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THE EUROZONE CRISIS, DECENTRALIZED  
BARGAINING AND THE THEORY OF EU  
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Mattia Guidi and Yannis Karagiannis

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LUISS School of Government

Via di Villa Emiliani, 14

00197 Rome ITALY

email: [sog@luiss.it](mailto:sog@luiss.it)

web: [www.sog.luiss.it](http://www.sog.luiss.it)



# ABSTRACT

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According to neoliberal institutionalism, sovereign states create centralized international organizations to limit information asymmetries, monitor compliance, and ensure the credibility of commitments to agreed-upon policies – in short, to minimize transaction costs in a world where the Coase theorem does not apply. Neoliberal institutionalism can thus help explain the delegation of powers to supranational bodies like the European Commission (‘Commission’) or the European Central Bank (‘ECB’). Yet, what we observe in the Eurozone in 2010-2013 is the emergence of a number of influential institutions of decentralized bargaining, such as the “Merkozy duumvirate” and the “Frankfurt Group”, whose creation reversed the logic of supranational delegation. To understand the causes and the consequences of these apparently anomalous institutions we develop a model of incomplete contracts. We demonstrate that, inasmuch as they receive monopolistic powers, centralized international organizations create potential problems of discrimination. Decentralized institutions are explained by their role in mitigating these problems.

*Keywords:* Coase theorem; European Union; Eurozone; International organizations; Sovereign debt crisis

# AUTHOR INFORMATION

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**Mattia Guidi** is a Post-doctoral Fellow at the Department of Political Science of LUISS Guido Carli, Rome. His research interests are political economy, regulatory policies and EU politics. His work has appeared in *Acta Politica* and *Comparative European Politics*.

**Yannis Karagiannis** is Associate Professor of political science at the Institut Barcelona d’Estudis Internacionals. He has published in several journals and university presses, including Cambridge University Press, the *European Law Journal*, *European Union Politics* and the *Journal of European Public Policy*.

## Contact Information:

LUISS School of Government,  
Via di Villa Emiliani, 14, 00197 Rome - Italy  
Tel. +39-06-85225051  
Fax +39-06-85225056  
Email: [sog@luiss.it](mailto:sog@luiss.it)  
Website: [www.sog.luiss.it](http://www.sog.luiss.it)

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# 1. Introduction

Since 2008 the European Union ('EU') is going through one of the most challenging economic, political, and institutional crises in its 60 years-long history. In the vast majority of EU countries, and for most of the period, macro-economic indicators, the number of corporate bankruptcies, and calls for beggar-thy-neighbour policies have all been alarming. To deal with that unprecedented situation, European leaders created a number of ad hoc and informal institutions of decentralized bargaining, such as the "Merkozy duumvirate" (i.e. the tandem consisting of the German Chancellor and the French President) and the "Frankfurt Group" (i.e. the decision-making group consisting of the Chief Executive Officers of France, Germany, the Commission, the ECB, the Eurogroup, the President of the European Council, and the European commissioner responsible for economic and financial affairs). This article seeks to explain the emergence of these institutions given that the main theory social scientists currently employ to study international organizations ('IOs') cannot account for them.

Before going on to present the logic of our argument, two preliminary points are in order. First, our definition of "institutions" is game-theoretical. Following Calvert, we define an institution as "an equilibrium of behaviour in an underlying game ... It must be rational for nearly every individual to almost always adhere to the behavioural prescriptions of the institution, given that nearly all other individuals are doing so" (Calvert 1995: 60). Note that this definition is not trivial; for example, it contrasts with North's (1990: 3) better known understanding of institutions as humanly devised constraints (or "rules of the game"). The definition of "institutions" that we adopt in this paper is further discussed in Section 2.

Second, the ad hoc creation of these informal institutions of decentralized bargaining (hereafter 'decentralized institutions') came at a cost. The "duumvirate of Germany and France" and the "F-group" (The Economist 04/11/2011) threatened to undermine the emerging spirit of the Treaty of Lisbon. The self-appointment of a few leaders as "commanders-in-chief" of the Eurozone aggravated the EU's democratic deficit, and undermined faith in the idea that the EU is a "community of law". Leftist newspapers run titles such as "The Great Putsch: Welcome to Non-Democratic Europe" (Roarmag.org 2011) or "The Merkozy decoy" (L' Humanité 01/02/2012). Right-wing ones wrote about "Europe's hit squad: If you thought the EU couldn't get any less democratic, meet the Frankfurt Group" (The Spectator 12/11/2011) and "Euro-globalization: The Merkozy System in Disrepair" (NationsPresse 22/10/2011). Even the mainstream press denounced

the absence of “firm legal foundations” of these institutions, which raises “serious constitutional problems” (Der Spiegel 16/12/2011; see also Habermas 2011). And outside the EU, the operation of these ad hoc institutions strengthened critics (e.g. Russia Today 11/11/2011). Given the costs illustrated above, of course, we must try to discover the benefits which made the decentralized institutions worth creating.

Our starting point is a striking dissonance between theory and the empirical record. According to the dominant lens used today to analyze international organizations (‘IOs’), neoliberal institutionalism (‘NI’), institutions exist because they mitigate certain informational problems inherent in international bargaining and decentralized bargaining (Keohane 1984; Milner and Moravcsik 2009; Broz et al. 2009; for an application to the EU, Pollack 2003). It follows that such highly institutionalized setups as the EU should be necessary and possibly sufficient to promote inter-governmental cooperation on all core matters covered by the corresponding treaties, and perhaps also various germane ones. IOs are a solution, and perhaps *the* solution; they should not be a problem. Yet the operation of the EU during the 2009-2013 crisis contrasts sharply with the theory. Far from being deemed necessary and sufficient to resolve the problems of the financial, economic, and sovereign-growth crisis, the operation of formal institutions of centralized bargaining were seen as a problem which had to be urgently resolved. Interestingly, these included problems of informational asymmetries and moral hazard generated by the operation of the Commission, the Eurogroup, and the ECB.

Among academics, the potentially far-reaching consequences of the new institutions have led to numerous comments on their causes, the unfolding of the negotiations which led to their creation, and their consequences (see de Witte et al. 2013). One of their aspects which remains to be explored, however, concerns their place in, and their implications for, the theory of international institutions in general, and European integration in particular. This article starts filling that gap by taking a perspective rooted in positive political theory. The questions we are trying to answer are the following: admitting that IOs are created to allow states to economize on the costs of their transactions, wasn’t that goal adequately served by the Maastricht and Lisbon treaties? How can we account theoretically for the puzzling situation where supranational solutions create problems which are addressed by reverting to inter-governmentalism, which was supposed to be the original problem? Is there any more theory-based and general explanation for the new decentralized institutions than the facile assertion that French President Sarkozy was incurably obsessed by

upcoming elections or that German chancellor Angela Merkel had the upper hand in all her dealings with her European partners?

With these questions in mind, the rest of this article is organized as follows. Section 2 reviews the main definitions of “institutions” that emerge from the literature, and explains why we opt for a game-theoretical definition. Section 3 reviews the neo-liberal institutionalist theory of international organizations (‘IO theory’), both as originally developed by Robert Keohane and as applied to European integration. Section 4 presents a few basic facts about the new ad hoc institutions, highlights their interconnection with EMU policies and politics, and argues that IO theory cannot account for their creation and functioning. To start thinking where IO theory gets it wrong, Section 5 turns to an under-explored alternative to IO theory, namely the Coase theorem of decentralized bargaining. Section 6 then produces a novel theoretical model about the role of the new ad hoc institutions in EMU in particular, and European integration in general, based on the theory of incomplete contracts. The intuition behind the model is simple: by giving rational re-election-minded national governments privileged access to information about each other’s ideal policy preferences, decentralized institutions allow them to avoid being discriminated against by supranational bureaucrats. This, we argue, is a more plausible explanation for the observed actions of numerous actors than extant explanations. Section 7 concludes.

## **2. Defining and explaining institutions**

Institutions are defined by political scientists in different ways. Following Crawford and Ostrom, we can distinguish between two main possible definitions: “institutions-as-equilibria” and “institutions-as-rules” (1995: 582). The first one is typically game-theoretical (see Riker 1980, Calvert 1995, Schofield 2002), and it posits that institutions are the result of mutual agreements between rational actors: in other words, “a regular behavior pattern sustained by mutual expectations about the actions that others will take” (Crawford and Ostrom 1995: 583). The second definition sees institutions as the “rules of the game in a society” (North 1990: 3; see also Ostrom 1986, Knight 1992), and it argues that equilibria of behaviour (or “shared strategies”) are only a

component of institutions. Another necessary element, according to this view, is the sanction associated with improper or unlawful behaviour.<sup>1</sup>

Between these two definitions, we adopt the former, for two important reasons. First, we assume that states are *boundedly rational* actors (on the concept of bounded rationality see Simon 1972, and Gigerenzer and Selten 2002) and we are interested in understanding why they choose particular arrangements over (or together with) others. The fact that some arrangements are not crystallized in binding rules must not prevent us from analysing them, if they constitute a tool by which their members organize their actions and influence the functioning of other institutions. Second, we believe that considering institutions as equilibria is the only way to satisfactorily conceptualize institutional change. An institution can sometimes take the form of a stable set of written rules. However, as rules are often changed through time, our primary interest is in explaining what happens between two different set-ups – why and how institutional change happens. To do so, we need to turn our attention to the “interstitial creation of *informal institutions*” (Farrell and Héritier 2007: 286) that arises when some equilibrium is not sustainable or optimal for all the actors. It is through the creation of informal institutions that formal institutions (rules) are then amended. The creation of informal institutions is favoured by the incompleteness of contracts, i.e. the fact that the rules are “vulnerable to reinterpretation *ex post* in circumstances that were not initially foreseen” (Farrell and Héritier 2007: 289). In an institutional system like the EU, where many rules can be changed only via unanimity, all actors tend to use informal institutions to negotiate better bargaining positions in future negotiation rounds (see also Farrell and Héritier 2003, Héritier 2007).

Some may say that, if institutions do not necessarily imply the existence of formal rules, it becomes difficult to ascertain what is an institution and what is just an ephemeral agreement between two or more actors. Calvert, whose definition of institution as “an equilibrium of behaviour in an underlying game” we have adopted, clarifies that (1995: 73-74):

“[w]hen [expectations about the behavior and reactions of others] take on a particularly clear and concrete form across individuals, when they apply to situations that recur over a long period of time, and especially when they involve highly variegated and specific expectations about the different roles of different

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<sup>1</sup> Crawford and Ostrom indicate another possible definition, that they label as “institutions-as-norms”. It is mainly adopted by sociologists (see Coleman 1988, Elster 1989), according to whom institutions entail some social reaction to what is perceived as a “wrong” behaviour.

actors in determining what actions others should take, we often collect these expectations and strategies under the heading of *institution*” (emphasis in the original).

Therefore, to have “institutions” we ought to have a “clear and concrete form”, something that recurs “over a long period of time”, and, above all, “specific expectations” about how actors that form the institution shape the behaviour of other actors. Is this the case for the phenomena we aim to analyse in this paper? We deem it is, because ‘Merkozy’ and the ‘Frankfurt Group’ possessed all of the three above mentioned characteristics. First, their form was clear. They had regular meeting during their existence, and they let the other actors know that they were meeting, deciding, acting. Although their form did not rely on *formal* rules, they were clearly identifiable: both their membership and their objectives were unambiguous. Second, they lasted a relevant amount of time. In this respect, time must not be measured in absolute terms, but relatively to the amount of *events* that take place in a certain period. By “events”, following Riker’s (1957, 1990) definition, we mean definite and “unambiguous” ones. An events is considered unambiguous “when the movers and actors of its initial and terminal situations are the same” (Riker 1990: 170).<sup>2</sup> Consequently, to be meaningfully analysed by social scientists, events must be short and definite: summits, meetings, ministerial appointments, and so on. It is therefore easy to note that many of these events took place in the period in which these decentralized institutions existed: there were frequent bilateral and multilateral meetings, governments resigned and others were appointed, formal and informal agreements were agreed on. Third, the institutions shaped specific expectations among their members and among non-members as well: all of the events that occurred in that period had a particular outcome because the actors that participated in them knew about the existence of (and was influenced by) these decentralized institutions, about their preferences, strategies and goals.

### **3. IO theory and european integration**

IO theory provides the dominant theoretical framework to interpret and analyse international institutions (i.e. rules, organizations, and regimes). Finding its inspiration in the work of economists Roland Coase and Oliver Williamson on transaction costs, the theory posits that international

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<sup>2</sup> According to Riker, focussing on this kind of events is the only way for social scientists to avoid arbitrariness and imprecision.

agreements can be thought of as economic barter transactions. Just like an economic transaction may consist in supplying 20 megawatts of electricity in exchange of 1,000 hours' worth of legal services, so an international agreement consists in one (or more) country agreeing to change some policy in exchange for changes by some other country in some of its own policies. Because these are barter arrangements, payment may not occur at the exact moment the transaction is agreed. Yet a promise to pay in the future may be cheap talk, and this creates a series of problems (e.g. becoming locked into a relationship with an untrustworthy partner who is thereby able to extort benefits by the other party). Anticipating such problems, the parties will either give up on their potential transaction, which leads to Pareto-inefficiency, or create appropriate governance structures to mitigate the risks of guile, untrustworthiness, or extortion.

According to neoliberal institutionalists, that economic reasoning has an obvious parallel in international relations. Despite the fundamentally anarchic nature of international relations, international institutions structure relationships, instil confidence that "payments" will indeed be made, and thereby make transactions possible. In other words, they "matter" because they resolve problems of asymmetrical information and make commitments credible. In fact, the distinguishing characteristic of IO theory is its claim that what matters most in the world of international politics is the configuration of information and institutions (i.e. neither, as realists argue, the configuration of capabilities, nor, as pure liberals argue, the configuration of state preferences – see Moravcsik 1997: 513). And the proof of the pudding is in the eating: if international institutions did not matter, then sovereign states would not get into the trouble of creating them in the first place. IO theory is thus rooted in the idea that, even when actors have common interests, international cooperation may fail. This may be due to a number of reasons, such as (1) high incentives to defect (as in the prisoner's dilemma); (2) the non-iterative nature of transactions (as in one-shot games of collaboration, including the prisoner's dilemma played a knowingly finite number of times); (3) the high number of actors, which makes mutual monitoring difficult, or (4) problems of information asymmetry (as in principal-agent models of moral hazard).

Just as in Coase's and Williamson's works on transaction costs and the limits of firms, however, the real possibility of failure in international relations is not the end of IO theorists' story. According to Keohane, international cooperation is not bound to fail. International institutions reduce the range of expected behaviour, limit uncertainty, and spread information widely. This, and the possibility to create issue linkages, leads to lessened risks of moral hazard. "The central conclusion is [that] international regimes can facilitate cooperation by reducing uncertainty." (Keohane 1984: 97)

Thus, international institutions, organizations, and regimes perform essentially four cooperation-enhancing tasks. First, they reduce contractual ambiguity by setting standards of behaviour which allow all parties to determine whether an actor is violating an agreement. Second, they reduce the costs of joint decision-making by routinizing procedures and decisions. Third, institutions such as IOs also facilitate cooperation by providing mechanisms for the authoritative resolution of disputes. And finally, they provide ways to acquire information on compliance, not only by permitting on-site inspections, but even when self-reporting is the starting point of official discussions. Hence, “Regimes are important not because they constitute centralized quasi-governments, but because they can facilitate agreements, and decentralized enforcement of agreements, among governments.” (Keohane 1984: 244)

Although Keohane’s IO theory was illustrated by the General Agreement on Tariffs and Trade, other scholars found it useful to understand EU institutions. Pollack (2003) and, with some variations, Moravcsik (1998) and Franchino (2007), set out to understand who does what and why in the EU. Applying Keohane’s transaction cost-economizing logic, Pollack argued that national governments delegate powers to centralized supranational institutions because these “solve problems of incomplete information (by providing policy-relevant information to legislators) and credible commitments (by monitoring legislators’ compliance with their agreements and by providing independent regulation of powerful economic actors).” (Pollack 2003: 6). Similarly, according to Moravcsik, “Delegation and pooling appear to have been employed primarily to implement or enforce prior agreements by precommitting governments to greater compromise and thus more efficient decision-making.” (Moravcsik 1998: 485-86)

#### **4. The puzzle of decentralized institutions**

This section turns to a description of the decentralized institutions that were created in 2011. We focus on the two institutions which we deem to be the most important, namely “Merkozy” and the “Frankfurt group” (other decentralized institutions that either appeared or were strengthened during the Eurozone crisis concern the coordination of northern creditor countries, chiefly Finland, Germany, and The Netherlands, and that of southern debtor countries, primarily Italy and Spain). Both emerged in 2011 as a way to push for fast and effective solutions to the European sovereign-debt crisis that had been intensifying since late 2009. The puzzle that they create for IO theory can be summarized as follows: why did some countries and representatives of IOs need to establish

informal and decentralized institutions if there already existed many IOs and institutions that allowed them to propose, discuss and adopt the measures they pushed for? Were the existing institutions more an obstacle than a means to solve the problems that European leaders faced? If this is the case, then current theories of European integration and the role of IOs might need to be amended.

“Merkozy” graphically characterizes the tight relationship between German chancellor Angela Merkel and former French president Nicolas Sarkozy, who engaged on sustained coordination beyond the traditional limits of the Elysée Treaty of 1963. The institution was first named by Dutch newspaper De Telegraaf on February 5, 2011 (‘Eurolanden krijgen korset aangemeten’), when it became evident that the two political leaders were determined to steer the EU decision-making process in the forthcoming months, particularly with regard to the measures to be taken in order to solve the European sovereign-debt crisis. The relationship took the form of frequent bilateral meetings before and between EU summits, common proposals and press conferences, and even joint electoral campaigning. Merkozy conveyed the message that they strongly agreed on the main issues on the Eurozone agenda, and that they were determined to see their proposals adopted by all Eurozone members. Merkozy was an institution because Sarkozy’s main concern was to preserve France’s “triple-A” bond rating by showing himself fully committed to implementing German-like austerity measures, while Merkel needed to show that even a traditionally anti-austerity country like France agreed with her policies.

Our intention here is not to explore minutely the contingencies that led the two leaders to form such a coalition. What is more relevant for us here is that they found it necessary to do so. It goes without saying that France and Germany had not the same ultimate goals at the time. However, as mentioned above, they both deemed that the “duumvirate” served their purposes better than ordinary bargaining within EU institutions. At the same time, we do not assess if the decisions they pushed for were good or bad for the governance of the debt crisis, but we point to the fact that, as long as their *liaison* existed, it was rather effective in imposing its own agenda on such diverse matters as the Tobin tax, the super-commissioner for the Euro, the hair-cut on the Greek sovereign debt, the strengthening of fiscal governance, and others.<sup>3</sup>

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<sup>3</sup> See respectively The Guardian, “Sarkozy and Merkel call for ‘true economic government’ to save Eurozone”, 16 August 2011, <http://www.guardian.co.uk/business/2011/aug/16/sarkozy-merkel-economic-government-eurozone>; Reuters, “Sarkozy and Merkel’s letter to Van Rompuy”, 07 December 2011, <http://www.reuters.com/article/2011/12/07/us-eurozone-france-letter-idUSTRE7B612Y20111207>; Barroso, J.M. Durão, “Briefing on the conclusions of the European Council of 26/10/2011” 27 October 2011,

The so-called “Frankfurt group” is another informal institution that was very active towards the end of 2011 and throughout 2012, and whose decisions were crucial in reaching an agreement, among other things, on the second Greek bailout loan and on enlarging the capital guarantee of the European Financial Stability Facility (‘EFSF’). The name of the group comes from the fact that its members (Merkel, Sarkozy, ECB President Draghi, European Council President Van Rompuy, European Commission President Barroso, former Eurogroup President Juncker, International Monetary Fund (‘IMF’) President Lagarde) met for the first time in Frankfurt at a farewell party organized for former ECB president Trichet on 19 October 2011. The group had another meeting before the EU Council of 23-26 October and frequent meetings were reported during the G20 summit in Cannes (3-4 November). During the G20,<sup>4</sup> the Frankfurt group is reported to have discussed (and rejected) former Greek Prime Minister Papandreou’s proposal of holding a referendum on the bailout agreement signed at the end of October,<sup>5</sup> and to have pushed Italy to accept IMF’s monitoring over the implementation of the fiscal austerity measures it had promised in August 2011.<sup>6</sup>

As mentioned above, if IO theory is right, then decentralized institutions such as “Merkozy” and the “Frankfurt Group” should not have existed at all. More specifically, if international institutions (rules, organizations, or regimes like the EU, the Commission, the ECB, and the Eurogroup) were created to solve otherwise unsolvable problems of cooperation, including in the monetary realm, it would be ironic to assume that these solutions create their own problems of cooperation which command the creation of a new layer of international institutions. After all, there is no visible end to that sequence: the second layer of institutions may also create problems of cooperation, which may need a third layer of institutions, etc. So, if, as IO theory has it, centralized institutions are necessary

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<http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/11/714>; Der Spiegel, “Tough Words: Merkel and Sarkozy Halt Payments to Athens”, 3 November 2011, <http://www.spiegel.de/international/europe/tough-words-merkel-and-sarkozy-halt-payments-to-athens-a-795638.html>. See generally, Frankfurter Allgemeine Zeitung (‘FAZ’), “Berlin und Paris übernehmen die Führung”, 2 December 2011, <http://www.faz.net/aktuell/wirtschaft/merkozy-berlin-und-paris-uebernehmen-die-fuehrung-11549225.html>.

<sup>4</sup> Several sources report that at the G20 summit of November 2011 there were delegates wearing badges of the “*Groupe de Francfort*” (e.g. “A crisis? Call the F-team”, The Economist, 4 November 2011, <http://www.economist.com/blogs/charlemagne/2011/11/euros-frankfurt-group>).

<sup>5</sup> Der Spiegel online, “Tough Words: Merkel and Sarkozy Halt Payments to Athens”, 3 November 2011, <http://www.spiegel.de/international/europe/tough-words-merkel-and-sarkozy-halt-payments-to-athens-a-795638.html>.

<sup>6</sup> La Repubblica, “Italia, sorveglianza rafforzata della Ue. Berlusconi: “Fmi è come certificazione bilancio””, 4 November 2011. [http://www.repubblica.it/economia/2011/11/04/news/g20\\_ultimatum\\_italia-24390352](http://www.repubblica.it/economia/2011/11/04/news/g20_ultimatum_italia-24390352).

<sup>6</sup> For a very critical view on the anti-democratic nature of the Frankfurt Group, see The Huffington Post, “Merkel’s Chilling Vision of a Post-democratic Europe”, 27 January 2012, [http://www.huffingtonpost.com/rory-fitzgerald/angela-merkel-eu\\_b\\_1235889.html](http://www.huffingtonpost.com/rory-fitzgerald/angela-merkel-eu_b_1235889.html)

and sufficient to minimize otherwise prohibitive transaction costs, why did such rational, experienced, and resourceful politicians as Merkel, Sarkozy, Juncker, or Draghi revert to decentralized bargaining?

Even admitting that the decentralized institutions were created to alleviate problems created by their predecessors, a theory which claims that treaties are signed to solve problems created by other treaties which were themselves signed to solve problems of credible commitments fails in terms of both analytical traction and theoretical parsimony. In addition, note that by the time the decentralized institutions were created, Eurozone members were not only members of the EU (including the ECB and the Eurogroup), but also of the Organization for Economic Cooperation and Development ('OECD'), the World Bank, the IMF, the Bank for International Settlements, as well as of the United Nations, the North Atlantic Treaty Organization, West European Union, and the Council of Europe, and they maintained close bilateral diplomatic relations. Their officials thus met, discussed, and monitored each other in several dozens forums on a daily basis, covering all relevant matters. According to IO theory, "above all, [such] institutions help states reach a collectively superior outcome by reducing the transaction costs of further international negotiations on specific issues and by providing the necessary information to reduce states' uncertainty about each other's future preferences and behaviour." (Moravcsik and Schimmelfennig 2009: 72). It follows that, seen under the light of IO theory, the new decentralized institutions seem at best superfluous, and otherwise counter-productive. Yet, they were not innocuous pieces of monetary diplomacy between stable partners with identical positions. Rather, as we argued above, they came at a great political cost, both domestic and international. In the language of game theory, then, these were not part of "cheap talk" diplomacy; on the contrary, they sent a costly (and therefore credible) signal that the governments involved wished to go well beyond what their IO obligations imposed on them. Considering these costs, their creation is puzzling.

Three possible, but ultimately unconvincing, answers to that puzzle include: (1) the possibility that these institutions were needed to coordinate on issues well beyond the remit of extant institutions; (2) the possibility that the new ad hoc institutions correspond to the transaction cost-economizing logic of full-blown integration; and (3) the possibility that they were actually substitutes to the EU, the ECB and the Eurogroup, in the sense that they were aimed to torpedo all efforts towards supranational integration by the extant institutions. Yet none of these explanations seems convincing in light of the empirical record.

The first one is not convincing because it assumes that the new *ad hoc* institutions... were not institutions in the end, but at most informal meetings of actors who happened to agree on some issues on the agenda in the organization they were part of. This is self-evident in the case of the Frankfurt group, for which there were no common institutions and there was no agenda (except the one the group itself set). On the other hand, also in the case of “Merkozy” we have shown that France and Germany did not agree to the same extent on all the proposals they made. In some cases, they advanced plans that were clearly pushed for by France, like the “Tobin tax”. In other occasions, France backed proposals that had been first put forward by Germany and other countries of the pro-austerity front (such as the Netherlands or Finland) – this happened with the “super commissioner” proposal. Finally, in other cases the two countries reached an agreement starting from very distant initial preferences (see the case of the EFSF “upgrade”). In other words, if everything France and Germany needed was coordination among countries with similar preferences in view of building consensus for their proposal in the Council, they would have found better allies in all of these issues. Occasional coalitions on various issues on the agenda happen all the time in EU politics. The way EU institutions are designed allows for discrete negotiations and diplomacy, and by no means requires sending costly signals that frustrate allies and potential allies. The facts prove that preserving the “duumvirate”, and showing that in fact it was something more than “cheap talk”, was more important than just coordinating on single topics.

The second and third answer must also be rejected. Nothing leads to believe that “Merkozy” and the “Frankfurt group” were the prelude to further integration between the actors who took part in them. Not only this or similar outcomes never happened or were close to happen, but they were also never declared (implicitly or explicitly) or aimed for by the members of these institutions. Suffice it to mention that for France, participating in these institutions was rather part of a strategy to reaffirm its national sovereignty in foreign politics and to advocate an “intergovernmental Europe” (quoted in Dehousse 2011) not to delegate sovereignty to other supranational organizations. Similarly, it cannot be said that the new *ad hoc* institutions were meant to replace or dismantle the existing EU institutions. This is true for “Merkozy”, which always exerted its leadership *within* EU institutions and in order to steer their decisions, but also for the “Frankfurt group”, that was composed by the highest representatives of those existing institutions, that were in this way legitimizing and reinforcing each other.

## 5. Decentralized bargaining and the coase problem

To start building an alternative perspective on the place of the new ad hoc institutions in the logic of European monetary integration, this section revisits a possibility explicitly rejected in Keohane's IO theory, namely that decentralized (i.e. non-formally institutionalized) bargaining among states may actually be as efficient, if not *more* efficient, than institutionalized cooperation. To do so, we first present Coase's theorem of decentralized bargaining, then review Keohane's argument against relying on that theorem, and finally discuss the merits and the limitations of Keohane's critique. We conclude that the decentralized cooperation sustaining the new ad hoc institutions may actually have made more economic sense than what IO theory would predict.

In his famous theorem, Coase argued that the existence of an external effect associated with a given activity did not inevitably require government intervention (Coase 1960). On the contrary, Pareto-optimal solutions to such externality situations can often be worked out between the affected parties without the help of some central authority ("the government"). Moreover, the nature of the outcome is independent of the assignment of property rights. Accordingly, for example, an Italian or French policy which might produce adverse effects on Germany or Finland should be more efficiently dealt with in a direct, inter-governmental fashion than through the mediation of the Commission or the ECB.

To see how the Coase theorem might work, consider a discrete case applied to Franco-German relations in the Eurozone. Let the French government be running a chronic fiscal deficit, thereby creating a debt problem which harms both German banks and the German public in general (e.g. French policies encourage southern debtor countries' profligacy, lead to so-called hair-cuts, and weaken of the Euro, which Germans do not want). This has an electoral cost for the German Christian-Democratic government: given the French policy, it commands the support of only twelve million German voters, and this makes it potentially vulnerable to the Social Democratic Party. But, if the German Christian-Democratic government could make France limit its deficit and reign in that of southern debtor countries, it could project itself as a more efficient protector of German savers and consumers, and could therefore command the support of fourteen million German voters – which would do away with the Social-Democratic threat. On the other hand, French deficits bring in 500,000 votes to the French Gaullist government, which is in the context of French politics is important, too. So, should the French government be forced to eliminate its deficit, or should the German government have to fear electoral defeat? Is the solution dependent on the existence of an IO like the European Commission or the ECB?

Consider first what outcome is socially efficient. A social planner aiming at maximizing the utility of that group of politicians as a whole would compare the benefits that the French Gaullist government gets from running a deficit to the costs that the German Christian-Democratic government bears from it. If the benefits exceed the costs, it would be deemed efficient for the French Gaullist government to keep its externality-generating policy, and for the German Christian-Democratic government to live with it – and vice versa. Further, according to the Coase theorem, inter-governmental negotiations between the two governments will reach the efficient outcome on their own, without the need for external intervention. In a first step, the German government can offer to pay the French government to eliminate the deficit. The latter will accept the deal if the policy the former offers yields more votes than the deficit does. If, for example, the French government would benefit by 800,000 votes from a more protectionist reform of the Common Agricultural Policy ('CAP') and an exclusion of cultural products from all international trade negotiations, then it might be tempted to indeed fight the deficit and accept the German government's proposal for a new CAP and a protectionist trade policy for the culture sector.

Crucially, by bargaining over the price of their deal, the two governments can always reach the efficient outcome without the need to set up a costly European Commission or an ECB. For instance, suppose again that the French government gets a 500,000 votes benefit from running a deficit and the German government bears a 2,000,000-votes cost from it. In this case, the latter can offer the former a policy  $p$  worth  $500,000 \leq p \leq 2,000,000$  to get rid of the subsidies. Assuming French factors of production can be costlessly redeployed, the former should accept, particularly if  $p > 550,000$  or  $600,000$  (i.e. if the benefits are obvious). Hence, both parties are better off than they were before, and the efficient outcome is reached.

It is possible, of course, that the German government would not be willing to offer any policy that the French government would accept. For instance, suppose that the French government gets a 2,200,000-votes bonus from the subsidies and that the German government bears a 1,800,000-votes cost from them. In this case, the French government would turn down any offer of a policy which would yield less than 2,200,000 extra votes, while the German government would not offer anything yielding more than 1,800,000. Therefore, the French government would end up keeping the deficit. Given these political costs and benefits, however, this outcome too would be efficient.

Note finally that the result of efficient decentralized bargaining does not depend on the assumption that the French government has a legal right to implement a policy of deficits (which, under current rules, it does in the short-run). Although the distribution of such rights (e.g. the treaty rules on fiscal deficits and public debt) does ultimately affect the distribution of political well-being, it does not affect the parties' capacity to reach the efficient outcome. For instance, suppose that the German government can legally compel its French counterpart to run a balanced budget. Although having this right works to the German government's advantage, it probably will not change the outcome. In this case, the French government can offer to pay its German counterpart to allow it to run a deficit. If the benefit of that policy to the French government exceeds the costs it imposes on the German government, then the two governments will strike a bargain in which the French government keeps its policy.

To be sure, the Coase theorem does not always hold, and inter-governmental solutions may not always work. In particular, the theorem applies only when the interested parties have no trouble reaching and enforcing an agreement. In the real world, however, bargaining does not always work, even when a mutually beneficial agreement is possible (e.g. Fearon 1995). According to Keohane,

The Coase theorem has frequently been used to show the efficacy of bargaining without central authority, and it has occasionally been applied specifically to international relations. [It] could be interpreted, therefore, as predicting that problems of collective action could easily be overcome in international politics through bargaining and mutual adjustment. ... [But this fails because] Coase specified three crucial conditions for his conclusion to hold. These were: a legal framework establishing liability for actions, presumably supported by governmental authority; perfect information; and zero transaction costs (including organization costs and the costs of making side-payments). It is absolutely clear that none of these conditions is met in world politics. World government does not exist, making property rights and rules of legal liability fragile; information is extremely costly and often held unequally by different actors; transaction costs, including costs of organization and side-payments, are often high. Thus an *inversion* of the Coase theorem would seem more appropriate to our subject. In the absence of the conditions that Coase specified, coordination will often be thwarted by dilemmas of collective action (Keohane 1984: 87).

Keohane's influential argument is not without merits. Nevertheless, at least two of its core points may carry less weight than it seems. First, there is no a priori reason to believe that information regarding partner states' preferences and policies is as prohibitively expensive as argued in the quote above. As long as we focus on democratic states with a functioning parliament, press, and diplomatic corps, the cost of acquiring such information does not seem to be excessively higher for a foreign government than for the national government itself. (Note that this may not necessarily be true in business and economics, where the real-world relevance of the Coase theorem is rightly questioned; here, if a business firm has no legal obligation or strategic reason to make its future plans known publicly, acquiring that information may indeed be costly for outsiders.) In the context of France and Germany in the Eurozone, their common membership of the EU, the Elysée Treaty, the OECD, the IMF, the World Bank, and several defence organizations points to the opposite conclusion than Keohane's.

Second, and perhaps more importantly, Keohane's definition of transaction costs is ambiguous, and their importance is exaggerated. His ambiguity stems from the "actorlessness" of his argument. The personification of states as players on the international arena allows Keohane to attribute to them calculations of transaction costs which (assuming they actually happen) are necessarily made by some sub-state actor. This may be a political party (e.g. the incumbent executive), a ministry (e.g. the ministry of foreign affairs), some more complex organization (e.g. a parliament), or even private-sector actors (e.g. peak business associations). Yet, each of these actors has its own utility function which may or may not include a negative term for transacting with foreign leaders. It follows that the cost of transacting with foreign states does not affect these actors in the same way. In short, what may seem to Keohane to be a very costly transaction from the point of view of states as a whole may not be one for specific decision-makers. For example, not only did President Sarkozy *not* avoid transacting with foreign leaders, but he strengthened the rule that European and foreign policies were his "*domaine réservé*". (For a serious journalistic account of how politicians strive on rising transaction costs, see Paxman 2002.)

Finally, Keohane almost certainly exaggerates the level of transaction costs. First and foremost, it is meaningless to talk about transaction costs without comparing them against production costs. In the economic theory of transaction costs, these occur where an agent seeks to economize on production costs (e.g. when a shoe manufacturer is unhappy for the price she has to pay for leather, and therefore decides to scan the market, spot a more competitive leather supplier, and negotiate a better

contract). Consequently, as long as economies in production costs are higher than the expense in transacting, the absolute value of the latter is irrelevant. Second, although transacting on an ad hoc basis certainly raises costs, transacting in an institutionalized environment is neither costless nor necessarily efficient either, since institutionalization gives partners a certain monopoly power. And finally, Keohane erroneously includes “costs of organization and side-payments”, which are production costs, and which occur under both decentralized and centralized mechanisms of governance, under the category of transaction costs. For example, to the extent that they form part of the final “price” paid in a transaction, side-payments occur even in transactions which are virtually frictionless. In fact, side-payments are, and have always been, routinely arranged in the EU, despite the highly centralized and institutionalized nature of these organizations. It follows that the real transaction costs of decentralized bargaining may actually be considerably lower than the productive efficiency of this mode of decision-making, and at any rate lower than speculated by Keohane.

For all these reasons, decentralized bargaining between member states of the Eurozone may not be as irrational as IO theory would have it. Merkel, Sarkozy, Juncker, and others may thus have chosen to create new ad hoc institutions because of some efficiency unaccounted for by the theory. Can this possibility be incorporated into a theory of European integration, or a theory of delegation to IOs? We take up this challenge in the final substantive section below.

## **6. An incomplete contracts theory of EU institutions**

This section presents the first steps towards a theory of European institutions which accommodates *both* supranational organizations such as the Commission and the ECB *and* inter-governmental institutions such as the Elysée treaty and Sarkozy, or mixed ones such as the Frankfurt Group. What we propose here does not intend to offer a substitute to IO theory, but to amend it in order to account for the new ad hoc institutions. Whereas IO theory answers relatively well why IOs are created, and correctly insists on the far-reaching implications of the fact that contracts between two or more states are never detailed enough to take into account all possible future contingencies, it does not offer much in terms of analyzing actual IO behaviour. To the extent that the new ad hoc institutions aimed precisely at correcting IO behaviour, the latter forms part of governments’ calculus, and should therefore be integrated into our theories of European integration and European institutions.

The theory proposed here can be summarized as follows. Two national governments seek to cooperate in a game with mixed motives, whereby (a) trading policies with each other produce certain gains, but (b) outperforming each other is an electorally valuable asset. Anticipating opportunistic behaviour from each other, these governments consider delegating powers to an international bureaucrat. Yet, contrary to the usual claim found in the literature, provided certain realistic conditions are met, this cannot possibly be an equilibrium institution, for the monopolistic power conferred on such a bureaucrat would allow her to discriminate between the two governments at the implementation stage. (This may be for different reasons, such as that discrimination reinforces the bureaucrat's bargaining position in subsequent legislative rounds, or that she can profitably trade clemency in one policy dimension for support on other policy dimensions.) The two national governments will anticipate the negative effects of such discrimination and will either revert to a Cournot-like equilibrium of lower levels of cooperation, or will (i) design an international organization with internal checks and balances; and (ii) coordinate to learn each other's type before the bureaucrat can discriminate.

Before giving more analytical explanations of the various steps of the theory, note preliminarily that the underlying assumptions are realistic and/or based on previous empirical findings. First, all players (i.e. the supranational bureaucrat, the national governments, and important opinion leaders within the two states) are rational, in the sense that they hold fixed and transitive preferences over all possible alternatives. Second, all players' utility functions incorporate the implementation measure of each national administration (see Franchino 2007: 31). As in Keohane's IO theory, member states "trade" policies. It follows that a member state  $X$  wants to sell its policy  $x$  to another member state  $Y$  at the highest price possible (i.e. it wants to see  $Y$  implementing as much  $x$  as possible, while itself being forced to implement as little  $y$  –  $Y$ 's policy – as possible). Third, the trade between member states occurs before implementation (i.e. European treaty amendments and other package deals occur before implementation, so that member states "pay" before their policy gets implemented). Fourth, even though national governments may or may not exhibit a positive ideological predisposition towards further European integration, this is always conditional on maximizing their probability of re-election. Further, that probability is best served when a government is seen as outperforming its peers. Fifth, a unitary international bureaucrat may exhibit a positive ideological predisposition towards further European integration, but, if there is a conflict between that goal and maximizing its powers and discretion, the latter prevails.

In this theory, the starting point is that, to attract delegated power, the supranational bureaucrat needs to commit to non-discriminatory implementation. Whereas internal checks and balances can be of some help, their absence (i.e. where the bureaucrat is a unitary actor) prevents her from credibly committing to uniform implementation. First, to take a generic and substantively meaningless example, suppose two national governments, *A* and *B*, are interested in trading competition and gender equality policies. *A* may want to trade competition policy with *B* because it fears business firms in *B*'s country may enter horizontal and vertical agreements which foreclose their market to *A*'s exporters. Similarly, *B* may want to trade gender equality policy with *A* because it wants to eliminate the possibility that businesses in *A*'s country may be more competitive due to their paying female workers less. (Another, possibly more substantively meaningful, example might be a transaction involving supranational supervision of national budgets and euro-bonds.) Hence, from the point of view of the two governments, there may be scope for political gains  $\pi$  from trade. Nevertheless, to the extent that neither government would implement the other's policy outside their trading relationship, they both make asset-specific investments (i.e. investments they would not have made were it not for their deal). Following Oliver Williamson's theory of transaction cost economics, this renders them vulnerable to hold-ups (Williamson 1996).<sup>7</sup> For example, *A* may suspect that, even if it grants women (costly) higher wages in its domestic economy, *B* will never implement *A*'s competition policy. Thus, one or both national governments anticipate opportunistic behaviour by the other. Following the mainstream logic of IO theory described in section 2 above, this leads them to delegate powers to a unitary international bureaucrat.

But the story cannot possibly end there. As the vast literature on principal-agent models of EU politics attests, the bureaucrat's incentives are not necessarily aligned with those of national governments. Suppose the redistributive effects of the two policies are well-known, and that there is agreement over the total value of the gains  $\pi$ . Given the terms of the trading agreement between *A* and *B*, the bureaucrat must then implement *A*'s competition policy both in *A*'s country *and in B's country*, and *B*'s gender equality policy both in *B*'s country *and in A's country*. If the bureaucrat promised to implement exactly *A*'s competition policy in both countries and exactly *B*'s gender equality policy in both countries (i.e. if she gave *A* and *B* exclusivity in the definition and implementation of their respective policies), then the two national governments would agree to

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<sup>7</sup> It is also conceivable that country *F* has an intrinsic motivation to implement the policy of country *D*. (See, for example, Meseguer 2009 on policy diffusion.) In that case, if *D* incentivizes *F* to implement *D*'s policy, *F* will interpret the extrinsic incentives as a signal either about the difficulty of the task, or about *F*'s true type. Hence, extrinsic incentives may crowd out intrinsic ones in a self-defeating manner. (See Bénabou and Tirole 2003) This logic may have far-reaching, but as yet under-studied consequences for policies of conditionality, including outside the EU.

delegate powers  $p$  to the supranational level, up to the point where  $p = \pi$ . However, once she has taken the first implementing decisions in competition policy in  $A$ , the bureaucrat has an incentive to renege on her promise to apply a “pure”  $A$ -like policy, and to engage in opportunistic behaviour. She can now offer  $B$  preferential treatment, probably in the form of a deal whereby, in exchange for more lenience in the application of competition policy in  $B$ 's country, she receives  $B$ 's support for more delegation of powers to the supranational level. If she promises  $B$  she will only make such a proposal once, and  $B$  believes that, the bureaucrat would obtain up to an additional  $\pi/2$  from  $B$ . By the same token, of course,  $A$  will have made a loss equal to  $\pi/2$ , since its business firms will not get access to  $B$ 's market. Once  $B$ 's support is cashed in, the bureaucrat could do the same with  $A$  over the implementation of gender equality wages.

Of course,  $A$  and  $B$  should anticipate all this, and if the bureaucrat were unable to commit to non-discriminatory implementation of policies, nobody would accept paying a specific price in exchange of highly uncertain benefits. Since national governments know that the bureaucrat has an incentive to renege on her promises, and that this will entail an electoral cost for them, the logical outcome is that there is no trade and no delegation to the supranational level. From a welfare point of view, this Cournot-like equilibrium may be good news for domestic democracy; however, it is bad news for all those who stood to gain from the transaction (including the prospective international bureaucrat herself). The only solution seems to consist in finding a way to make the bureaucrat's commitments to non-discrimination credible.

That is precisely what is achieved by designing the international bureaucrat *not* as a hierarchical unitary actor, but as a collegiate organization, such as the Commission or the ECB. Collegiality operates as an effective internal check against a bureaucrat who might be tempted to discriminate between member states. For, even though the treaties forbid commissioners from acting as representatives of their respective member states, any commissioner (or member of the ECB's board) whose country of origin might be knowingly discriminated against would obviously trigger the alarm bell. This, we believe, is a first preliminary result of the theory proposed here: we finally have an explanation for the curious, administratively inefficient but politically crucial, structure of the Commission and the ECB.

Unfortunately, however, collegiality is not a panacea – had it been one, there would be no reason for de Gaulle and Adenauer to negotiate and sign the Elysée treaty, or for Merkozy to seek to appoint a super-commissioner in charge of the Euro (see Karagiannis and Guidi 2013). In order to

be able to operate as an internal check and balance on potentially discriminating bureaucrats, members of the college must have (a) full information on each other's important business, (b) the possibility to set the agenda, and (c) the possibility to vote by majority rule. Yet, these are precisely the attributes of systems which do not yield rational, stable outcomes. According to Arrow's impossibility theorem, the preferences of the members of a voting body display a modicum of diversity, then majority voting need not generate a transitive ordering of the alternatives available for choice; rather, the alternatives cycle, even though individual preferences are coherent. Indeed, incoherence will often take the form of the non-existence of a collectively "best" alternative, and the final outcome will therefore be arbitrary (Hinich and Munger 1997: 95-99). It follows that neither the individual members of the voting body nor outside observers (in this case, national governments) can know the results before the occurrence of the vote. Thus, collegiality introduces an element of uncertainty which might have been too difficult for national governments to cope with, particularly in the context of the Eurozone crisis. That uncertainty, we submit, together with the risk of a "decision trap", is what Merkel, Sarkozy, Juncker, and other European leaders aimed at limiting by creating the new ad hoc institutions. By committing to work towards reaching common positions before supranational bureaucrats brought them before a *fait accompli*, they made clear that the modicum of diversity necessary for the operation of Arrow's theorem would not exist.

## 7. Conclusion

In this article we set out to offer a theoretical (as opposed to historical) explanation for the emergence of a host of new, ad hoc institutions which seemed to challenge the supranational nature of the European Union. That was a worthwhile exercise because, according to the currently dominant theory of international organizations, liberal institutionalism, existing centralized institutions should have been more efficient than the new ad hoc ones. It follows that either the latter are inefficient (and therefore their creators were rather unintelligent), or the theory is incomplete. Our goal was to investigate the latter possibility, not from a critical point of view, but from a constructive one.

Despite the highly theoretical and systemic orientation taken here, the analysis has clear implications for how we think about (a) European integration, (b) the new ad hoc institutions, and (c) French and German European policies in the Euro era. In particular, we were able to show that, independently of whether international regimes economize on transaction costs and make

commitments credible, their institutional design matters, and probably does so to an even greater extent than liberal institutionalist authors argue. In the specific case at hand, it is not sufficient to argue that the Eurozone and its supranational Commission and ECB may have solved problems of credible commitments the way that, say, the World Trade Organization ('WTO') does in trade policy. For, unlike the WTO, the Commission and the ECB carry with them the in-built uncertainty of organs whose decision-making rule is majority rule with no restrictions on amendments. It follows that, although such institutions eliminate some kinds of uncertainty, they also generate new ones.

In line with that social choice-theoretical reading of Eurozone institutions, we have argued that, if we want to understand exactly the *raison d'être* of the new ad hoc institutions, we first have to acknowledge that centralized supranational implementation can yield inefficient outcomes. Yet, this raises the question of why the EU centralized institutions (the Commission and the ECB) were designed that way. And, again, we have argued that this was a rational response to the very real problem of being discriminated against by international bureaucrats. Finally, an incomplete contracts theory of European integration solves the two puzzles simultaneously: the Commission and the ECB were created as potentially "chaotic" organizations (in the social choice-theoretic sense of the term) in order to limit bureaucratic discretion; and the costs that such a design created were then limited by the new ad hoc institutions.

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