states can be influential.

The debate on the ability of large and small member states to influence common institutions and policies emphasizes relative gains. Whether the small member states merely follow the leadership of the large member states or have a serious added value in the evolution of EMU, affects their respective ability to prosper economically, and affects how the clubs' costs and gains are shared. Empowerment of institutions can and does have important distributional consequences, even as they provide aggregate benefits to the club, and even if relative gains are not the sole driver of integration. We argue that the empowerment of central and supra-national institutions in the euro area has provided relative net gains to small member states over large ones.

We review the entire record since the launch of the euro in 1999, but also examine whether financial stress situations have been costlier to the small member states than to the large ones.

We review recent contributions to this debate in the second section. The third section lays out our research design. We compile data on the bureaucratic capacity of the euro area's principal institutions, and compare it with the capacity of national governments. We then use regression analysis to study the relationship between institutional empowerment and relative changes to member states' GDP.

The fourth section reports results. We find that empowering the Council, the Commission or the European Central Bank (ECB) provides relative gains to small member states, although not against Germany, and that the voting rules in the Council provide an additional relative advantage to the small states. We also find that in crisis times, participants in bailout programs lost out to France and Germany, and the small member states lost their advantage in Council decision-making. However, Germany was not advantaged during the crisis years, and the ECB's Securities Market Program (SMP) was actually helpful for the small member states. The bottom line is that the small member states of the euro area are certainly not powerless against the large member states. The fifth section provides conclusions.

This paper adds value to the literature by providing robust, institution-specific and comprehensive post-crisis evidence that the empowerment of central and supranational institutions in the euro area reallocates resources in favor of small states. We thus challenge the classic LI approach by suggesting that small states can sometimes use institutions to catch-up with large states. This does not void the LI interpretation (Germany still gains in the majority of scenarios, and France and Germany do dominate the small member states in times of crisis), but calls for further nuance. While we focus on the Euro area, our results should travel well to inter-state relations on other international organizations.

Franco-German leadership, the small member states and the institutions

Germany is sometimes viewed as a hegemonic power in the euro area. However, as we argue below, in balancing the euro area and navigating it throughout the crisis it had to compromise with France (Krotz and Schild, 2013), and smaller member states too. Indeed, while Germany regarded the euro area as a mechanism of fiscal discipline (Jabko, 2015), France viewed it as a mechanism to curb German dominance (Vail, 2015). In balancing Germany, France often positioned itself as mediator between Germany and the smaller euro periphery member states (Wallace, 2015). This was reflected in October 2007, in the euro area's €1.3 trillion bailout package to save European banks (Jabko, 2015), and in the 2010 Deauville summit, which imposed limitations on bank bailouts.

During the euro crisis, Germany's cooperation was indispensable (Fabbrini, 2015), given its fiscal surplus since 2014, and impeccable credit ratings (Bulmer, 2014). This allowed Germany to play a key role in negotiating the Fiscal Compact and the European Stability Mechanism (ESM) (Howarth and Quaglia, 2016), and to impose financial discipline on other member states (Henning, 2017; Majone, 2014; and Schimmelfennig, 2015), and much of the current account adjustment burden on the deficit countries (Bini Smaghi, 2015; Kincaid and Watson, 2015).

Despite Germany's influential position during the crisis, different coalitions, consisting of small member states, the ECB and the Commission forced Germany to compromise, over issues such as banking supervision (Epstein and Rhodes 2016a), or the 2011 Pact for Competitiveness (Schäfer, 2016; Steinberg and Vermeiren, 2016). Germany was skeptical of the European Banking Union (EBU), but eventually agreed to transfer more authority to the ECB (Epstein and Rhodes 2016a; Howarth and Quaglia, 2016). The ECB's monetary policy and methods did not conform to the preferences of Germany's central bank either (Wallace, 2015). Some ECB

policies, including various intervention programs in bond markets, especially Quantitative Easing (QE), were highly unpopular within the German establishment (Wallace, 2015).

These German concessions are in part the result of internal divisions, which potentially provide scope for smaller states to influence policy. Germany's central bank, federal government, and Constitutional Court were at odds over various ECB policies, such as the ECB's Outright Monetary Transactions (OMT) program to support distressed governments (Bulmer, 2014; Majone, 2014, 261; Wallace, 2015, 191-3). On EBU, Germany's domestically-focused cooperative and savings banks fought its big commercial banks (Epstein and Rhodes 2016a; Howarth and Quaglia, 2016).

Domestic politics also influenced Germany's position towards Greece. Early in 2009, Germany's Social-Democratic Finance Minister Peer Steinbrück declared that Greece cannot be allowed to default. This position later changed under the centre-right government (Jones, 2015). Nevertheless, exposure of German banks to the Greek economy drove Germany to support a bailout (Newman, 2015). While the fear of incalculable consequences of Grexit was more important, the German government may have supported the second Greek bailout also in order to avoid unpopular massive migration from Greece and other small periphery member states (Bernhard and Leblang, 2016).

On the other side of the creditor-debtor divide, an alliance of eight small fiscally-hawkish EU member states led by the Netherlands, known as the new Hanseatic League, including six euro-area member states, have cooperated to force the large member states to take their interests into account. They resisted French attempts to cajole Germany into accepting a euro area budget, pushed to increase the powers of the ESM to improve member states' debt sustainability and promote proposals for a 'Capital Markets Union' (Howarth and Schild, 2018; Verdun, 2018).

In the aftermath of the euro crisis, several reforms contributed to an era of unprecedented institutional evolution within the EU (Caporaso *et al*., 2015). This process of policy centralization increased the competence of intergovernmental and supranational EU institutions, at the expense of the autonomy of all member states. However, in relative terms the small states gained over the large ones because playing for national interests in the absence of supranational institutions tends to favor large states, which have greater capabilities to pursue their interests. Any delegation of authority involves some agency loss, as even the larger member states find out that they cannot perfectly control institutions. For the same reason, institutions that are built to lock-in commitments form a relatively tighter constraint on large member states' ability to act opportunistically, because the larger member states could otherwise asymmetrically enforce the rules on the small member states (Deckarm, 2017; Hooghe and Marks, 2009; Maes and Verdun, 2005). Policies that are delegated to supranational institutions involve less interstates haggling, saving on bureaucratic resources, which again levels the playing field between large and small states. Finally, in intergovernmental bargaining, if there are a few large member states in the club with disagreements, as is the case in the euro area, they need support from small member states to form winning coalitions. Thus, all else being equal, a strong role for EU institutions potentially protects the interests of the

small member states against the opportunistic behavior of large ones (Schure and Verdun, 2008).[1]

At the break of the euro crisis, ECOFIN (Council of ministers of finance) and other intergovernmental institutions gained prominence. The member states established various bailout funds outside EU law (*De novo* EU agencies), through which the European Council and the Euro Group (finance ministers of the club's member states) enjoyed significant autonomy in policy-making (Fabbrini, 2015; Howarth and Quaglia, 2016). According to the New Intergovernmentalism literature, this came at the expense of the Commission's powers.[2]

However, the remit of the supranational Commission and ECB, and their room for discretion also expanded (Epstein and Rhodes 2016b). The Commission oversees the harder post-crisis fiscal rules, which limit the scope for political bargaining in ECOFIN. Specifically, the Fiscal Compact mandates balanced budgets. The European Semester and the Two Pack, coordinate member states' fiscal policies, as means of crisis prevention. Member states submit their annual macroeconomic programs to the Commission, which evaluates them and may recommend corrective measures to ECOFIN.

The Commission monitors progress in structural reforms, and autonomously determines statistical methods (Wallace, 2015, 107; Schmidt, 2015), shaping ECOFIN debates (Gandrud

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[1] This is true even if, in the particular case of bailout programs management, Germany insisted on involving the IMF together with the Commission and the ECB (the Troika) perhaps in order to play these institutions against each other (Henning, 2017).

[2] Bickerton, Hodson and Puetter, 2015; Hartlapp, Metz and Rauh, 2014; Wille, 2013.

and Hallerberg, 2016; Mabbett and Schelkle, 2016). The Commission makes it harder to hide deficits. Reversed qualified majority voting in the Council now makes it harder for the member states to overrule the Commission. Thus, while it cannot unilaterally force compliance with fiscal rules on reluctant member states, the Commission does play an important role in writing the rules and enforcing them,[3] and recent reforms have increased its ability to do so (Becker *et al.*, 2016).[4]

The ECB too acquired significant agenda-setting powers, transforming into a lender-of-last-resort (Caporaso and Kim, 2016; Marzinotto, 2016). The ECB's refinancing operations (Jones, 2015) and especially its interventions in secondary bond markets can be interpreted as monetary financing of governments, considering the timing and centrality of purchases of distressed governments' debt (Mabbett and Schelkle, 2016; Wallace, 2015, 179). Indeed, several Governing Council members considered this course of action as an indirect bailout (Wallace, 2015, 94), which the ECB in turn used to persuade governments to adopt structural reforms and intensify fiscal consolidation (Bini Smaghi, 2015). These actions culminated in President Draghi's 2012 pledge to do "whatever it takes" to prevent the euro's area collapse, including

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[3] Bauer and Becker, 2014; Blom-Hansen and Senninger, 2021; Carstensen and Schmidt, 2018; Crespy and Menz, 2015; Finke and Blom-Hansen, 2021; Nielsen and Smeets, 2018; Schmidt, 2015; Schön-Quinlivan and Scipioni, 2016.

[4] Indeed, Baerg and Hallerberg (2016) provide empirical evidence that even the large member states do not get everything they want.

unrestricted purchases of sovereign bonds (Wallace, 2015, 187-8), conditional on structural reforms and fiscal consolidation (Jones, 2015).

In addition, after the banking scares of 2011-12 and the bail-in of investors in the 2013 Cyprus crisis, member states recognized the importance of greater centralization of banking regulation (Jones, Kelemen and Meunier, 2016; Wallace, 2015, 189-91). Since 2014, the ECB assumed supervision responsibility over 128 systemically important banks, and could potentially opt to supervise any of 6,000 smaller banks (Epstein, 2017). In the EU's resolution regime, bail-in is the first recourse and state aid to banks is forbidden (Howarth and Quaglia, 2016). Since 2016, a centralized resolution board replaced national authorities and oversees a centralized resolution fund (Epstein and Rhodes, 2016a).

Empowering the ECB asymmetrically favors the smaller member states relative to the large member states because the ECB's mandate is to pursue price stability in the entire euro area, not any particular member state, and National Central Banks (NCBs) are autonomous from national governments. In a global world small states find it hard to maintain policy autonomy so this represents a greater opportunity cost to larger member states. Even if the NCBs are regarded as nationally-minded, they are leveled by the ECB's Governing Council's formal voting system of one vote per member state regardless of its size until 2015, and a voting system thereafter, in which France, Germany and Italy rotate on an equal basis with the Netherlands and Spain. In practice, decisions are regularly taken by consensus, which provides even the smallest member state with veto power.

Research design

We regard income as a correlate of size, so the share of small member states in aggregate income of the euro area is smaller than the share of a large member states. As small member states become more influential, their share increases and the difference between their share and the share of the large member states falls. We thus expect the following hypotheses to be supported:

> *H1: Empowerment of central and Supranational institutions (independent variable) is associated with decreasing divergence of aggregate gains between large and small member states (dependent variable).*

This should be true in either causal direction: Institutions may offer relative gains to small member states, and those gains may improve their position to shape institutions. In particular:

> *H2: Empowerment of central and supranational institutions is associated with decreasing divergence of aggregate gains between the largest member states and the smallest ones.*

Because sensitive issues are characterized by an incomplete contract (Schure and Verdun, 2008), we explore whether the empowerment of institutions is associated with relative losses for small member states in circumstances of financial stress, when the literature expects them to be particularly vulnerable to political pressure: during a bailout program (as creditors or debtors), through ECB bond market interventions, or in Council decision-making. In such circumstances, large creditors should have leverage over small debtors, and large debtors could use their predicament to extract concessions from small creditors, lest all suffer from the debtors' collapse.

H3: Empowerment of central and supranational institutions is associated with increasing divergence of gains between large and small member states during crisis times.

We use an annual dyadic dataset of euro area member states during 1999-2016. This is helpful in testing hypotheses that relate to divergence of gains between subsets of countries. Considering the successive enlargements of the euro area, there are potentially 1,832 observations.

Two alternative measures of divergence of economic gains operationalize our dependent variable in a way that directly relates to differences between large and small member states (see descriptive statistics in online Appendix 1). First, we use the dyadic absolute difference in member states' nominal GDP (based on Eurostat data). GDP is the basis for funding member states' governments and reflects the potential scope of resources that they can tap. Member states that prosper under the euro area's institutions and rules should see their GDP expand, through greater trade, higher productivity, and a higher standard of living. Since price inflation is low in the euro area, we do not expect nominal values to seriously bias our results. If any, slow price inflation within a currency union may reflect the gradual rise in productivity, which is certainly a gain. Our second measure of divergence of gains is the dyadic absolute difference in member states' shares of total EU GDP, in percent points, discounting price effects.[5] Because GDP is also a measure of the size of states, declines in these measures of relative gains necessarily mean that the absolute gains for the small member states exceed those for the large

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[5] Total EU GDP is the annual sum of all member states' nominal GDP.

one. Thus, in a regression with any of these measures as a dependent variable, any negative coefficient indicates relative gains for the small member states.[6]

We run log-linear regression analysis with robust standard errors clustered on panels, a lagged dependent variable to control for serial correlation, a battery of GDP control variables (see below) and a dummy for the 2008-16 period to control for the more turbulent times. We logarithmically transformed all non-dummy variables to allow for negative values, as a zero lower bound is inconsistent with the assumption of normal distribution.[7] Thus, regression coefficients represent elasticities – the percent change in the dependent variable for every one percent increase in the independent variable.

An international organization is empowered when it is mandated to perform more tasks, in a wider set of issue areas, and with greater financial and staff capabilities at its disposal to carry out its mandate (Heldt and Schmidke, 2017). Scholars of the EU have mostly focused on measuring the *de jure* depth and scope of European integration, which can be broadly related to the first two of these three components of organizational power, if the EU is considered a single institution. However, many of these measures are less helpful to this particular study

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[6] Studies also use population or Council voting rights as measures of state size (Maes and Verdun, 2005; Schure and Verdun, 2008; Verdun, 2018), but using dyadic differences in these measures as alternative dependent variables would not be helpful, as it is harder to argue that they result from institutional empowerment.

[7] The dyadic absolute difference in shares in EU GDP is additionally transformed to remove its upper bound of 1, before the logarithmic transformation, using the formula: $x/(1-x)$.

because they code the empowerment of an IO over its entire membership, without considering that IO empowerment varies across member states.[8] Existing measures also code the entire EU, not any of its component bodies, such as the Council and ECB. We cannot use measures that do not vary at all post-1999, or do not yet cover the post-2010 period. Thus, we chose Leuffen, Rittberger and Schimmelfennig's (2013) index of the depth of European integration (*DEPTH*).

For all of these reasons, we additionally operationalize the empowerment of each of the relevant EU institutions based on their resources, i.e. the size of their staff and their staff compensation, which is the bulk of their administrative budgets (Heldt and Schmidke, 2017).[9] Specifically,

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[8] For example, some member states may be excluded from parts of the IO mandate, or pose a greater challenge to pursue its mandate. Recent attempts to code differentiated delegation in the EU are not relevant to the euro area, whose member states have no formal opt-outs from the authority of its institutions.

[9] Staff numbers are based on EU and ECB annual financial reports. We considered all personnel directly employed by the institutions, excluding contract personnel. Numbers of staffers in member states' governments taken from ILOSTAT database and include all levels of government. Data on staff compensation in EU institutions are based on EU and ECB annual financial reports. We considered all labour costs, including salaries, social benefits and pensions disbursements. ECB data retrieved from https://www.ecb.europa.eu/pub/annual/html/index.en.html; Data on other EU institutions retrieved from https://publications.europa.eu/en/home and https://eur-lex.europa.eu/homepage.html?locale=en. Member states' data are based on IMF Government

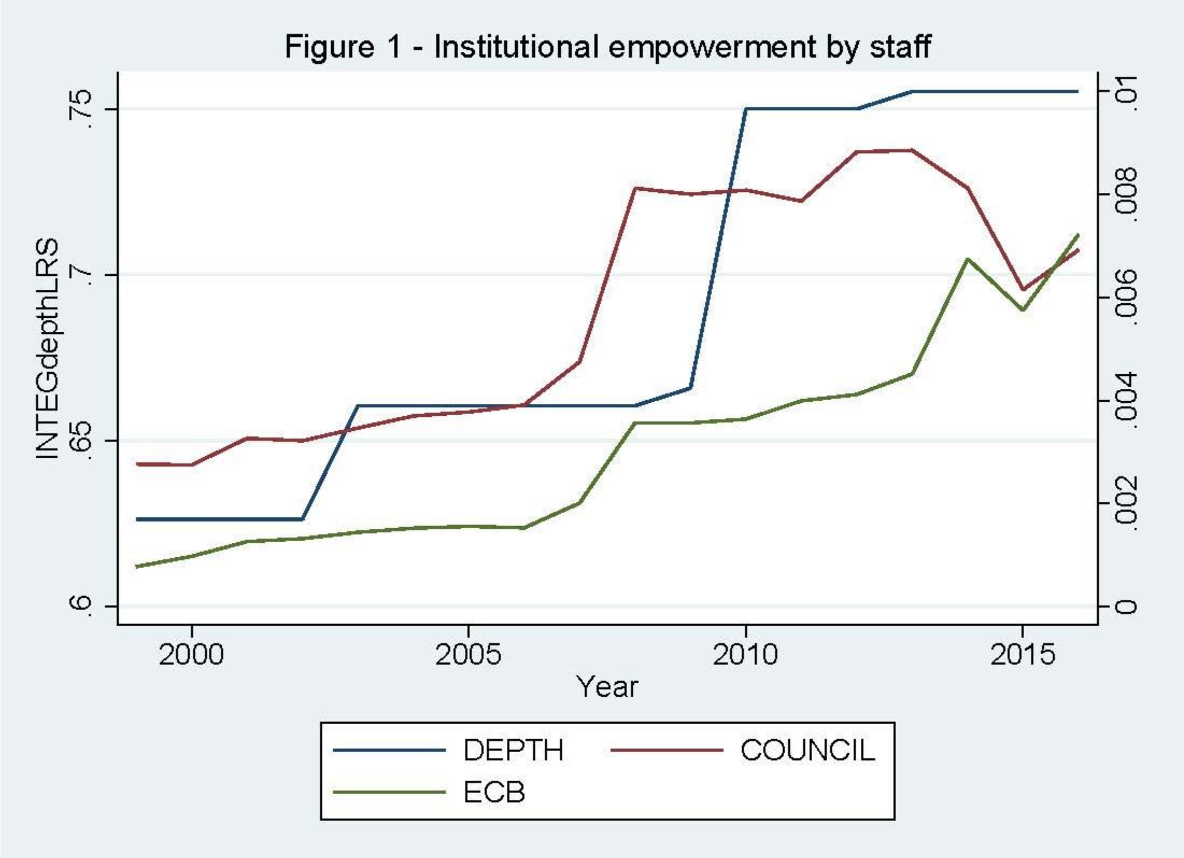
we measure the ratio between the total number of staffers/compensation in the institution, and the dyadic average of the number of staffers/compensation in member states' governments. The number of staffers/compensation in the institution is also divided by the number of member states in order to discount the effect of enlargements. We appropriately label these variables as *COUNCIL* (representing centralization by either staff or compensation) or *ECB* (supra-nationalization by either measure).[10] A negative coefficient for any of these measures of institutional empowerment would support H1.

The logic behind our measures is that any office needs staff and budgets to pursue its mandate. Under-staffed or under-budgeted organizations can achieve less than may be prescribed in legislation. More administrative resources mean more bureaucratic capacity and thus potentially a more central role for the institutions. Indeed, as Figures 1 and 2 show, staff size and costs of the Council and ECB relative to the member states (based on annual EMU averages) generally tend to rise with the depth of European integration (Bauer and Ege, 2016).[11]

Finance Statistics (GFS) database. They include salaries, social benefits and pensions disbursements of staffers in all levels of government.

[10] We do not similarly operationalize the empowerment of the Commission, because its data are highly correlated with the Council's.

[11] Staff size is determined by a variety of other factors, some of which vary only across international organizations (but are fixed for a given organization). Other factors may also vary over time, such as the number of member states (for which we control) and their heterogeneity in per capita income (Vaubel, Dreher and Soylu, 2007). The latter factor is



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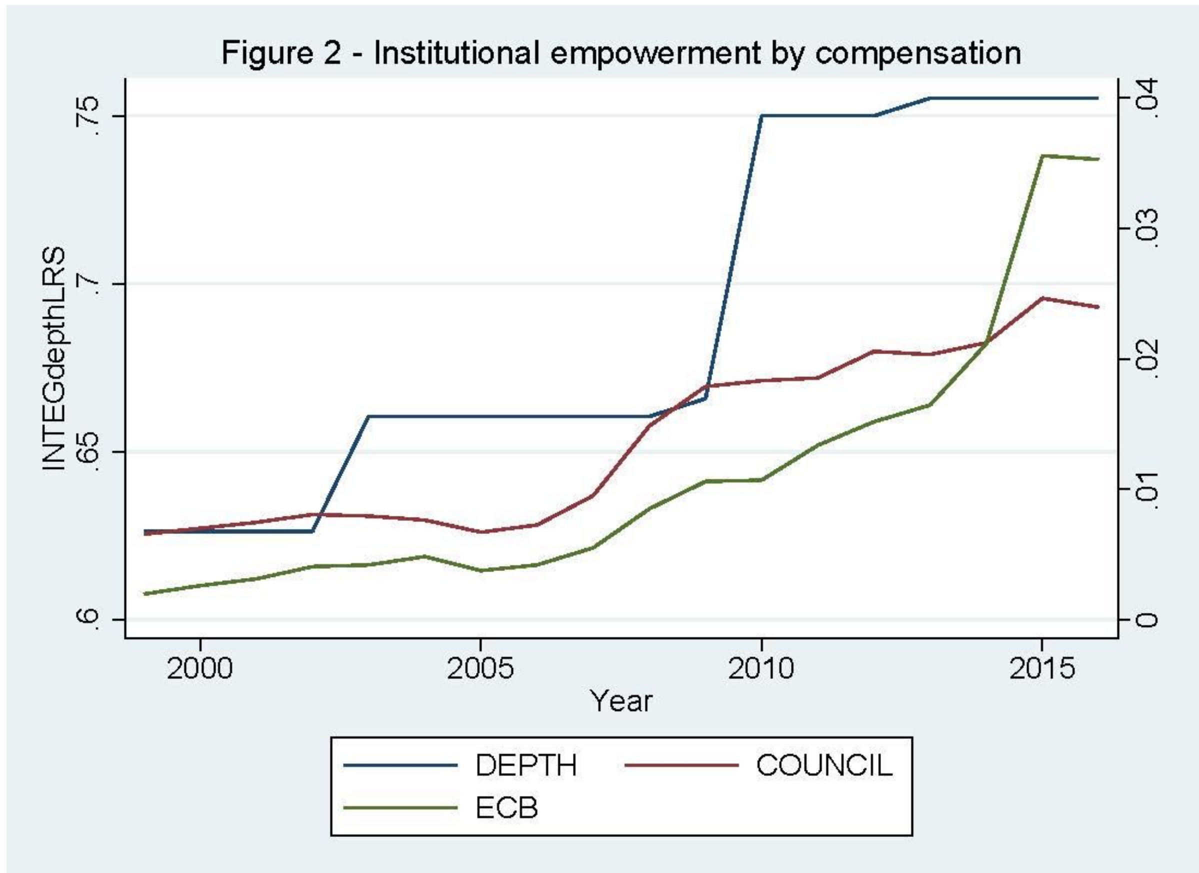
more important in global organizations with very rich and very poor memberships, than in the Euro area.



Our index does not reflect how effectively staff are assigned to tasks, but we have no reason to believe that slack or inefficiency in EU institutions is worse, or better than what is common in national bureaucracies. Nor does our index capture the relative importance of particular inputs from institutions and governments in European policymaking. Indeed, EU staff is puny compared with national staff. For these reasons, what matters are the differences in this measure, not its levels (hence again the logarithmic transformations).

We specify six alternative dummies for testing H2. *GERMANY* flags 189 dyads with Germany on one side, and any small state on the other side (none larger than the Netherlands). *SMALLvsBIG* codes 201 dyads including either Germany, France or Italy on one side, and any state in the lower PPP GDP quartile (based on World Bank data, quartiles computed annually). *SMALLEST* codes 54 dyads with either Germany, France or Italy on one side, and the smallest

member state by PPP GDP on the other side. *VETO* is a dummy that codes 488 dyads with a member state that has strong veto power in the Council over euro-area related matters, and another member state that has weak veto power (see online Appendix 2). *HANSEATIC* codes 48 dyads with one euro-area member state aligned with the new Hanseatic league (Estonia, Finland, Ireland, Latvia, Lithuania and the Netherlands) and any other of the four largest member state, since 2015. *EASTERNERS* codes 116 dyads with one previously Communist euro-area member state (Estonia, Latvia, Lithuania, Slovenia and Slovakia) and any other of the four largest member state. We interact these dummies with the measures of institutional empowerment. Negative coefficients for these interactions would support H2.

We use three alternative dummies to test H3. *BAILOUT* codes 277 dyads with both a creditor and a debtor state in an active fiscal bailout program. *SMP* codes 159 dyads with a beneficiary state of the SMP and a non-beneficiary state. *PROGRAMS* codes 104 dyads with either one of the main recipients of fiscal bailouts (Greece, Ireland or Portugal) and either France or Germany, throughout the data period. H3 would be supported by positive coefficients for these three dummies' interactions, and by positive coefficients for the above six interactions when restricting the regressions to the 2010-16 period.

We specify a battery of control variables for idiosyncratic effects on dyadic differences in GDP, all as log-transformed absolute bilateral differences. Data on *AgeDepend* – the dependency ratio (people under 15 or over 65 to total population), *FemaleLabor* – the rate of women participation in the workforce and *LaborEdu* – the rate of citizens with tertiary education, are

based on the World Bank's WDI database. Data on *Population* and *UrbanPop* – the rate of urban population, are from Eurostat.[12]

Results

Figure 3 demonstrates in eight scatterplots the relationship between the two variants of our two measures of institutional empowerment and the two variants of the dependent variable. A clear negative relationship emerges, regardless of the variants used. This suggests a general egalitarian effect of institutional empowerment on divergence of gains in the euro area in support of H1.

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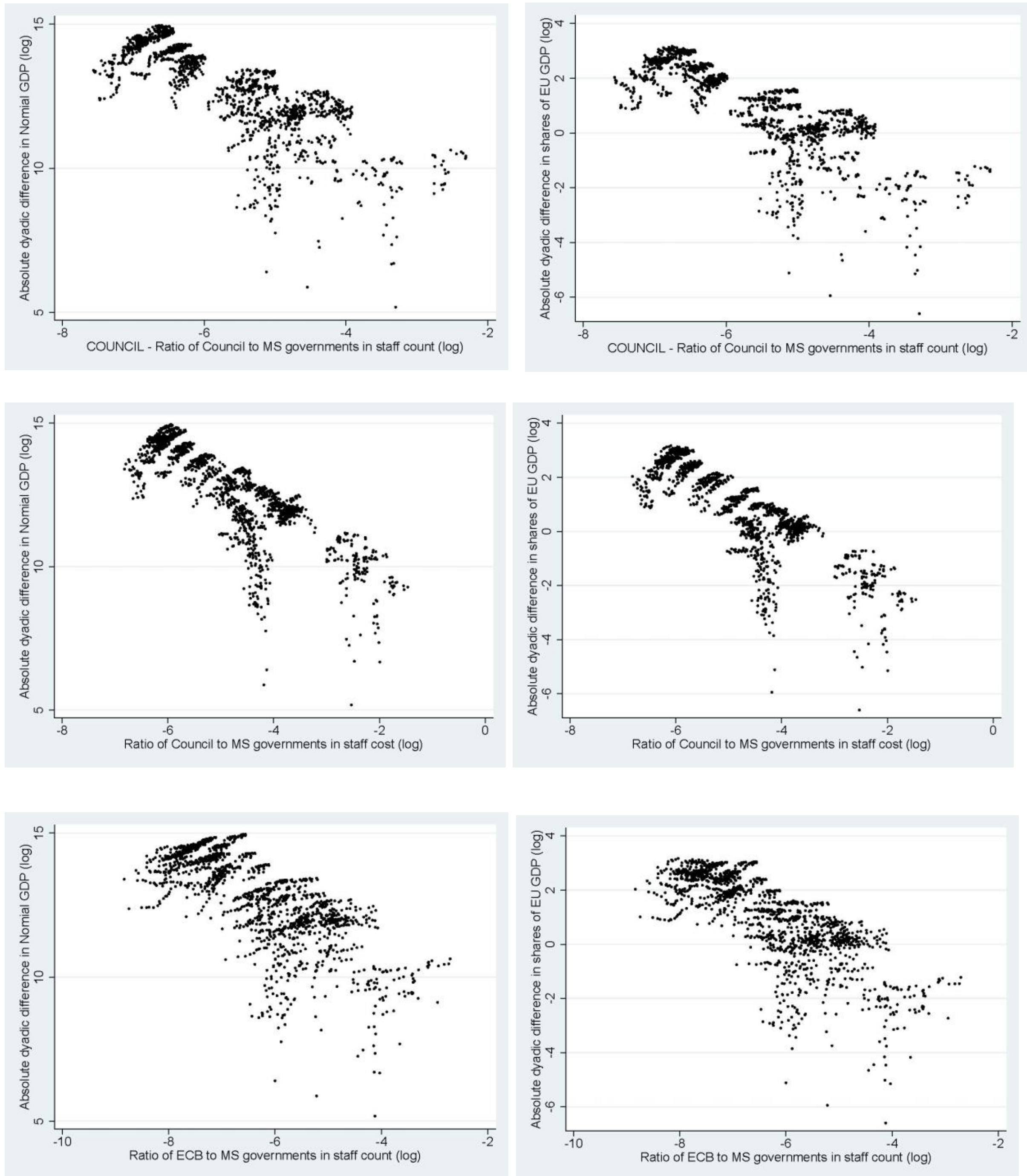
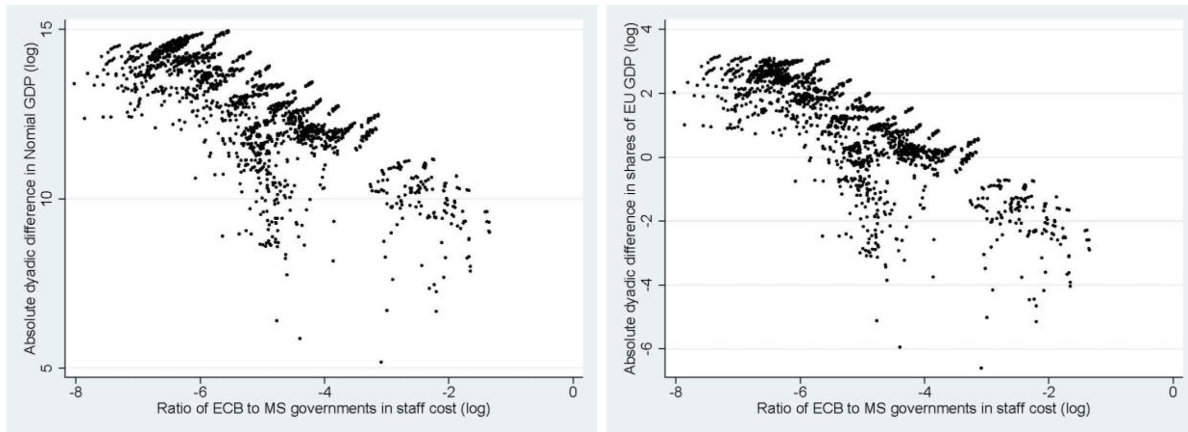
[12] Note that the bilateral differences are absolute (only positive), not linear combinations of the national values. The dyadic absolute differences in *FemaleLabor*, *LaborEdu* and *UrbanPop* were additionally transformed to remove their upper bounds.

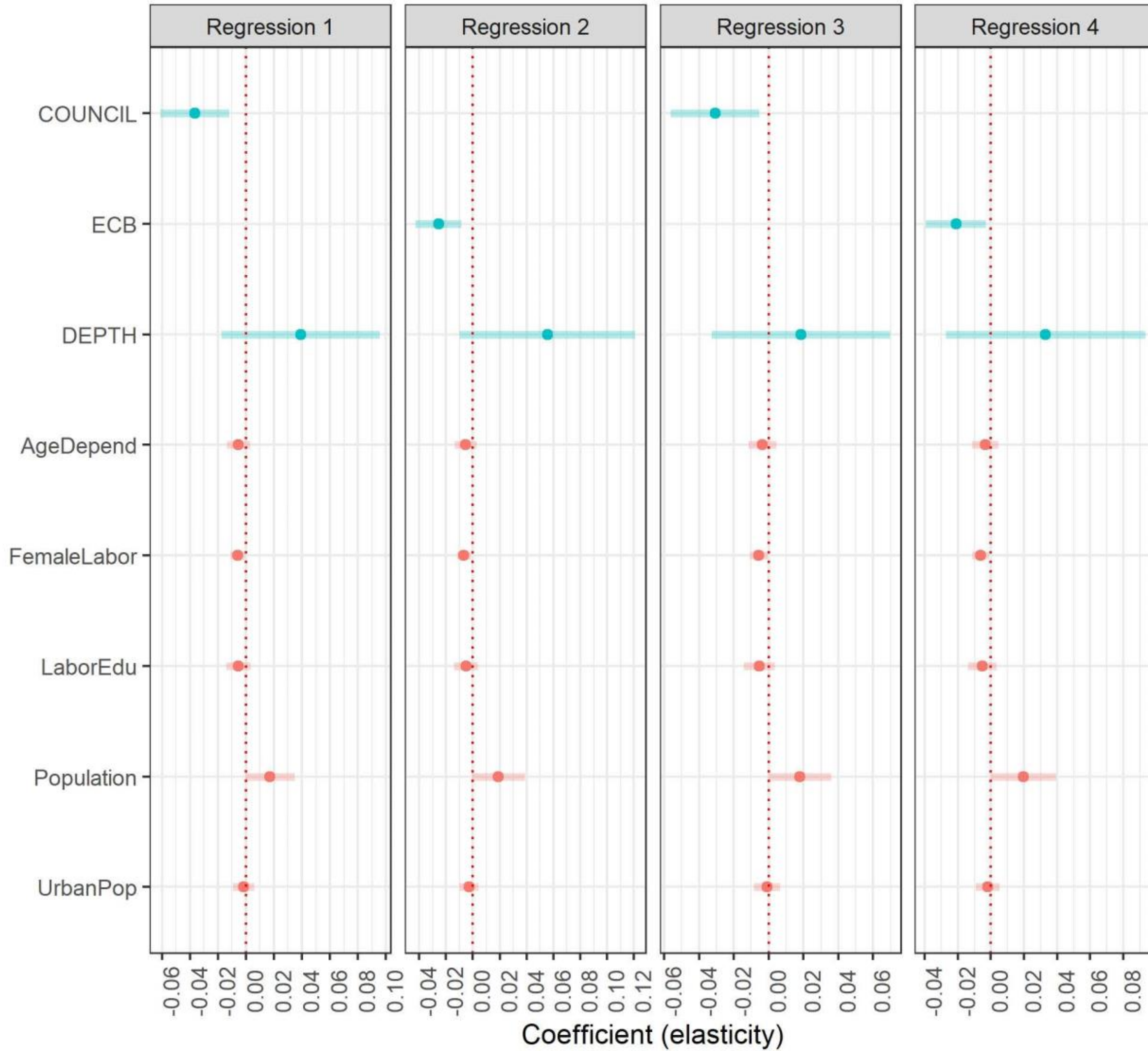
Figure 3 – Relationship between institutional empowerment and divergence of gains





We next run a simple regression, without interactive terms, to test H1. The regressions that we report relate only to Council and ECB empowerment as measured by staff numbers. Results were not meaningfully different when using staff compensation data. As the coefficients plot for Regressions 1-4 in Figure 4 shows (for full results see Table A3-1 in online Appendix 3), all of the coefficients of the institutional empowerment measures are negative and statistically significant, demonstrating an egalitarian effect on the distribution of benefits in the euro area, indicating that absolute gains of small member states increase at a higher rate than absolute gains of large member states. In substantive terms these effects would seem small. At most, increasing the Council's staff relative to the staff of national governments by one percent, yields a fall of 0.03 percent on average in GDP differences. However, as the marginal effects analysis below demonstrates, these effects accumulate and can effectively be more substantial than the coefficients here suggest. In contrast, *DEPTH* has no statistically significant effect on divergence of GDP, which is probably due to its crudeness. To rule out the possibility that collinearity is driving these results, in online Appendix 3 we drop *DEPTH* from the regressions (see Table A3-1a), but the results are similar.

Figure 4 – Coefficients plot



The results are also similar when we use lagged independent variables (Regressions 5-8 in Table A3-1 in online Appendix 3), reducing the likelihood that smaller divergence of GDP is a cause of institutional empowerment (if small member states are driving it) rather than its effect. We next introduce the dummy interactions to test H2-H3. Given the similarity of the scatterplots and the similarity in the results reported in Table A3-1, we report below only results based on the dyadic difference in nominal GDP and staff numbers. Wherever relevant, we discuss different results obtained with the other variants of the variables.

The only statistically significant interactions in Table A3-2a in online Appendix 3 are those involving *GERMANY* (Regressions 9-10). Rather than supporting H2, the positive coefficients of these interactions support claims of German dominance. We are not suggesting that short-term profiteering drove German policy, but it did naturally seek to minimize banking and current account adjustment costs to its economy, which led to a relative gain (see also Bulmer and Paterson, 2019, 60). Otherwise, the insignificant interactions mean that institutional empowerment does not provide relative gains to the smallest member state, or to member states in the lower GDP quartile, any more than it does for the average case in the euro area.

In Table A3-2b, the only significant interactions are those of *VETO* and *EASTERNERS* with *COUNCIL* (Regressions 15 and 18 respectively). Their negative coefficients support H2. This suggests that the voting rules in the Council provide relative gains to the small member states. The Council also seems favorable to the eastern member states, but this result disappears when switching from staff numbers to staff compensation measures, or from nominal GDP gaps to shares of EU GDP (not reported), leading us to disregard the result in Regression 18. The new Hanseatic League does not seem to reap special gains.

Turning to H3, Table A3-3a reports statistically significant results only for the interactions of *PROGRAMS* with *COUNCIL*, and *SMP* with *ECB* (Regressions 20 and 24 respectively). However, the former result is not replicated when switching from staff numbers to staff compensation measures, or from nominal GDP gaps to shares of EU GDP (not reported). Table A3-3b offers more tests for H3 by running regressions restricted to the 2010-16 period. The insignificant results in Regressions 25-26 suggest that any effect of German dominance on divergence of gains disappeared during the crisis years, contrary to some prevalent views. Similarly, in Regression 27 the egalitarian effect of the Council voting system disappears. This cannot be traced to the change in the voting rules, which only empowered the small member states. In contrast, in Regressions 30-31 the coefficients of the positive coefficients of the interactions of *PROGRAMS* are significant, and remain so when switching from staff numbers to staff compensation measures, or from nominal GDP gaps to shares of EU GDP.[13]

The upshot is that the test results for H3 are mixed: The fiscal bailout programs did not have a discernible effect on the divergence of gains in the euro area, Germany did not gain against the small member states during the crisis years, and the SMP actually improved the situation of the small member states. All this does not support H3. However, Greece, Ireland and Portugal lost out to France and Germany in the crisis years, and the small member states lost their advantage in Council decision-making, which does support H3, at least in spirit.

[13] Regressions with *SMALLEST*, *SMALLvs*BIG and *HANSEATIC* returned insignificant interaction coefficients in the 2010-16 period as in the entire data period, and are not reported.

We follow on these tables with marginal effects analysis of the more statistically significant dummies, starting with *GERMANY* in Figure 5. Here we analyze the combined effect of *GERMANY* on dyadic differences in GDP, considering the combination of its coefficient and the coefficient of its interaction with *COUNCIL*. The vertical axis measures the percent change in the absolute dyadic difference in nominal GDP when comparing dyads with Germany and one of the small member states, to other dyads. The horizontal axis shows different levels of *COUNCIL* (transformed back to their original scale for tangibility). The solid line shows how the effect of *GERMANY* increases with *COUNCIL*, according to Regression 9. Thus, the slope of the curve reflects the estimated coefficient of the interaction between *GERMANY* and *COUNCIL*. The dashed lines show the 95 percent confidence intervals. Figure 4 shows that for values of *COUNCIL* lower than 0.0007 (where the upper dashed line crosses the horizontal axis) the effect of *GERMANY* is actually negative, but this is not practical, as only 31 observations lay in that range, none with *GERMANY*=1. For values of *COUNCIL* between 0.0007 and 0.0012 (where the lower dashed line crosses the horizontal axis) the effect of *GERMANY* is statistically insignificant. This relates to 316 observations, of which 49 are coded *GERMANY*=1.[14] For the remaining 1,334 observations, including 131 coded *GERMANY*=1, the

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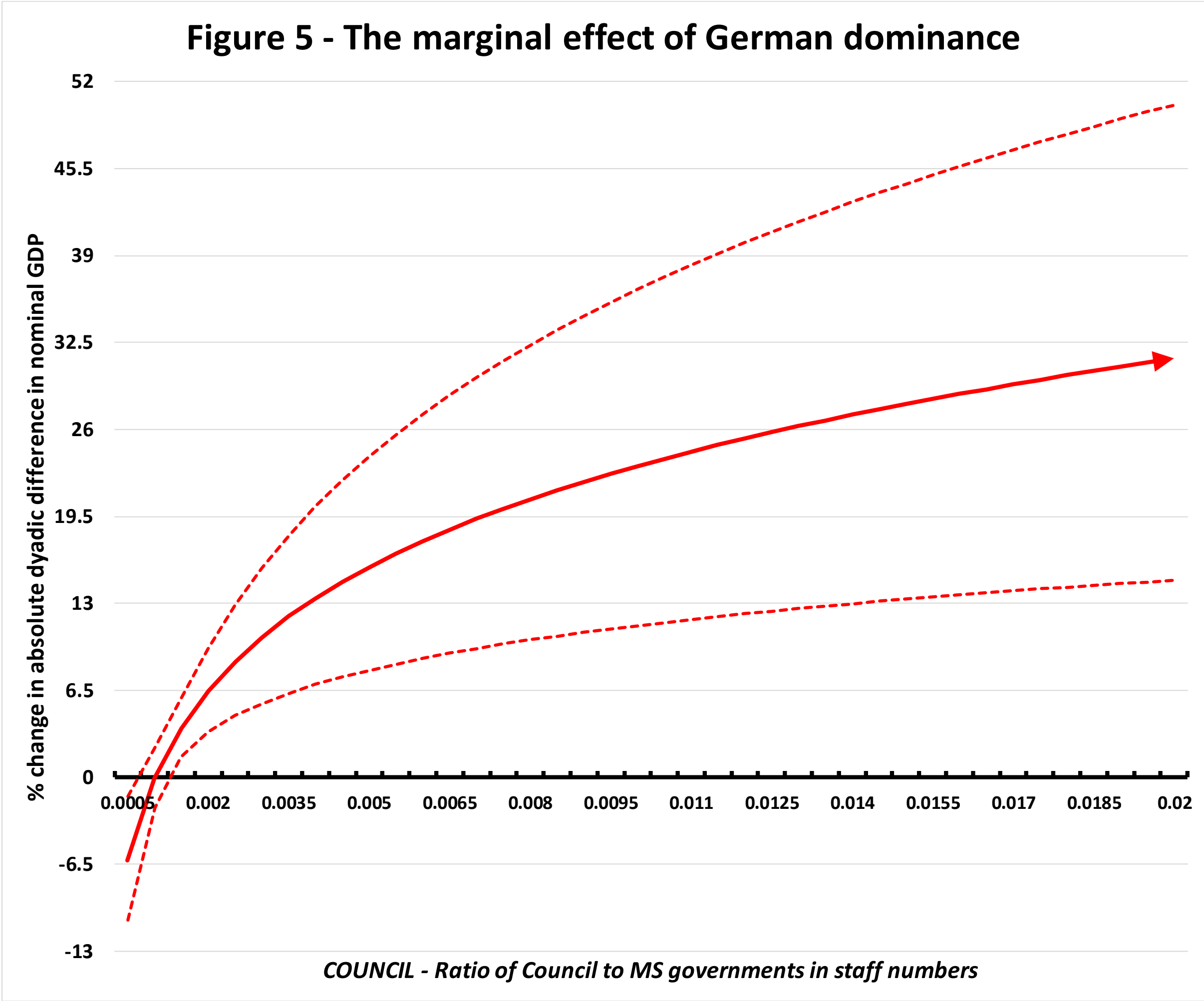
[14] Note that within this range, the interaction between *GERMANY* and *COUNCIL* remains statistically significant, only the combined effect of *GERMANY* on the dependent variable loses its significance.

effect of the German advantage is statistically significant.[15] For the average *COUNCIL* value (0.006) the potential advantage for Germany is an increase of 18.6 percent in the absolute dyadic difference in nominal GDP.



[15] An additional 9 observations with *GERMANY*=1 are lost due to missing observations in *COUNCIL*. For clarity of presentation, Figures 5-8 do not cover *COUNCIL* values exceeding 0.02, which are relevant for only 72 observations.

Figure 6 analyzes the effect of the Council's voting rules on dyadic differences in GDP, as identified in Regression 15. The lower dashed line shows that for values of *COUNCIL* lower than 0.0013 the effect of *VETO* is positive. 393 observations fall in this range, of which 177 are coded *VETO*=1. These 177 observations include almost exclusively France and Germany on the large member state side (not Italy or Spain), and a variety of small states, Ireland and Luxembourg most frequently. For values of *COUNCIL* between 0.0013 and 0.0169 the effect of *VETO* is statistically insignificant. This relates to 1,179 observations, of which 311 are coded *VETO*=1. This is also where the average *COUNCIL* value lays. In other words, on average VETO has no effect on relative gains. For the remaining 109 observations, the effect of the voting rules is indeed negative, but no observations are coded *VETO*=1 in this range. The upshot is that at low levels of empowerment, the Council and its voting rules serve mostly France and Germany, but this effect disappears as Council resources expand relative to the member states.

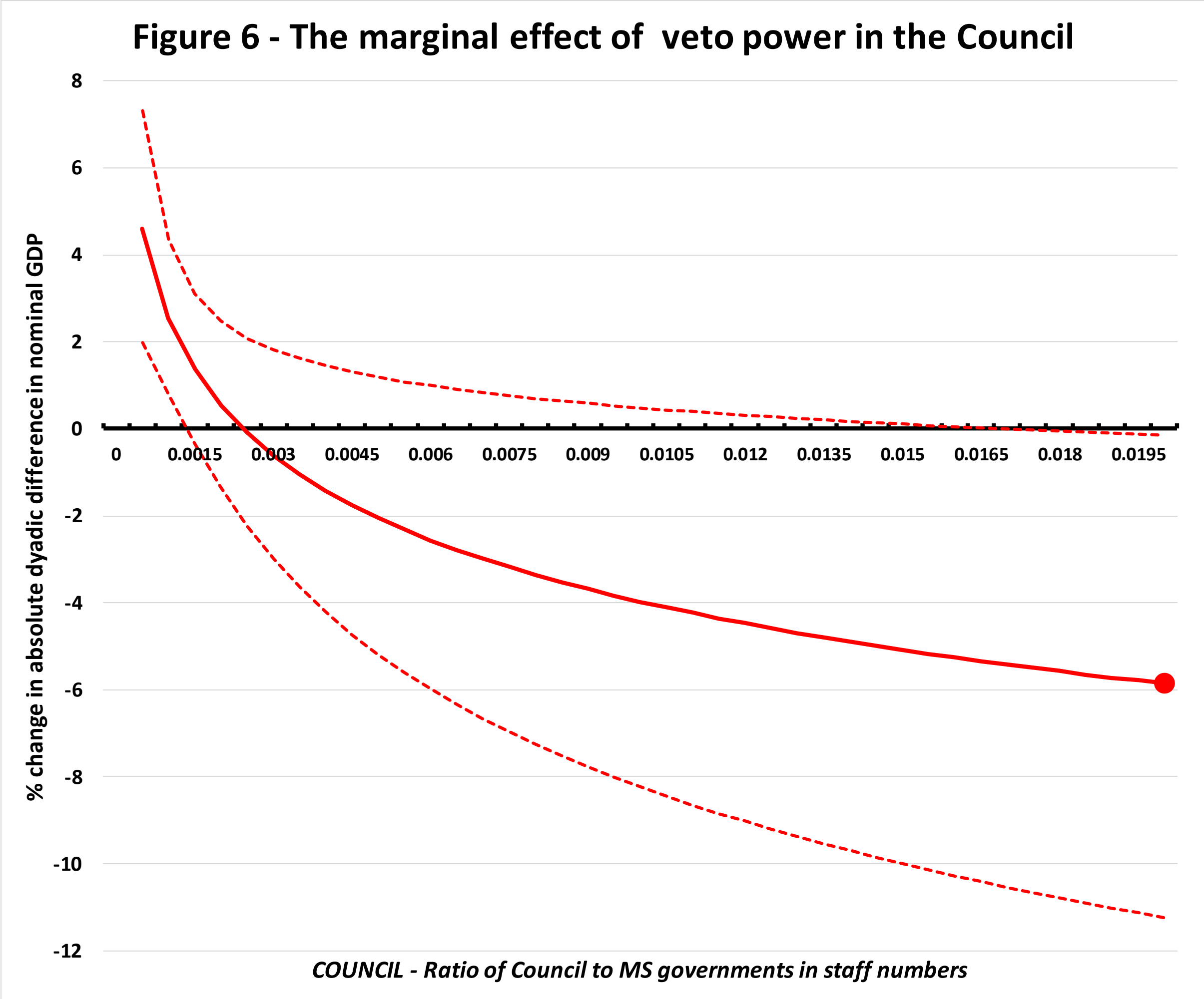
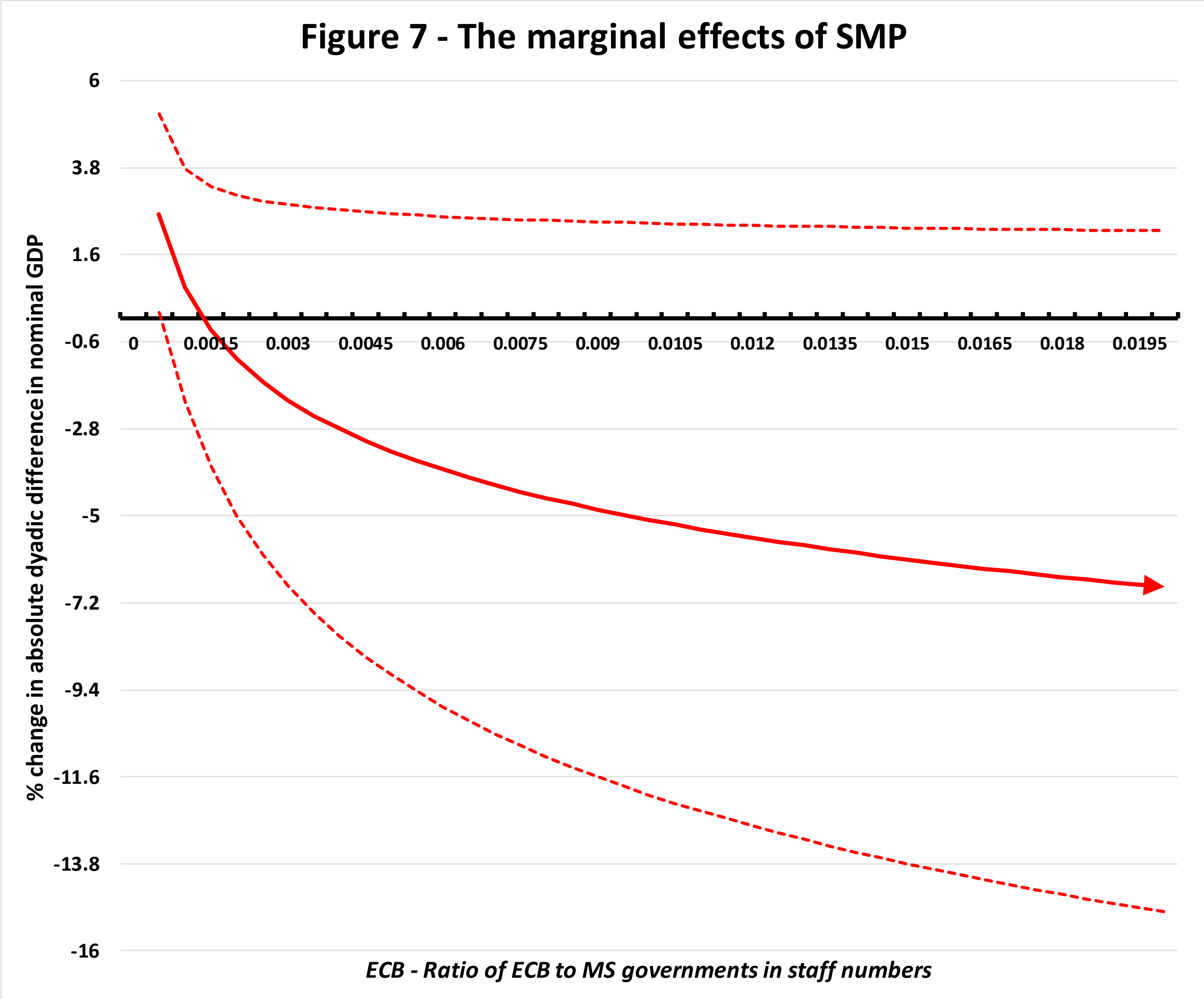
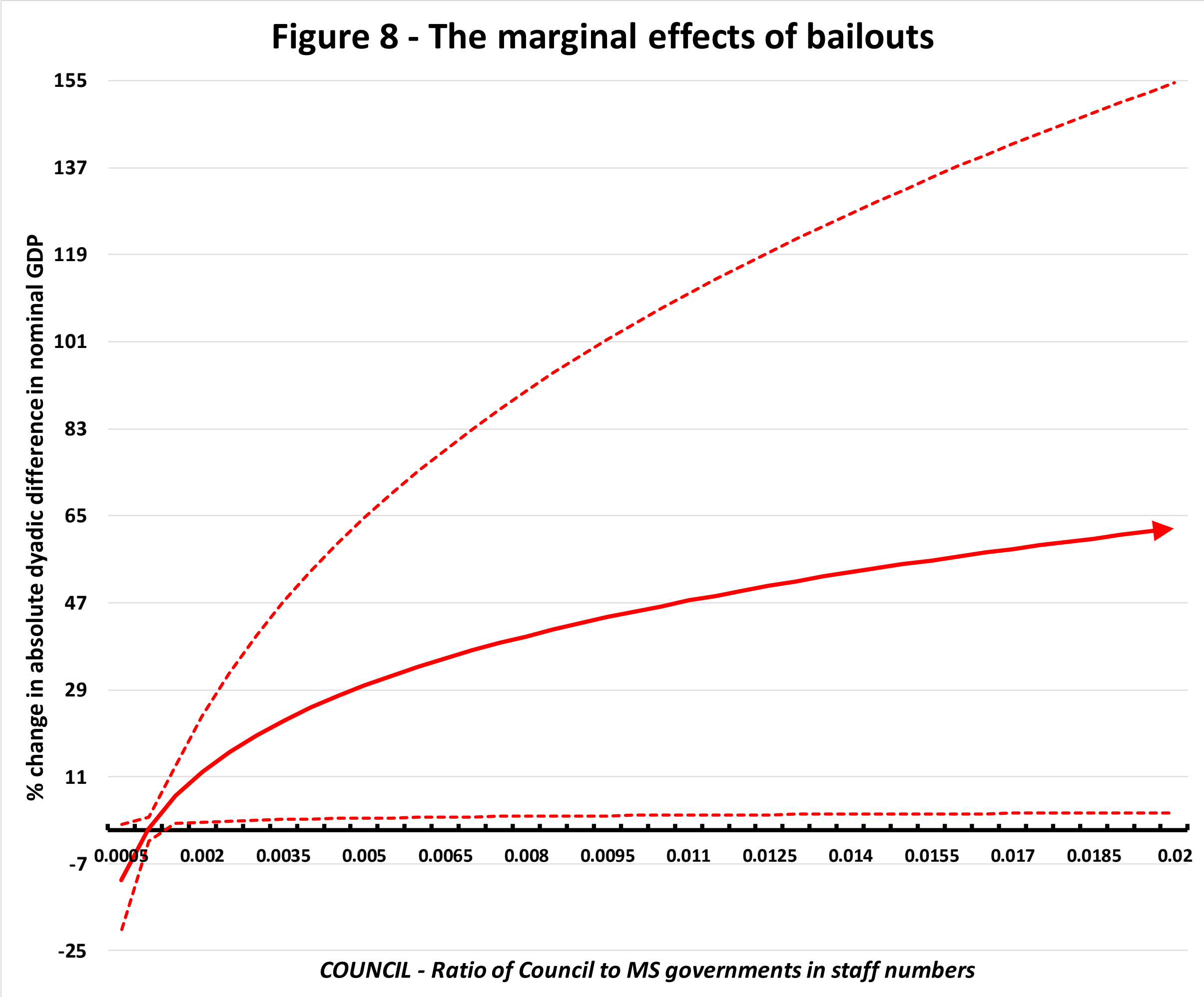


Figure 7 repeats a similar analysis for the SMP, based on Regression 24 and ECB empowerment data. This program is shown to have had no significant effect on the distribution of gains in the euro area, except when *ECB* values were lower than 0.0005. Of the 277 observations in this range, only 17 are coded *SMP*=1, with similar frequencies for all five recipient member states (Cyprus, Greece, Ireland, Italy and Spain), and in all of these 17 observations the non-recipient member state is either France or Germany. Even Italy (not a small state) lost out to both France and Germany, but did not gain against the other member states. However, at roughly 2-4 percent, the magnitude of this effect is small.



Finally, Figure 8 analyzes the marginal effect of *PROGRAMS* since 2010, based on Regression 30. For 114 observations with a COUNCIL value less than 0.0011, 21 of which are coded *PROGRAMS*=1, the *PROGRAMS* effect is insignificant. For 778 observations, including another 21 coded *PROGRAMS*=1, the effect is positive and significant. These 21 observations split evenly among the three recipient member states, but all include Germany as the large member states, none include France. For the average *COUNCIL* value, the potential disadvantage for the recipients of fiscal bailout programs is an increase of 35.4 percent in the absolute dyadic difference in nominal GDP.



Conclusions

Is the euro area a club run by large states, for their own benefit, at the expense of small states? Are euro area institutions merely a tool at the service of large states? The literature provides conflicting arguments about how dominant Germany and other large states really are in the euro area. Small states, aided by their better potential for policy coherence, and by the power of ideas, can use internal divisions within large member states, in order to pursue their interests. Small states also rely on empowering the institutions of the euro area in order to restrict the large states' freedom of action.

Indeed, scholars agree that the Council has gained much authority during the crisis at the expense of the policy autonomy of member states. The Commission and the ECB did so too, even if, as some scholars suggest, they merely enforce the rules agreed at intergovernmental negotiations. After all, the effectiveness of rules depends on the capacity of the Commission and ECB to enforce them. Some scholars suggest that the euro area's supranational institutions went beyond strict enforcement of rules, and acquired room for interpreting the rules. This is evident for example in the Commission's control of statistics, and in its discretion over trading-off deficit reduction against progress in structural reforms, and over extending deadlines for reducing deficits. Similarly, the ECB's creative use of monetary tools to indirectly assist troubled governments, effectively assuming the role of lender of last resort, has demonstrated entrepreneurship. Any delegation of authority to common institutions involves some agency loss, which potentially improves the position of small states relative to that of large states. However, are these institutions indeed using their new roles to serve the interests of the small member states? Or are they taking advantage of financial crisis situations to promote the interests of the large member states?

To answer these questions, we estimate the effects that empowering central and supranational institutions has on dyadic differences of gains among the member states of the euro area since its launch. Specifically, we study the empowering of the Council, Commission and ECB relative to the member states, in terms of their mandates and allocated human resources. We operationalize gains in terms of changes in GDP. We are not suggesting that the governments of euro area member states necessarily pursue relative gains as their main goal, but we acknowledge that integration has distributional consequences, and expect the small member states to 'fight their corner'.

We test hypotheses on the entire membership of the euro area since its launch in 1999, but also focus on particular relationships. These alternatively involve Germany and the small member states, the smallest member state and the large member states, dyads among wider groups of small and large member states by GDP or by veto power in the Council, or dyads involving the large member states and either the New Hanseatic League or the Eastern Member States. We also explore whether the expanding resources of EU institutions has relatively undermined the small member states in circumstances of financial stress: during a bailout program (as creditors or debtors), through ECB bond market interventions (SMP), or generally during the euro crisis period. Small member states should be particularly vulnerable to political pressure under such circumstances.

We find that empowering the Council, the Commission or the ECB provides relative gains to small member states, although not against Germany, and that the voting rules in the Council provide an additional relative advantage to the small states, once institutional empowerment crosses a certain threshold. In crisis times, Greece, Ireland and Portugal, all of them participants in bailout programs, lost out to France and Germany, and the small member states lost their advantage in Council decision-making. However, Germany lost its advantage too during the crisis years, and the SMP is actually associated with relative gains for the small member states. This is surprising because LIG literature, which is one of the leading approached in the analysis of European integration, expects European institutions to serve the national interest of the large member states, especially in times of crisis. However, we find that the small member states of the euro area are not powerless against the large member states. Our findings thus challenge the classic LI approach by suggesting that small states can sometimes use institutions to catch-up with large states. While we focus on the Euro area, our results should travel well to inter-state relations on other international organizations.

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