STATES AND THE EXERCISE OF POWER IN THE NEW EUROPEAN UNION

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ABSTRACT

In this paper we adopt a game-theoretic approach to analyze legislative bargaining of small and large member states in the Council of the European Union (EU). Our model shows that small member states tend to support different types of legislative acts in the Council than large member states. All other things equal, small member states strive to adopt acts that have few ambiguities and describe extensively how the act is to be applied, whereas large member states advocate the adoption of acts in which certain matters have been left open-ended deliberately. By backing acts that leave few ambiguities, small members states intend to curb the scope for Council involvement as to application decisions, while large member states intend to enhance the discretionary power of the Council in the application phase. We show that several recent developments surrounding the Stability and Growth Pact can be understood in light of the model.

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1. Introduction

In this paper we analyze strategic behaviour of individual member states in the Council of the European Union (EU). We introduce a model that shows that small and large member states aim at advancing different types of legislative acts. All other things equal, small member states advance acts that are specific and detailed ('complete contracts'). By contrast, large member states seek to adopt acts that are more vague and open-ended ('incomplete contracts').

By adopting different types of legislative acts, member states ensure that the discretion in the application stage of the act lies with different EU institutions. By adopting acts that are specific and detailed, small member states reduce the scope for discretion in the application phase of EU legislative acts and effectively delegate execution of the acts to the Commission. In contrast, large member states prefer vague and open-ended arrangements to strengthen the discretionary role of the Council. Large member states have more power in the Council.

The model of this paper assumes that member states in the Council bargain over new EU legislative acts proposed by the Commission at two distinct points in time. *Ex ante* member states decide whether a legislative act will be adopted, and, if so, whether the act is formulated as a complete or an incomplete contract. A complete contract is comprehensive and specific and stipulates exactly how it is applied in all future contingencies. By contrast an incomplete contract leaves certain ambiguities so that application decisions become non-trivial. *Ex post*, that is, in the application phase of the act, member states in the Council enter a 'renegotiation stage' in case the act is formulated as an incomplete contract. The Council may also have to renegotiate the act in case it is formulated as a complete contract, however this happens only if the Commission proposes to replace it by a new act.

In our model an incomplete contract has the advantage that it implies flexibility, and thus that *ex post* renegotiation in the Council is swifter and less costly. Yet, there is also a downside to flexibility. *Ex post*, individual member states may attempt to block Council decisions that are beneficial for the EU as a whole. Both small and large member states display this type of opportunistic behaviour. However, the option to block decisions in the Council is more valuable to a large member state than a small one because the large member state has more voting power in the Council. The model hence shows that the difference in payoff between an incomplete contract and a complete contract is larger for a large member state than for a small member state. This is why in reality large member states will more often lean towards acts formulated as incomplete contracts, while small member states more often favour acts formulated as complete contracts.
Through a complete contract small member states buy insurance against ex post opportunistic behaviour of large member states.

Our model builds upon recent advances in contract theory, particularly the theory of *incomplete contracts* (e.g. Hart 1995 and Hart and Moore 1988). It is well-known that legislation can be seen as an incomplete contract (e.g. Doleys 2000, Persson 2002). The perspective that the degree of incompletion is a *choice variable* is new, but it is closely related to formal models that endogenize the degree of discretion an Agent has when being delegated a task by a Principal. For examples in the EU context, in which the Agent is the Commission, see e.g. Franchino (2000, 2005). Unlike Franchino we do not treat the EU member states as a single actor and show that large and small member states may have different preferences as to the choice of the degree of discretion of the Commission. Finally, Schure and Verdun (2006) explore questions that are closely related to the ones we study here, however in the context of a different and richer model. In their model the Council jointly decides (1) whether the act is a complete or incomplete contract, and, if the act is an incomplete contract, (2) whether or not to delegate the discretionary power to the Commission. It turns out that in this more general model, both small and large member states favour incomplete contracts, however they disagree about the delegation decision. Small member states wish and large member states wish not to delegate the discretionary power to the Commission. In this setting there may be also medium-sized member states and these support the adoption of complete contracts by the Council.

Our model predicts a general trend in the behaviour of member states in the EU assuming all other things equal. The legislative acts this paper applies to are only those acts that may require further future decisions (*‘application decisions’*) at the EU level. The EU legislative acts that satisfy these criteria are typically regulations and EU treaties (i.e. treaty articles and protocols). The model does not apply to the creation of directives, as discretion at the implementation stage with directives is dealt with at the national level. In addition our model only applies to acts where member states face considerable uncertainty regarding their national interest in the future.

In theory the implementation of a complete contract should be trivial in terms of execution. In practical terms, implementation decisions of *‘complete contracts’* in the EU are often – but not always – delegated to the Commission. Incomplete contracts often require additional Council decisions. In the EU, incompleteness of legislative acts in the sense of our model can take on the following forms: 1) provisions that expressly require the Commission to make proposals to the Council regarding application decisions; 2) *‘expiry dates’* on acts after which a
new Council decision is needed; 3) vague language so that the Commission has to refer the matter to the Council to obtain a mandate at the application stage.

Let us consider a specific example. On 25 November 2003 the Council of the European Union (EU) of Ministers of Economic and Financial Affairs (Ecofin) decided to suspend temporarily the Stability and Growth Pact (SGP) for the cases of France and Germany. These two countries were running high budgetary deficits, and the SGP (in particular the Excessive Deficit Procedure) stipulates that at some point in time sanctions be placed on these countries. The Netherlands, a small EU member state, urged the Commission to take the Council to the European Court of Justice (ECJ) and challenge that Council decision of 25 November 2003. The initiative of the Netherlands was remarkable because the Dutch government at the time knew it was itself going to violate the three per cent excessive deficit rule very shortly thereafter, and thus risked facing the penalties stipulated in the SGP itself. In our view, the Netherlands was attempting to curb the ability of the Council to bend the excessive deficit rule ex post. Indeed, the model of this paper explains the paradoxical behaviour of the Netherlands as fully rational.

The structure of the paper is as follows. In the next section we argue that the Treaty of Nice and ‘enlargement’ have made our model more relevant because these changes have increased the scope of qualified majority voting in the Council and also increased the contrast between individual large and small member states because of an increase in voting power of large member states vis-à-vis smaller member states. Sections three and four present the model and an example of it. Section five turns to a discussion of recent developments related to the Stability and Growth Pact and shows how they can be understood in light of the model. The final section concludes.

2. VOTING IN THE EU COUNCIL: BEYOND CONSENSUS

Decision-making in the European Union has undergone a number of changes since the Single European Act (SEA) introduced qualified majority voting (QMV) in the Council. The 1992 Treaty on European Union (the ‘Maastricht Treaty’) extended QMV into more areas of policy making. The fourth Enlargement of EU (with Austria, Finland and Sweden joining on 1 January 1995) was based on the Maastricht Treaty and only marginal changes were made (the new member states

Note that the Netherlands has had a tradition of ensuring the Commission’s role is not undermined by the Council or by large member states (see for example Maes and Verduin 2003).
were merely given their share of votes in the Council, Commissioners and seats in the European Parliament). However more fundamental institutional changes needed to be made before a next enlargement could take place in which a large number of Central and Eastern European Countries (CEECs) and smaller Mediterranean states could eventually join. The Intergovernmental Conference (IGC) that resulted in the Treaty of Amsterdam (1997) dealt with many of these issues, yet was unable to settle all of them. What became known as the ‘Amsterdam leftovers’ were dealt with in the fifth IGC that led to the Treaty of Nice.

As is well-documented (Wessels 2001; Laursen 2005; Maurer 2005) the 2001 Nice Treaty (which entered into force in February 2003) represented a compromise package that solved a few of these matters in a haphazard fashion, but pushed other matters to the future. These issues were subsequently the subject of discussion in the Convention which came up with a draft Treaty Establishing a Constitution for Europe in the summer of 2003. The European Convention aimed at creating a Constitution that was simplified and in which there would be fewer veto points and which would resort more frequently to simple majority voting (see Crum 2005). The Constitution was eventually approved in June 2004 after a few changes were made following the Summit in December 2003 that had failed to accept it.³ The two negative referenda put into question whether the Constitution will ever be adopted in its present form. Yet it is not unlikely that parts of it will be adopted gradually.

For the purpose of our paper let us look at how the weights of the votes in the Council have been distributed in the EU (see table 1). What is immediately clear is that the weighting of the votes of the larger member states has increased in recent years and was increased further in the Constitutional Treaty. For example, on average the weights of the votes per member state increased by a factor of $237/87 = 2.7$ with the Treaty of Nice. However the weights of the votes of the

³ Heads of State and Government were unable to find sufficient common ground between, in particular, Spain and Poland on the one hand, and Germany on the other, on the issue of voting in the Council. A few important changes were made. The 2003 text of the draft Constitutional Treaty recommended that a law could be adopted if a majority (50 per cent) of member states representing 80 per cent of the population would support it. The revised text, adopted in June 2004, stipulated that a law will be passed if 55 per cent of the number of member states representing 65 per cent of the population approves it. There are numerous other changes to the draft Constitutional Treaty which we will not list here. Suffice to say that the revised text postponed the starting date of the many of the institutional changes called for by the July 2003 draft Constitutional text (e.g. size of the Commission) and scrapped others (the rotating presidency of Council of Ministers will not be abandoned). Note that the treaty will only enter into force if ratified by all member states, which has been put into question by the negative referenda outcomes in spring 2005 in France and the Netherlands.
large countries increased by more: Germany, France, Italy and UK went to 29 from 10, an increase by a factor 2.9. According to the text of the Constitutional Treaty in June 2004 the voting weight of individual large member states in the Council would increase further since the size of their populations count as the main weight (for a proposal to pass would require a 55% per cent majority of the member states representing at least 65 percent of the population of the EU).

What does the academic literature on voting in the Council tell us about who wins and loses and what strategies are adopted? The literature on EU governance, decision-making and voting in the Council is enormous. There are qualitative policy analyses which discuss why a certain policy was adopted, but there are also many quantitative studies and formal models that study voting in the Council based on relative weight and voting coalitions. The first type of analysis often reflects on specific situations in a policy-making field (environment, telecommunications etc.), whereas the latter usually studies the process across larger range of policy areas. Our paper fits in this latter body of literature.

Whether changes in formal voting rules actually have (or will have) an effect on the legislative outcome is still a matter of debate. Nurmi and Hosli (2003) support our assumption that the re-weighting of votes among the member states will have as the effect that the 'culture of consensus' will be impractical in the enlarged EU (Nurmi and Hosli 2003: 37). Mattila and Lane (2001) also examine voting practices in the Council and offer explanations as to why there is more frequent unanimity voting then one might expect by merely looking at voting procedures. Part of the answer is vote-trading; another might be that the preference of Council members might be far from the status quo point (thus non-decision would be more costly than compromising). They do however suggest that the enlargement process might change the spirit of unanimity in the Council and that there would be increased voting in the Council (Mattila and Lane 2001: 49).

Hug (2003) examines how discussions in the Convention led to a reconceptualization of the governance structure of the European Union. Without a significant transfer of sovereignty to the European institutions, the governance structure will remain between that of an international organization and a federal state. Thus, power struggles between the Commission and the Council and between the member states and European institutions will continue. Our paper is complementary to these analyses in that it presents specific predictions in this new environment.

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4 Jon Golub (1999) explains what the 'culture of consensus' means in practical terms. He finds that actual voting the Council occurs much less frequently than one would expect based on the formal rules.
Table 1. Weighting of Votes in the Council Prior to and after the 2001 Nice Treaty (March 2005).

<table>
<thead>
<tr>
<th>Member Countries</th>
<th>Before Nice</th>
<th>After Nice (today)</th>
<th>Draft Constitution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>5</td>
<td>12</td>
<td>1*10</td>
</tr>
<tr>
<td>Denmark</td>
<td>3</td>
<td>7</td>
<td>1*5</td>
</tr>
<tr>
<td>Germany</td>
<td>10</td>
<td>29</td>
<td>1*82</td>
</tr>
<tr>
<td>Greece</td>
<td>5</td>
<td>12</td>
<td>1*10.5</td>
</tr>
<tr>
<td>Spain</td>
<td>8</td>
<td>27</td>
<td>1*40</td>
</tr>
<tr>
<td>France</td>
<td>10</td>
<td>29</td>
<td>1*58</td>
</tr>
<tr>
<td>Ireland</td>
<td>3</td>
<td>7</td>
<td>1*3.6</td>
</tr>
<tr>
<td>Italy</td>
<td>10</td>
<td>29</td>
<td>1*58</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>2</td>
<td>4</td>
<td>1*0.4</td>
</tr>
<tr>
<td>Netherlands</td>
<td>5</td>
<td>13</td>
<td>1*16</td>
</tr>
<tr>
<td>Austria</td>
<td>4</td>
<td>10</td>
<td>1*8</td>
</tr>
<tr>
<td>Portugal</td>
<td>5</td>
<td>12</td>
<td>1*10</td>
</tr>
<tr>
<td>Finland</td>
<td>3</td>
<td>7</td>
<td>1*5</td>
</tr>
<tr>
<td>Sweden</td>
<td>4</td>
<td>10</td>
<td>1*9</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>10</td>
<td>29</td>
<td>1*58</td>
</tr>
<tr>
<td><strong>Sub-total:</strong></td>
<td><strong>87</strong></td>
<td><strong>237</strong></td>
<td><strong>371</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Candidate Countries (as of March 2005)</th>
<th>Before Nice</th>
<th>After Nice (today)</th>
<th>Draft Constitution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>10</td>
<td></td>
<td>1*8.5</td>
</tr>
<tr>
<td>Cyprus</td>
<td>4</td>
<td></td>
<td>1*0.7</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>12</td>
<td></td>
<td>1*10</td>
</tr>
<tr>
<td>Estonia</td>
<td>4</td>
<td></td>
<td>1*1.5</td>
</tr>
<tr>
<td>Hungary</td>
<td>12</td>
<td></td>
<td>1*10</td>
</tr>
<tr>
<td>Latvia</td>
<td>4</td>
<td></td>
<td>1*2.6</td>
</tr>
<tr>
<td>Lithuania</td>
<td>7</td>
<td></td>
<td>1*3.7</td>
</tr>
<tr>
<td>Malta</td>
<td>3</td>
<td></td>
<td>1*0.4</td>
</tr>
<tr>
<td>Poland</td>
<td>27</td>
<td></td>
<td>1*38.5</td>
</tr>
<tr>
<td>Romania</td>
<td>14</td>
<td></td>
<td>1*23</td>
</tr>
<tr>
<td>Slovakia</td>
<td>7</td>
<td></td>
<td>1*5</td>
</tr>
<tr>
<td>Slovenia</td>
<td>4</td>
<td></td>
<td>1*2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>345</strong></td>
<td><strong>232</strong></td>
<td><strong>478</strong></td>
</tr>
<tr>
<td><strong>Qualified Majority</strong></td>
<td><strong>62</strong></td>
<td><strong>232</strong></td>
<td>Simple Majority of MS + 3/5 population</td>
</tr>
</tbody>
</table>

Source: Treaty texts (adapted by authors).

Focusing on the actual decision-making in the EU that took place over the past years, Stokman and Thomson (2004) argue that procedural models suggest
that the formal procedure of the decision-making process which is to be followed (e.g. co-decision, assent, etc.) is crucial to understanding the outcome. In contrast, informal bargaining models, such as the compromise model (in which actors try to find a cooperative solution that takes into account the interests of all actors) or the position exchange model (in which pairs of actors take advantage of situations in which both gain by supporting each other’s position on the issue that is relatively more important to the other) treat the procedure largely as a black box. Overall, they find that bargaining models, and in particular the compromise model, do much better than procedural models in generating accurate forecasts (Stokman and Thomson 2004: 19. see also Arregui, Stokman and Thomson 2004). They argue that positions of actors shift in EU decision-making, but that these shifts occur during the bargaining process in reaction to exchange and/or so as to enable a compromise (Stokman and Thomson 2004: 69).

Bailer’s study of bargaining in the Council looks at the influence of endogenous and exogenous sources of influence (Bailer 2004). ‘Endogenous power resources’ include the extremity of the position a member states picks on a policy matter, and closeness to the agenda setting process of the Commission. ‘Exogenous power resources’ are, for instance, voting weight and economic strength. Bailer finds that endogenous resources are important to predicting bargaining outcomes, and that exogenous resources are only helpful predictors in certain policy areas. In our model we assume implicitly that member states have identical endogenous resources.

3. THE MODEL

Our model is a stylized game-theoretic model of EU decision-making that stresses the role of the Commission and the Council in deciding on new EU legislative acts.\(^5\) We distinguish two points in time at which the Commission and the Council take decisions regarding a legislative act. Ex ante the Council decides on a new act proposed by the Commission. The ex post decision regards whether and how exactly the act will be applied. Throughout the model we assume that the Commission is ‘benevolent’ and only makes proposals that are considered ‘good’

\(^5\) Our argument for only including the Commission and the Council is not that the role of other institutions, such as the European Parliament, is marginal. Rather, we argue that the intuition to our theory is best understood in a simple framework and does not change when modelling EU decision making in a more realistic way.
for the EU as a whole. In reality, of course, power struggles between member states and other matters such as personalities are important for Commission decisions. However, we view as realistic the assumption that Commissioners will protect the interest of the EU (rather than of a particular member state).

We initially do not explicitly model the voting game governing Council decisions, but assume that the voting outcome of the Council is probabilistic. Moreover, in line with the literature on voting power in the Council, we assume that the probability is higher that a large member state is in a winning coalition or a blocking minority than a small member state. In the next section we back up these assumptions by providing an example in which we explicitly model the ex post Council voting game. In the example we assume that member states' attitudes to a given proposal are probabilistic and that the voting game is non-cooperative.

A central assumption of our model is the aspect of intrinsic uncertainty regarding the 'benefits of the legislative act'. This assumption captures the fact that the member state attitudes towards the act may change between the ex ante and ex post decision moments. In the case of the Stability and Growth Pact (SGP) (i.e. EC 97/C 236/01) this happened, for instance, in Germany. Germany strongly supported the SGP at its inception, but actively opposed its enforcement in the fall of 2003. More generally, any legislative act that is considered beneficial ex ante may turn out harmful ex post, both for individual member states and the EU as whole. Changes in the economic outlook in the EU may be one of the factors that can trigger a change in position. We model uncertainty by a choice of a player called Nature. A draw of Nature may determine that a legislative act that was accepted ex ante by the Council may be contended ex post by one or more member states or the Commission.

Our framework builds upon recent advances in contract theory, particularly the theory of incomplete contracts (e.g. Hart 1995 and Hart and Moore 1988). New EU legislative acts may take the shape of either a complete contract (i.e. a contract that is comprehensive and specific when it comes to the future moments when the particular legislative act is applicable) or an incomplete contract (i.e. a contract that is vaguer when it is actually applied). We will illustrate in section 5 that the Stability and Growth Pact is an example of such an incomplete contract.

In reality, contractual incompleteness is a matter of degree and difficult to pin down. To make the concepts of complete and incomplete contracts concrete and

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6 For simplicity we assume that preferences of member states and the Commission are binary and are either 'good' or 'bad'. In reality preferences are obviously not on a binary scale. In fact, Stokman and Thomsson (2004) show that relative importance of member states' positions may provide additional information as to coalition formation.
testable, we will slightly abuse these terms and translate them as follows. We
assume that in case the legislative act is formulated as a complete contract the
Commission has the authority to take care of its application ex post (i.e., the
Council need not be involved). This assumption is natural if the act were a true
complete contract, because complete contracts do not contain any ambiguities, so
that applying the act is merely a matter of execution, i.e. the task of the
Commission. We assume that if the legislative act is formulated as an incomplete
contract the Council has to be involved when it comes to application decisions.
This will indeed be the case if the act is sufficiently vague, but also in case a role
for the Council is explicitly stipulated, or if the act expires before an application
decision is to be taken (the contract is short-term).

Above we have assumed on the one hand that complete contracts are specific
as to their application, while on the other hand the attitudes towards an act may
change between the ex ante and ex post decision moments. If, in our model, the
Commission wished to not apply an act that was written up as a complete contract
it may submit an amendment to that act to the Council. In contract theory such a
situation is called renegotiation. In case the act is written up as an incomplete
contract a second bargaining stage (which we shall also term ‘renegotiation
stage’) always takes place.

The details of the model are given in Figure 1 below. Ex ante the Commission
proposes an act to the Council. The Council can reject the act, accept the changes
as an incomplete contract, or accept the act as a complete contract. If the act
passes, Nature next makes its draw regarding the ex post attitudes of the
Commission and the member states towards the act. In Figure 1 we only make the
preferences of member state $i$ (MS$_i$) and the Commission explicit, which leaves
us with four options. The act can be (in spirit) (1) good for both the EU and MS$_i$,
(2) good for the EU, but bad for MS$_i$, (3) bad for the EU, but good for MS$_i$, (4)
and bad for both the EU and MS$_i$. In case the act is formulated as an incomplete
contract the Council next has to decide whether to act in accordance with the spirit
of the act, or ‘bend the rules’. In case (1) above, neither the Commission nor MS$_i$
would like the rules to be bent, but they may be outvoted by other member states
in the Council. Assume, therefore, that in case (1) the rules are bent with
probability $P_i$. Let us denote the probabilities that the rules are bent in cases (2),
(3), and (4) by $P_i$, $\overline{P}_i$, and $\overline{P}_i$, respectively. We make the natural assumption

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7 Recall the assumption made above that the rules can be bent so much that it is never necessary to
renegotiate and amend the legislative act written up as an incomplete contract.
that the more support there is for bending the rules, the larger is the probability that the Council will indeed decide to bend the rules:

\[
P_i < P_j < \overline{P}_i < \overline{P}_j
\]  

(1)

We also assume that large member states have more leverage in the Council. In particular, we assume

\[
P_i < P_j \quad \text{for all } i \in L \text{ and } j \in S
\]

(2)

\[
\overline{P}_i < \overline{P}_j \quad \overline{P}_i > \overline{P}_j \quad \text{for all } i \in L \text{ and } j \in S
\]

(3)

Here \(L\) and \(S\) represent the sets of large and small member states, respectively.

In case the act is formulated as a complete contract the ex post bargaining game is different because the Commission has the authority to execute the act as it was crafted ex ante. Thus, in case the act turns out (1) good for both the EU and MS\(_i\) or (2) good for the EU, but bad for MS\(_i\) the Commission will not propose an amendment and apply the act as is. Only in the cases that the act turns out (3) bad for the EU, but good for MS\(_i\), or (4) bad for both the EU and MS\(_i\) will the Commission propose an amendment to the Council. Figure 1 makes clear that we assume in these cases that the Council changes the act with exactly the same probabilities as it bends the rule in case of the incomplete contract.

Finally, we need assumptions regarding the payoff of the decision for MS\(_i\) to make a meaningful comparison between the two types of contracts. Assume that the benefits to MS\(_i\) are \(B_i\) in case the decision falls in line with the preferences of MS\(_i\), and that MS\(_i\) suffers a cost of \(C_i = 0\) if the decision goes against the will of MS\(_i\). \(B_i\) and \(C_i\) are pecuniary measures for the benefit and costs to MS\(_i\) of the possible decision outcomes. The assumption that \(C_i = 0\) is merely a normalization. We also allow there to be costs attached to ex post bargaining. We again normalize the costs of renegotiating an incomplete contract to zero since it does not involve a reformulation of the legislative act. Renegotiation of a complete contract is more involved (and may actually lead to reputation loss for the EU), hence, we assume that replacing a complete contract by a new one costs
$C_i^R = \alpha B_i$ for all member states $i$. The assumption that the renegotiation costs of a complete contract is proportional to its benefits is convenient, but also realistic, as both are in practice related to a common factor, for instance the Gross Domestic Product (GDP) of the member state.

![Diagram of EU decision making](image)

Figure 1. Stylized model of EU decision making after Nice.

Let us next analyze the model. Absent actual information of the power structure in the Council we cannot derive the actual ex ante Council decision. However, we can derive what are the preferences of each member state regarding the act ex ante. Proposition 1 below shows that large member states obtain higher expected payoffs from the adoption of legislative acts than small member states. This result holds simply because large member states have more leverage in the Council (equations (2) and (3)) when it comes to application decisions. Thus, the result applies both for acts that are complete contracts and acts that are incomplete contracts.
Proposition 1. Large member states obtain greater benefits from the adoption of legislative acts than small member states.

Proof. The proof uses equations (2) and (3). First, consider the adoption of an incomplete contract. The expected payoff of an incomplete contact for a member state \( i \) is given by:

\[
\sum_{i}^{IC} = \left[ \pi_1 (1 - \overline{P}_i) + \pi_2 \overline{P}_i + \pi_3 (1 - \overline{P}_i) + \pi_4 \overline{P}_i \right] B_i
\]

It is easy to verify from equations 2 and 3 that \( \sum_{L}^{IC} > \sum_{S}^{IC} \). The payoff of a complete contract is given by:

\[
\sum_{i}^{CC} = \left[ \pi_1 + \pi_3 (1 - \overline{P}_i - \alpha) + \pi_4 (\overline{P}_i - \alpha) \right] B_i
\]

It is again easy to verify that \( \sum_{L}^{CC} > \sum_{S}^{CC} \). Q.E.D.

Proposition 2 below is the main result of our paper. It implies that if some, but not all, member states support adopting an act as an incomplete contract these must be the large member states. Also, if some, but not all, member states support adopting an act as a complete contract these must be the small member states.

Proposition 2. The difference in the payoff between an incomplete contract and a complete contract is larger for large member states than for small member states.

Proof. The proof is again trivial and it hinges only on equation (2). A member state \( i \) favours adopting the act as incomplete contract if

\[
\sum_{i}^{IC} = \left[ \pi_1 (1 - \overline{P}_i) + \pi_2 \overline{P}_i + \pi_3 (1 - \overline{P}_i) + \pi_4 \overline{P}_i \right] B_i > \\
\sum_{i}^{CC} = \left[ \pi_1 + \pi_3 (1 - \overline{P}_i - \alpha) + \pi_4 (\overline{P}_i - \alpha) \right] B_i \Rightarrow \\\n- \pi_1 \overline{P}_i + \pi_2 \overline{P}_i + (\pi_3 + \pi_4) \alpha > 0
\]

Equation (2) shows that the left-hand side of the inequality in equation (4) is larger for large member states than for small member states. Q.E.D.
Equation (4) in the proof to Proposition 2 summarizes the considerations of a member state MS$_i$ in the *ex ante* negotiation stage. A disadvantage to MS$_i$ of formulating the act as an incomplete contract is that it is renegotiable in case both MS$_i$ and the Commission are satisfied with it *ex post*. An advantage to MS$_i$ is that the act is potentially renegotiated in case MS$_i$ is not satisfied, while the Commission is. In case the act turns out bad according to the Commission, the Council will have to renegotiate independently of whether the act was formulated as a complete contract or an incomplete contract. However, in this case the incomplete contract would be better since renegotiation is cheaper.

4. **AN EXAMPLE WITH NON-COOPERATIVE VOTING**

To make our model more concrete let us make the *ex post* voting game explicit in a stylized example. Assume there are ten small member states, each with a single vote, and one large member state with two votes. The example could easily be altered to describe different compositions of member states and voting weights, however the message would stay the same (see e.g. Schure and Verdun 2006).

After the act has been accepted *ex ante* Nature picks the *ex post* preferences regarding the act. We assume that member state preferences are picked from independent Bernoulli trials; for each member state $i$ the act turns out ‘good’ with probability $P_{\sigma}$ and ‘bad’ with probability $1 - P_{\sigma}$. Thus, should it come to an application decision in the Council *ex post*, a member state casts a vote in support of applying the act with probability $P_{\sigma}$ and supports renegotiation with probability $1 - P_{\sigma}$. The probability $P_{\sigma}$ may depend on whether the act is good for the EU as a whole, i.e. $\sigma = G$, or bad, $\sigma = B$. If so, it is natural to assume that $p_G \geq p_B$. Assume that Council decisions are adopted by a qualified majority vote. Specifically, since there are twelve votes the act is applied without modification *ex post* if it attracts $12^*q$ or more votes, where $q$ is the qualified majority threshold.

We can derive the probabilities $P_L$, $P_L$, $\bar{P}_L$, $P_i$, $\bar{P}_i$, as follows. If $i$ is the large country we get $P_L = 1 - \Pr\{X \geq 12^*q - 2\}$, where $X$ follows a binomial
distribution with \( n=10 \) draws and a probability of success of \( p_G \). For a small country we obtain \( P_S = 1 - \Pr\{Y + Z \geq 12^* q - 1\} \), where \( Y \) follows a binomial distribution with \( n=9 \) and a probability of success of \( p_G \), and \( Z \) becomes 2 with probability \( p_G \) and 0 otherwise. We can also show that \( P_L = 1 - \Pr\{X \geq 12^* q\} \) and \( P_S = 1 - \Pr\{Y + Z \geq 12^* q\} \). The other probabilities can be computed in a similar fashion.

In general we have \( P_L \leq P_S \) and \( P_L \geq P_S \), i.e., large member states have more leverage in the Council. In practice the probabilities \( P_L \) and \( P_S \), and also \( P_L \) and \( P_S \) can lie quite far apart. For instance, in case \( p_G = 3/4 \) and \( q=2/3 \) we obtain \( P_L \approx 0.08 \), \( P_S \approx 0.14 \), \( P_L \approx 0.47 \) and \( P_S \approx 0.30 \). Thus, in case a large member state supports applying the act without any changes \textit{ex post} it will be in a winning coalition with about 92 per cent chance. A small country supporting the act will only win with about 86 per cent probability. Moreover, in case a large member state would like to see the act changed \textit{ex post} it will successfully block its application in about 47 per cent of all Council votes, compared to about 30 per cent for a small member state.

Proposition 2 shows that large member states are more prone to propose to adopt the act as an incomplete contract than small member states \textit{ex ante}. Let us extend the example above to show this numerically. Assume the act turns out to be good for the EU with probability 4/5. Recall that if the act is good for the EU as a whole, then individual member states support it \textit{ex post} with probability \( p_G = 3/4 \). Assume that member states only support the act with probability \( p_B = 2/5 \) in case the act is bad for the EU as a whole. In this example the large member state backs the incomplete contract because:

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\(^8\) Recall that individual member states vote in support of applying the act from a series of ten independent Bernoulli trials with a probability of 'success' of \( p_G \). The total number of supporting votes of the ten small member states hence follows the binomial distribution above. The large member state supports the act so that it will cast its two votes in favour. The act is thus applied as it was crafted in advance in case \( X + 2 \geq 12^* q \), i.e., with probability \( \Pr\{X \geq 12^* q - 2\} \). The rules are bent with probability \( 1 - \Pr\{X \geq 12^* q - 2\} \).
\[-\pi_1 P_1 + \pi_2 P_2 + (\pi_3 + \pi_4) \alpha = \frac{4}{5} \cdot \frac{3}{4} \cdot 0.08 + \frac{4}{5} \cdot \frac{1}{4} \cdot 0.47 + \frac{1}{5} \approx 0.048 + \frac{1}{5} \alpha > 0\]

By contrast, a small member state prefers the complete contract provided that the renegotiation costs are small enough:

\[-\pi_1 P_3 + \pi_2 P_2 + (\pi_3 + \pi_4) \alpha = \frac{4}{5} \cdot \frac{3}{4} \cdot 0.14 + \frac{4}{5} \cdot \frac{1}{4} \cdot 0.30 + \frac{1}{5} \alpha \approx -0.022 + \frac{1}{5} \alpha\]

It turns out that for \( \alpha \leq 0.11 \) the equation above is smaller than zero, that is, a small member state prefers the complete contract if the renegotiation costs are eleven per cent or less of the potential benefits \( B_i \) of the act.

5. The Case of the Stability and Growth Pact

The Stability and Growth Pact (SGP) was finalized in June 1997 to support sound fiscal policies in member states once Economic and Monetary Union (EMU) entered into the third stage (the introduction of the euro in financial markets on 1 January 1999 and the circulation of euro banknotes and coins in the eurozone as of 1 January 2001). EMU contains a new supranational institution responsible for monetary policy, but leaves budgetary and fiscal policies in the hands of national member states. The SGP consists of two Council Regulations and a Council Resolution.\(^9\) It strengthens, speeds up, and makes more explicit the so-called excessive deficit procedure (EDP) that is stipulated in Article 104 (Treaty establishing the European Community, TEC).\(^10\) That article contains different steps that should ensure that budgetary deficits stay below three per cent of Gross Domestic Product (GDP). The Commission’s first step may be to issue a so-called ‘early warning’ if a member state is likely to exceed the three per cent ceiling.\(^11\) After many steps, the EDP could lead to a fine of a member state that

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\(^10\) On the origins of the Stability and Growth Pact and why it was deemed to be needed see Heipertz and Verdun (2004).

\(^11\) Formally the Commission proposes a recommendation to the Council to address an early warning.
over a period of two years has still failed to correct the excessive deficit. Such fines are between 0.2 and 0.5 per cent of the member state’s GDP, depending on the severity of the excessive deficit. The Council plays a key role in the enforcement of the SGP as it votes in each of the steps on a Commission proposals.

The SGP is an example of an incomplete contract as it is vague as to specifics in the application stage. To give an example, the wording of Article 104 paragraph 9 TEC reads:

‘If a member state _persists in failing_ to put into practice the recommendations of the Council, the Council _may decide to give notice_ to the member state to take, within a specified time-limit, measures for the deficit reduction which is _judged necessary_ by the Council in order to remedy the situation.’ (Art 104 (9) TEC, emphasis added).

It is not exactly clear what the exact meaning is of, for example, ‘may decide to give notice’. It thus took additional Council decisions to clarify how the treaty articles, the two regulations and the Council Resolution were to be applied. The regulation Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure stipulates in Article 5 when this should happen:

‘Any Council decision to give notice to the participating member state concerned to take measures for the deficit reduction in accordance with Article 104c (9) shall be taken within one month of the Council decision establishing that no effective action has been taken in accordance with Article 104c (8)’.

The wording of the SGP was even so vague that opinions differed on its content. In first instance the SGP was seen by most as a system to enforce discipline by a symbolic, ‘blaming and shaming’ effect (see e.g. Heipertz and Verdun 2004). But by 2001 it became clear that the Commission was serious about the SGP and that it could actually have pecuniary effects.

The SGP is also an example of EU legislation that large member state did attempt to renegotiate and small member states did not. The first two countries to receive an early warning under the EDP were Germany and Portugal. Portugal, a small member state, responded strongly to the early warning and managed to reduce its deficit before entering the serious steps of the EDP procedure (Article 104 (9) TEC). In May 2004, the procedure was closed for Portugal. Germany, a large member state, reacted furiously to its early warning, but did not make the
necessary steps to reduce its deficit. The Commission nevertheless withdrew its early warning shortly thereafter. In January and June 2003 Germany and France and respectively entered the next steps of the EDP when the Commission proposed a recommendation on the basis of the Treaty Article 104 paragraph 7.\textsuperscript{12} Rather than taking active steps to reduce their deficits France and Germany spent the month of October convincing other member states that the EDP would need to be suspended for these two countries. This indeed happened at the Ecofin Council meeting of 25 November 2003 (2546\textsuperscript{th} Council Meeting Economic and Financial Affairs, Brussels 14492/03, Presse 320). A proposal of the Commission to take France and Germany to the next steps of the EDP was rejected and instead the Council adopted a decision to hold the SGP 'in abeyance' (temporarily abandon the SGP) for these two countries.\textsuperscript{13}

The November 2003 Ecofin Council decision boiled down to a case of contract renegotiation. It had not been anticipated by the founding fathers of the SGP that the Council could decide to suspend the excessive deficit procedure set out in Article 104 TEC and further elaborated on in the SGP. Indeed, even the Commission put in the minutes that it regretted the decision by the Council and reserved the right to investigate subsequent actions.

After the November 2003 Ecofin Council meeting the Dutch government openly voiced the possibility of taking the governments of France and Germany to Court. In the end it was the Commission that challenged the controversial November 2003 Council decision in a case brought before the European Court of Justice (ECJ). The Dutch insistence to stick to the rules was striking, as it was clear that the Netherlands were going to breach the three per cent deficit rule and enter the EDP themselves.\textsuperscript{14}

Our model explains the paradoxical move of the Dutch government. The Netherlands realized that, as a small member state, it has little leverage in the Council to bend the rules. Rather then attempting to renegotiate the EDP, it realized the importance of hardening the rules, i.e. making the contract more complete.

A hearing was held on 28 April 2004 in which the Commission questioned the legality of the Council decision. The Council pleaded that it had the right not to take over the Commission proposal (see the language in Article 104(9) cited

\textsuperscript{12} The Council adopted the recommendation on 25 November 2003 for both France and Germany.

\textsuperscript{13} To be precise, a proposal for a Council recommendation based on Article 104 (7) was accepted (see above), but two proposals for Council recommendations based on Art 104 (8) and 104 (9) of the Treaty on European Union were not adopted. There were no provisions in the SGP that allowed the Council to hold the SGP in abeyance in these particular circumstances.

\textsuperscript{14} In December 2003 the Dutch statistical office ('Statistics Netherlands', or the 'Centraal Bureau voor de Statistiek') forecast a deficit above the three per cent ceiling.
above ‘... the Council may decide to give notice ...’). Nevertheless, although the ECJ agreed with the Council that it had the right to decide whether or not to adopt the Commission proposal, the ECJ ruled on 13 July 2004 that the Council decision had been illegal, as it did not have the right to rule that the EDP could be held in abeyance in the cases of Germany and France since this decision did not follow a proposal of the Commission.

6. Conclusion

This paper has analyzed the extent to which changes in EU governance affect strategic behaviour of individual member states in the Council. We have introduced a model that shows how the changes affect small and large member states. Our model shows that small member states will tend to back proposals for legislative acts that have few ambiguities and ones that describe extensively how the act is to be applied in the future (complete contracts). By contrast, large member states will favour proposals that contain ambiguous statements and will leave discretion to the Council for the aftermath (incomplete contracts).

We have also argued (Section 2) that we believe that the contrast between large and small member states has widened in recent years and thus will more often play a role in the present and the future than in the past. We offered two reasons for this change, namely, first, that the Treaty of Nice and ‘enlargement’ mean a further increase in the scope for qualified majority voting in the Council and, secondly, the increase in the relative voting power of individual large member states.

The paper has discussed the Stability and Growth Pact (SGP) as an example of our model. We have focused on how small and large member states have dealt with the aftermath of the SGP. Small member states in violation of the Excessive Deficit Procedure (EDP) (Portugal and the Netherlands) have accepted their fate and were willing to fight for the integrity of SGP. Large member states, for example, France and Germany, challenged the act so that it be applied less stringently to them than originally agreed to.

Our theoretical model assumes all other things equal. Thus we would only expect to find the model’s predictions to hold over the long run and when considering large numbers of cases of legislative acts that are binding on member states and that cover a broad variety of policy-making areas. In smaller samples many other factors might disturb the findings.
REFERENCES


Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, *Official Journal L 209*, 02/08/1997 pp. 6-11


