Intrinsic vs. Extrinsic Incentives for Reform: An Informational Mechanism of EU Conditionality

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Paper prepared for PEIO 2013, Mannheim

Abstract

How does the prospect of EU accession affect candidate members' incentives to implement political and economic reforms? On the flip side of the question, how does the threat of expulsion from a union affect a member-state government's political will for compliance with existing policy standards and criteria? To answer these questions, we propose an informational mechanism of EU conditionality drawing on Bénabou and Tirole's (2003) formalization of intrinsic and extrinsic motivation. In a Bayesian game of enlargement between a principal (EU Commission) and an agent (candidate member government), we find that the extrinsic bonus of post-accession transfers may, on one hand, reinforce short-term incentives to satisfy membership criteria, yet, at the same time, it will increase moral hazard by 'crowding out' the agent's intrinsic motivation to liberalize in the long-term. As a result, we expect that i) net-recipient countries' post-accession pace of reform will decline over time, ii) the 'crowding out' effect will be stronger for countries that enjoy higher levels of net transfers, and iii) 'early liberalizers' are ex ante more likely

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to accept the conditionality package and implement the necessary reforms for accession..
We corroborate our predictions with anecdotal evidence and case studies from the EU's
Eastern enlargement and the Eurozone's debt crisis.

1   Introduction

Why do apparently similar countries respond so differently to identical external incentives schemes? Why, for example, does the Czech Republic so often fail to transpose and implement EU directives while Lithuania systematically ranks among the 'top students'? To take a more topical example, why has Greece been so loath to embrace the structural reforms package negotiated with its international lenders, while Spain is diligently cutting back its public sector deficit, limiting regions' spending, freezing public sector appointments, reforming its labor market, redesigning its market regulators, and revising the financing of public health services? Beyond Europe, why do some sub-Saharan African and Latin American countries make long-run commitments to Structural Adjustment Programmes of the IMF, while others abandon reforms a mere few months after entering such programs? Why, for example, was the 1990s increase in structural conditionality attached to IMF programs accompanied by historically low rates of compliance, while previous increases were not?

Although European and international conditionality policies have been investigated to considerable extent and with unambiguous success, we still do not have adequate answers to certain questions pertaining to the different responses of otherwise similar targets. Accordingly, this paper investigates the potentially negative effects of conditionality policies on the *intrinsic* motivation of target countries to pursue reforms. To do so, it builds on cutting-edge insights from economics (Bayesian games and behavioral game theory) and political science (principal-agent models in international relations and European Union politics).

The core idea of the paper is that, contrary to a common assumption in the literature,

the political-economic world does not always replicate the upward-sloping supply curves of neoclassical economic theory. Whereas a shoemaker with no *intrinsic* motivation to keep producing additional pairs of shoes may be convinced to do so if offered a higher price (thereby confirming the assumption of an upward-sloping supply curve), a country which recognizes the necessity of reforms may not always respond to *extrinsic* incentives in such a linear way. In the long run, *extrinsic* incentives will 'crowd out' its *intrinsic* motivation for reform, thereby producing a counter-productive effect.

Since the 1950s, numerous organizations, including the government of the United States, the International Monetary Fund (IMF), and the European Union (EU), have operated conditionality policies to gain positive leverage on political and economic reforms. The logic informing such policies is simple: if target countries want to gain certain benefits (usually cash, policy concessions, or membership to an organization), these could and should be exchanged for political and/or economic structural reforms (usually, democratization, human rights, free trade, or fair antitrust enforcement). In such an exchange the donor acts as 'principal' while the government of the target country is the 'agent'. Following a central theme in neoclassical economics, such policies uniformly assume that incentives (i.e. the combination of 'carrots' and 'sticks') offered by the principal promote effort and performance on behalf of the agent. What principals still struggle to come to grips with, however, is the variation in agents' responses.

The academic literature is only of limited help here. On the one hand, a burgeoning literature in economics, law, and political science does analyze principal-agent incentive schemes with an international dimension (e.g. Pollack 2003, Steunenberg 2010, Stone 2008). Building upon it, a number of sophisticated works on EU enlargements arrive at clear and falsifiable predictions. The main prediction is neoclassical in spirit if not in its derivation: candidate countries' effort to achieve convergence with the *acquis communautaire* is a function of the

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power of the incentives facing these countries (Böhmelt and Freyburg 2013, Falkner and Treib 2008, Schimmelfennig and Sedelmeier 2005, Sedelmeier 2008, Steunenberg and Dimitrova 2007, Vachudova 2005). Interestingly, however, one part of the literature on EU accession conditionality finds that accession did not actually affect the compliance rate of Central and Eastern European countries. Hence, the power of incentives may not be as consequential as theoretically predicted (Falkner and Treib 2008, Sedelmeier 2008).

On the other hand, there is still no answer to the question of why similar incentive schemes applied to similar target countries produce widely diverging results. Differential responses constitute an empirical fact highlighted both in the literature on IMF conditionality (Burnside and Dollar 2000, Mosley et al. 2004) and in the literature on EU compliance (Börzel et al. 2010.) For example, the finding that new member states' compliance rates remain high even after the power of *extrinsic* incentives weakens is usually explained away by reference to arguments based on altogether different ontological and theoretical perspectives. This paper seeks to address this puzzle by documenting and explaining differential rates of compliance with conditionality programmes while steadily remaining within the same rationalistic theoretical perspective. To do so, it takes an altogether novel step, which consists of analyzing the effect of conditionality policies on target countries' *intrinsic* motivation to reform.

2   A Model of Intrinsic and Extrinsic Incentives for Reform

The goal of this paper is to explain differential target-country response to similar conditionality policies by reference to the potentially negative effect of *extrinsic* incentives on *intrinsic* motivation. Why does the prospect of accession to an international organization, or of receiving an aid package, affect different candidate countries' incentives to implement political and economic reforms in different ways? On the flip side of the question, why does the threat of expulsion from an international organization, or of cancellation of an aid programme, affect

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different governments' political will for compliance in different ways?

Until recently, these questions could not be investigated theoretically; a researcher's best chance stood in a-theoretical empiricism. As mentioned above, the neo-classical economic assumption of upward-sloping supply curves was taken to reflect an immutable characterisitc of human nature. Yet, this assumption clashes with important findings in cognitive psychology, according to which incentives do not necessarily promote effort and performance, and may even turn out to be 'negative reinforcers' in the long run (Deci et al. 1999). Finally, at the frontier of research on the effect of incentives on human performance, Bénabou and Tirole (2003) formalize the concepts of *intrinsic* and *extrinsic* motivation, tease out the mechanisms which reinforce one or the other in the context of strategic signaling games, and define conditions under which *extrinsic* incentives harm performance.

To introduce the possibility of counter-productive incentives, we investigate the relationship between a designer organization (the principal) and a target country (the agent), focusing on the effect of conditionality on the target country's *intrinsic* motivation for reform. More specifically, the research proposes an informational mechanism of conditionality, whereby the agent receives and interprets an informative signal by the principal in the form of *extrinsic* incentives. In a Bayesian game between the principal and the agent, it is expected to be found that the *extrinsic* bonus of post-agreement transfers may, on one hand, reinforce short-term incentives to satisfy the criteria set by the principal, yet, at the same time, increase *moral hazard* by 'crowding out' the agent's *intrinsic* motivation to reform in the long run. As a result, it is expected that (a) target countries' post-agreement pace of reform will decline over time, (b) the 'crowding out' effect will be stronger for countries that enjoy higher levels of transfers, and (c) 'early liberalizers' are *ex ante* more likely to accept the conditionality package and implement the necessary reforms for accession.

We adopt a principal-agent contractual framework in order to derive incentives for reform

in the face of accession (and/or expulsion) from a regional/ international organization. The government of country i (agent) interacts with a supranational authority c (principal) representing the member states of that organization. For the sake of analytical parsimony, we assume that the agent has to choose an optimal level of liberalization l_{it} at time t along a single dimension; therefore, economic (political) reforms consist of a single unidimensional change in the level of economic (political) liberalization, i.e., $r_i = \Delta l_i$.[1] In the context of the European Union as a regulatory state (Majone 1996), l_{it} may also be construed as the level of quality of the national regulatory framework.

We now proceed to examine how this contractual relationship between the supranational authority c (principal), e.g., the European Commission in the case of the EU, and the incumbent government of an aspiring members-state i affects the latter's political will for reform. We apply Bénabou and Tirole's (2003) game-theoretic framework to highlight the informational content of the contract proffered by the principal to the agent. We argue that this informational mechanism encompasses both pre-accession conditionality and post-accession compliance as part of a single repeated and strategically intertwined principal-agent relationship.

The principal c (or in this case the supranational authority of an international organization) has a direct positive interest in other countries' overall level of liberalization denoted by $W(l_{it})$. Removing bureaucratic red-tape, opening up markets to foreign competition, protecting consumer interests, enhancing efficiency gains, and creating opportunities for more profitable foreign investments constitute some of the positive spillover effects of liberalizing reforms in non-member state countries, irrespective of whether the latter aspire to become members. Moreover, harmonization of liberalization efforts across members can also have the effect of minimizing political decision-making costs by way of converging policy preferences

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[1] Note that reform policies r_i can also take negative values, in the form of retraction, import substitution, weak regulation of monopolies, and other distortionary and protectionist measures.

across member-states; thus, the principal acts as the guardian of the existing *acquis* (A) of rules, standards, and regulations of the international union (Alesina et al. 2005). Standard liberal intergovernmentalist accounts of regional integration explain how credibility and enforceability concerns often result in member states' deciding to pool their monitoring, oversight, and proposal competences to the supranational level (Moravcsik 1998). We, therefore, assume that any prospective candidate may only become a member of the union as long as it fully endorses the existing *acquis*, or else *if and only if* its (observed) level of liberalization at the time of accession l_{it} is greater or equal to A.[2] This rule certainly applies to existing members alike.

We find that under certain conditions agent i's *intrinsic* incentives to reform will be 'crowded out' by the conditional *extrinsic* bonus attached to union membership. Governments are generally more interested in immediate side benefits or transfers; however, accession conditionality may undermine a country's perception of its long-term benefits of liberalization and integration within an enlarged economic space. The principal's ability to offer a wide range of conditional accession contracts is predicated on Schneider's (2009) notion of *differentiated* membership, whereby c can make use of several legal instruments (opt-out and derogation clauses, phase-in of benefits, etc.) to negotiate a variety of distributive transfers t_i conditional on the full adoption of the *acquis* A. Note that net budgetary contributions t_i may also be negative for a member-state. In addition to the *extrinsic* monetary net benefits of union membership, acceding countries also stand to gain in terms of political influence and security to the degree of $B_i > 0$. Principal c's preferences are, therefore, represented by the following utility function (where m_{it} is an indicator function that takes the value of unity *if and only if* country i is a full member of the union in period t):

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[2]The *acquis* may also function as a screening device for prospective candidates both at the application stage (see for example the EU's Copenhagen criteria of democratic conditionality) and the accession stage (*acquis* conditionality). Plümper, Schneider, and Tröger (2006) examine the strategic differences in the logic of the application and the accession stages.

$$U_c\left(l_{it}; m_{it}\right) = W\left(l_{it}\right) - m_{it} \times t_i \tag{1}$$

We formalize our notion of government i's political will for reform through a simple utility function. Let $V\left(l_{it}; \alpha_{it}\right)$ denote country i's aggregate economic benefits of liberalization within a relatively globalized environment in period t, where $V\left(\cdot\right)$ is assumed to be an increasing, weakly concave function. Parameter $\alpha_{it} > 0$, which captures the economy's relative overall competitiveness and/or total factor productivity, is (for the purposes of our analysis) assumed to be *exogenous* and subject to random period-specific shocks. Let us further assume that marginal economic benefits are weakly increasing in competitiveness, i.e., $\frac{\partial^2 V\left(l_{it}; \alpha_{it}\right)}{\partial l_{it} \partial \alpha_{it}} \geq 0$. On the other hand, liberalization always has its discontents, i.e., special rent-seeking groups whose former political and economic privileges are undermined by more democratic and transparent institutions and well-functioning markets more open to foreign and domestic competition. As a result of the gradual removal of market and government distortions, every government i will incur some variable political costs $\kappa\left(l_{it}\right)$, where $\kappa\left(\cdot\right)$ is an increasing, weakly convex function. This political cost function, as conditioned by the domestic political configuration of interests and the partisan make-up of the government, is also assumed to be common knowledge.

Putting all of the above components together yields the following utility function for the agent i (where m_{it} is an indicator function that takes the value of unity *if and only if* country i is a full member of the union in period t):

$$U_i\left(l_{it}; \alpha_{it}, m_{it}\right) = V\left(l_{it}; \alpha_{it}\right) - \kappa\left(l_{it}\right) + m_{it} \times \left(t_i + B_i\right) \tag{2}$$

The first two components of the utility function $V\left(l_{it}; \alpha_{it}\right) - \kappa\left(l_{it}\right)$ capture government i's *intrinsic* motivation to pursue economic and political liberalization on the basis of domestic

cost-benefit considerations within a given external environment. The latter component $t_i + B_i$ denotes the *extrinsic* net benefits of *conditional* membership. The primary objective of our ensuing analysis is to examine how in equilibrium the balance between those two sets of incentives for reform shapes and is shaped by the contractual arrangement offered by the supranational principal c. The informational mechanism that we propose naturally relies on an asymmetric information structure with respect to the economic link between liberalization and real convergence, which we outline right below.

2.1 Model with fully observable reforms

In this benchmark version of the model without any *moral hazard* in the form of some unobserved *implementation drift*, we may safely focus on simple non-negotiable contracts that make reward (i.e., accession to the union) contingent on a fully observable set of reforms r_i. In this two-period model, we posit that an exogenous random shock $\varepsilon_i \in [\underline{\varepsilon}, \overline{\varepsilon}]$ on competitiveness α_{i0} materializes in period 1, drawn from a regular cumulative distribution function $F_\varepsilon(\cdot)$ with density $f_\varepsilon(\cdot)$ of full support. While ε is perfectly known to the principal c, the agent i only observes a private noisy signal $\sigma_i \in [0,1]$ with a conditional distribution function $G(\sigma_i; \varepsilon)$ and full-support density $g(\sigma_i; \varepsilon)$. So an essential feature of the model is that the principal, albeit fully cognizant of the agent's *intrinsic* motivation,[3] is uncertain about the agent's *self-perception* of the true desirability of reforms r_i depending on the actual value of its ensuing competitiveness parameter $\alpha_{i1} = \alpha_{i0} + \varepsilon$.[4] To rule out unintuitive equilibria, we further assume that the signal technology enjoys the following Monotone Likelihood Ratio Property

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[3]The justification of this information structure seems quite straightforward in the context of the European Union, where supranational actors (e.g., European Commission, European Central Bank) are endowed with the accumulated experience and necessary technical wherewithal to be able to estimate any member or non-member country's economic standing within the overall economic space under their purview.

[4]Note that it would not make any difference if we assumed asymmetric information over the true political costs of liberalization. The logic of the model would remain unaltered as again the principal would be uncertain about the agent's self-awareness over the *intrinsic* desirability of reforms.

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(MLRP):

$$\forall \sigma_i, \sigma'_i \in [0,1] \text{ with } \sigma_i > \sigma'_i, \frac{g(\sigma_i; \varepsilon)}{g(\sigma'_i; \varepsilon)} \text{ is increasing in } \varepsilon \qquad \text{(MLRP)}$$

In other words, the higher signal σ_i is, the more likely it is that ε is also higher and so are the *intrinsic* net benefits of reform.

The timing of the game is as follows: first, in period 0, the initial level of competitiveness α_{i0} materializes and is perfectly known to both the principal and the agent. The government of non-member state i then implements its *autarchic* first-period liberalization program $l_{i0}(\alpha_{i0})$, where the optimal level $l^*_{i0}(\alpha_{i0})$ is such that $V'(l^*_{i0}; \alpha_{i0}) = \kappa'(l^*_{i0})$. In period 1, nature picks a random shock $\varepsilon_i \in [\underline{\varepsilon}, \overline{\varepsilon}]$ on competitiveness α_{i0} from the distribution function $F_\varepsilon(\cdot)$. The principal gets to fully observe country i's second-period competitiveness parameter $\alpha_{i1} = \alpha_{i0} + \varepsilon$, while the agent i only receives a signal $\sigma_i \in [0,1]$ with a known conditional distribution function $G(\sigma_i; \varepsilon)$. In light of this information, the supranational authority c decides to offer a conditional membership package to the government of country i, including membership net transfers of size t_i, conditional on a minimum set of reforms $\underline{r_i} = A - l^*_{i0}$.[5] The agent then decides whether to accept the contract (depending on its observed signal), thus gaining candidate-member status, and implements its desired level of reforms $r^*_i = l^*_{i1} - l^*_{i0}$. Finally, at the end of period 1, country i decides whether to join the union subject to the fulfillment of the accession criterion $r^*_i \geq \underline{r_i}$.

In order to examine the properties of the Perfect Bayesian equilibrium of this game, one needs to start at the end. In the final stage of the game, the period-1 government of country i accepts the contract, implements the necessary reforms, and accedes to the union *only if* $t_i \geq -B_i$. In a Perfect Bayesian equilibrium, the agent will form its *interim* assessment of its

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[5]Admittedly, this single 'take-it-or-leave-it' offer on behalf of the principal abstracts away from the bargaining complexities of the accession negotiation process. We discuss this point in more depth in the section applying the model to the case of EU enlargement.

period-1 productivity parameter $\widehat{\alpha}_{i1}$ on the basis of its private signal as well as the *extrinsic* accession *bonus* (or *malus*) t_i offered by the supranational principal. In formal terms,

$$\widehat{\alpha}_{i1}\left(\sigma_i, t_i; \alpha_{i0}\right) = \alpha_{i0} + E\left(\varepsilon | \sigma_i, t_i\right)$$

Its *autarchic* period-1 level of liberalization reforms will then be $\widetilde{r}_i = \widetilde{l}_{i1} - l_{i0}^*$, where $\widetilde{l}_{i1}$ is such that $V'\left(\widetilde{l}_{i1}; \widehat{\alpha}_{i1}\left(\sigma_i, t_i; \alpha_{i0}\right)\right) = \kappa'\left(\widetilde{l}_{i1}\right)$ and $\widetilde{l}_{i1} = \widetilde{l}_{i1}\left(\cdot\right)$ is an increasing function of $\widehat{\alpha}_{i1}\left(\sigma_i, t_i; \alpha_{i0}\right)$. This level of liberalization gives rise to the agent's reservation utility $\overline{U}_i$ (participation constraint). If $\widetilde{r}_i$ falls short of the accession criterion, i.e., $\widetilde{r}_i < \underline{r_i} \Leftrightarrow \widetilde{l}_{i1} < A$, then the government will decide to accept the conditionality package and implement the necessary reforms in compliance with the *acquis if and only if*

$$V\left(A; \widehat{\alpha}_{i1}\left(\sigma_i, t_i; \alpha_{i0}\right)\right) - \kappa\left(A\right) + t_i + B_i \quad \geq \quad V\left(\widetilde{l}_{i1}; \widehat{\alpha}_{i1}\left(\sigma_i, t_i; \alpha_{i0}\right)\right) - \kappa\left(\widetilde{l}_{i1}\right) = \overline{U}_i$$

$$V\left(A; \widehat{\alpha}_{i1}\left(\sigma_i, t_i; \alpha_{i0}\right)\right) - V\left(\widetilde{l}_{i1}; \widehat{\alpha}_{i1}\left(\sigma_i, t_i; \alpha_{i0}\right)\right) \quad \geq \quad \kappa\left(A\right) - \kappa\left(\widetilde{l}_{i1}\right) - t_i - B_i \qquad (3)$$

Given that the first difference of the aggregate benefit function $V\left(\cdot\right)$ is weakly increasing in the productivity parameter α_{it} and in light of the MLRP property of the signaling technology and the envelope theorem, then there must exist a unique threshold $\sigma_i^*\left(t_i; \alpha_{i0}\right)$ such that inequality 3 holds *if and only if* $\sigma_i \geq \sigma_i^*\left(t_i; \alpha_{i0}\right)$. Only then will prospective members accept the offer and follow through with the necessary reforms for accession. This in turn implies a unique threshold productivity parameter α_{i1}^* implicitly defined by:

$$V\left(A; \alpha_{i1}^*\right) - \kappa\left(A\right) + t_i + B_i = V\left(\widetilde{l}_{i1}\left(\alpha_{i1}^*\right); \alpha_{i1}^*\right) - \kappa\left(\widetilde{l}_{i1}\left(\alpha_{i1}^*\right)\right)$$

Moreover, by the Implicit Function Theorem on equation 3, we also get that the unique threshold signal value is decreasing in initial competitiveness, i.e., $\frac{\partial \sigma_i^*\left(\cdot\right)}{\partial \alpha_{i0}} < 0$. *All else equal*

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countries that are 'early liberalizers' are *ex ante* more likely to accept the conditional membership package and adopt the existing *acquis* A. In a game with multiple agents at distinct early stages of liberalization, this would also follow quite naturally from the assumption that random productivity shocks are *identical* and *independently* distributed.

If, on the other hand, the period-1 government of country i is *intrinsically* motivated enough to fulfill the accession criteria, i.e., $\widetilde{r}_i \geq \underline{r_i} \Leftrightarrow \widetilde{l}_{i1} \geq A$, it must be that $\widehat{\alpha}_{i1}(\sigma_i, t_i; \alpha_{i0}) \geq \widetilde{\alpha}_{i1}$, where $\widetilde{\alpha}_{i1}$ is implicitly defined by $V'(A; \widetilde{\alpha}_{i1}) = \kappa'(A)$. Hence, the equilibrium level of reforms in period 1 will be

$$
r_i^* = \begin{cases} \widetilde{r}_i, & \widehat{\alpha}_{i1}(\sigma_i, t_i; \alpha_{i0}) \geq \widetilde{\alpha}_{i1} \text{ or } \widehat{\alpha}_{i1}(\sigma_i, t_i; \alpha_{i0}) < \alpha_{i1}^* \\ A - l_{i0}^* & \widetilde{\alpha}_{i1} > \widehat{\alpha}_{i1}(\sigma_i, t_i; \alpha_{i0}) \geq \alpha_{i1}^* \end{cases}
$$

Taking into account the above equilibrium response of the agent, the principal will therefore maximize the following expression for true types $\alpha_{i1} < \widetilde{\alpha}_{i1}$ with respect to intra-union distributive transfers t_i:

$$
(1 - G(\sigma_i^*(t_i; \alpha_{i0}); \varepsilon)) \times [W(l_{i1}^*) - t_i] + G(\sigma_i^*(t_i; \alpha_{i0}); \varepsilon) \times W\left(\widetilde{l}_{i1}\left(\widehat{\alpha}_{i1}\left(E\left(\sigma_i | \sigma_i < \sigma_i^*(t_i; \alpha_{i0})\right), t_i\right)\right)\right)
$$

Define the set of equilibrium transfers to country i as $T_i^* \subset \mathbb{R}$. For any materialization of the random shock ε on initial competitiveness α_{i0}, i.e., for any given α_{i1}, let $t_i^*, t_i^{*\prime} \in T_i^*$. Then, in a Perfect Bayesian equilibrium it has to be the case that $\sigma_i^*(t_i^*; \alpha_{i0}) > \sigma_i^*(t_i^{*\prime}; \alpha_{i0})$ for any $t_i^* < t_i^{*\prime}$. This has to be so, since otherwise the principal c would be able to offer lower distributive transfers and simultaneously induce a higher proportion of signal types to accept the conditionality contract and implement the desired levels of reform $\underline{r_i}$; hence, $t_i^{*\prime}$ would not be part of the equilibrium transfer schedule. This formal argument essentially implies that, although *extrinsic* rewards do act as positive short-term reinforcers of reform

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incentives, they sap the country's willingness to 'keep the foot on the gas' in the long-run or else to comply with the evolving *acquis* post-accession. Real policy convergence is thus undermined by accession conditionality. This leads us to the following proposition:

Proposition 1 *A Perfect Bayesian Equilibrium of the above game is characterized by the following:*

(i) for any $t_i^* < t_i^{*\prime} \in T_i^*$, then $\sigma_i^*\left(t_i^*; \alpha_{i0}\right) > \sigma_i^*\left(t_i^{*\prime}; \alpha_{i0}\right)$, i.e., the extrinsic distributive transfers of membership are positive short-term reinforcers of reform efforts,

(ii) if $\alpha_{i1} < \alpha_{i1}'$, then $t_i^* \geq t_i^{*\prime}$, i.e., higher transfers are essentially 'bad news' about the country's ability to compete in a wider market with harmonized rules and standards and thus reap the intrinsic economic benefits of integration; this further imples that, for given $\varepsilon_i \in [\underline{\varepsilon}, \overline{\varepsilon}]$, if $\alpha_{i0} < \alpha_{i0}'$ then $t_i^* > t_i^{*\prime} \in T_i^*$, i.e., countries that need to make up more ground in terms of reaching the *acquis* (because of lower period-1 *intrinsic* motivation) will receive higher *extrinsic* bonus transfers,

(iii) for some α_{i0} and for all $\sigma_i, \sigma_i' \in [0, 1]$ and $t_i^* < t_i^{*\prime} \in T_i^*$, then $E\left(\alpha_{i1} | \sigma_i, t_i^*, \alpha_{i0}\right) > E\left(\alpha_{i1} | \sigma_i', t_i^{*\prime}, \alpha_{i0}\right)$, i.e., higher extrinsic transfers (rewards) 'crowd out' intrinsic incentives for reform by undermining the agent's self-assessment of the intrinsic desirability of liberalization (political will), and

(iv) for any $t_i^* \in T_i^*$ and $\alpha_{i0} < \alpha_{i0}'$, then $\sigma_i^*\left(t_i^*; \alpha_{i0}\right) > \sigma_i^*\left(t_i^*; \alpha_{i0}'\right)$, i.e., 'early liberalizers' are *ex ante* more likely to accept the contract and engage in the necessary reform to achieve membership in the union, and

Proof. See above. ∎

To characterize the equilibrium further, let us examine some of the possibilities. It is quite straightforward to rule out a *perfectly separating* equilibrium, whereby the principal c

offers a different equilibrium transfer t_i^* to an agent i with initial productivity α_{i0} for any materialization of the random shock ε. In such an equilibrium, the agent would disregard its own private signal altogether and, therefore, the principal would try to induce the highest level of liberalization possible by pooling on the highest competitiveness type possible $\overline{\alpha}_{i1} = \alpha_{i0} + \overline{\varepsilon}$. This obviously leads to a contradiction. Moreover, as shown above, a *perfectly pooling* equilibrium is ruled out by the principal's partial incentive to impart its private information to the agent and thereby induce the expected reform efforts. This implies that the Perfect Bayesian equilibrium of the game has to be *semi-pooling*.

Let us assume that $\overline{\alpha}_{i1} > \widetilde{\alpha}_{i1}$ and examine equilibrium strategies with respect to highly competitive types $\alpha_{i1} \in [\widetilde{\alpha}_{i1}, \overline{\alpha}_{i1}]$, whose *intrinsically* motivated *autarchic* level of liberalization, if known, already satisfies the accession criterion without any additional inducements. If the government of country i knew that it belonged to this category, then it would be *able* and *willing* to join the union regardless of its own private signal, as long as $t_i \geq -B_i$. Hence, the principal has an incentive to signal to these types that they belong to the category of countries willing to liberalize over and beyond the existing *acquis A*. However, the supranational principal has no incentive to separate between these highly competitive types, since it would always stand to benefit from extracting a higher net contribution to the common budget $t_i < 0$ as well as convincing them that they should liberalize further. Therefore, in equilibrium, all highly competitive types $\alpha_{i1} \in [\widetilde{\alpha}_{i1}, \overline{\alpha}_{i1}]$ receive the same membership package $t_i = -B_i$.[6]

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[6]Note that whenever $B_i < 0$, it would never be in the supranational principal's interest to offer positive net transfers to highly competitive types $\alpha_{i1} \in [\widetilde{\alpha}_{i1}, \overline{\alpha}_{i1}]$, since the governments of these country-types will liberalize above the *acquis A* anyway. Instead, the principal would again propose a positive budget contribution schedule attached to membership, which the agent would find unacceptable and reject. It would still, however, form the consistent belief that it belongs to the category of highly competitive types and thus liberalize according to the value of its private signal. In the European Union context, this captures the cases of countries such as Norway and Switzerland, which prefer to liberalize within the framework of the European Economic Area (or some type of bilateral relationship) rather than to assume the obligations of core membership (see Gstöhl 2002).

On the other hand, pooling on all possible types cannot be an equilibrium strategy, since then agent i will only form its estimate of its true competitiveness α_{i1} on the basis of its own signal, which would lead to a suboptimal outcome according to Proposition 1. Instead, the principal will pool on intervals of true competitiveness types $\left[\alpha_{i1}^{j}, \alpha_{i1}^{j+1}\right], j = 0, 1, \ldots$ offering decreasing levels of distributive transfers t_i^{j*} for higher values of j.

2.2 Moral hazard

So far we have assumed that liberalization reforms are perfectly observable and that the cost of monitoring is negligible. While existing rules and regulations may be visibly transposed into domestic law, it is often the case that actual on-the-ground implementation of such reforms falls short of the desired level. This supposed implementation drift could stem from the government's weak implementation capacity, its reluctance to take full ownership of reforms and to see them through, or the internal resistance of other veto players within the public sector. Such unobservable moral hazard may take the form of data manipulation and 'fiscal gimmickry' (see Alt et al. 2012 for an analysis of moral hazard in the context of the EMU), non-transparent procedures, and bureaucratic drift.

In the context of our model, we now assume that the agent can take a *hidden* action $x_{i1} < 0$ at the end of period 1 in an effort to retract transposed reform policies and thus signal its true 'political will' to its voters. If the monitoring costs of the unobserved level of liberalization x_{i1} are infinite, then according to subgame perfection the principal expects that the agent will implement liberalization policies only to the extent allowed by its self-perceived *intrinsic* motivation $E\left(\alpha_{i1}|\sigma_i, t_i, \alpha_{i0}\right)$. Therefore, the principal c has an incentive to enhance the agent's perception of its *intrinsic* motivation. Given that accession may only be made contingent on the observable level of true liberalization l_{i1} and that the agent can always later retract those reforms through some *hidden* action $x_{i1} < 0$, then i will always be willing

to accept the contract, legislate the necessary reforms, and accede to the union, as long as $t_i \geq -B_i$. Therefore, since the instrument of *extrinsic* incentivization of reforms has no value in the face of *moral hazard*, the principal will offer the same equilibrium accession package of $t_i \geq -B_i$ to all productivity types. The true level of liberalization $l_{i1}^* = \max\left\{\widetilde{l}_{i1}, A\right\} + x_{i1}^*$ will be such that $V'\left(l_{i1}^*; E\left(\alpha_{i1}|\sigma_i, \alpha_{i0}\right)\right) = \kappa'\left(l_{i1}^*\right)$.

Proposition 2 *The Perfect Bayesian equilibrium of the game with moral hazard amounts to perfect pooling of all productivity types $[\underline{\alpha}_{i1}, \overline{\alpha}_{i1}]$ with the same conditional membership contract of $t_i \geq -B_i$ subject to observable liberalization levels of $l_{i1} \geq A$.*

Let us now assume a finite level of monitoring costs $\mu > 0$ that the principal may decide to incur, in order to verify whether a candidate member's true levels of liberalization conform with the *acquis* and thus whether it fulfills the agreed accession criteria. The addition of a possible monitoring stage at the end of period 1 gives rise to a mixed-strategy equilibrium.

2.3   Distributive conflicts and the profitability effect

What if $W\left(\cdot|m_i = 1\right)$ is a negative function of the acceding member's true competitiveness type? How does that impact the above conditionality mechanism? So far we have assumed that the enlargement negotiation process is presided by an impartial supranational authority such as the European Commission with no particular distributive preferences or biases *vis-à-vis* existing members.

3   An Empirical Narrative of EU Conditionality

The proposed research aims at analyzing models of conditionality both for the EU and for other international organizations, notably the IMF and the World Bank. This section presents a plausibility probe of the theoretical argument exposed above by presenting a case study of

Greece in Europe's Economic and Monetary Union (EMU) backed up by a shadow comparison with Spain.

Greece is a country with a very strong incentive to implement all the structural reforms required to maintain its membership in the Eurozone and possibly also the EU.[7] Despite the extraordinarily high-powered nature of that incentive, however, over the past decade Greek politicians have not only struggled to maintain the pace of necessary reforms, but have also declined all ownership of European-style liberalizing measures.

To understand Greek responses to EU-level incentives it is necessary to go as far back as the early 1980s, when Greece exhibited low *intrinsic* motivation to converge with the *acquis*. The socialist government led by Andreas Papandreou openly advertised its hostility to Greek membership to the EEC (Koliopoulos and Veremis 2007). Despite substantial aid packages from the EEC/EC, the competitiveness of the Greek economy was swiftly decreasing. In 1985 the government was forced to devaluate the drachma by 15%. In the absence of credible accompanying measures (the stabilization program of 1985 was unilaterally suspended by the government less than two years later), the resulting boost in competitiveness proved short-lived. As a result, by 1987 the size of the Greek economy was overtaken by that of Portugal.

Greeks' preferences underwent a dramatic change around 1989-1990, converting the country into an own-motivated reformer with extraordinary potential for economic growth. In 1990, the conservative party was elected to power. Its economic priorities included liberalizing the economy, balancing the budget, limiting costly state subsidies, fighting inflation, and trimming the public sector. The socialists' return to power did not lead to outright policy reversal. Its historical leader, Andreas Papandreou, became more detached, allowing power to shift towards a group of more professional, liberal socialists dubbed the 'modernizers'.

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[7]Since there is no legal provision for an exit from the single currency, Greece might be forced to leave the EU as a whole under Article 50 of the Lisbon Treaty.

One of them, Kostas Simitis, succeeded Papandreou in 1996 and immediately embarked on a reformist economic policy midway between the old socialist party and the conservatives' program. Simultaneously, he led a wide-ranging policy change in the fields of human rights and minority issues, state-church relations, and international relations. In short, from 1990 onwards, Greece exhibited a strong *intrinsic* motivation to reform.

In 1996, *extrinsic* incentives were added to *intrinsic* motivation for reform. The combination of (a) progress on Stage 3 of EMU by a group of core countries including the original Six member states of the European Communities, (b) the temporary exclusion of Greece from that group of 'first wave' members, and (c) the promise that, if it met the Maastricht criteria, Greece would be granted entry in the Eurozone, created clear *extrinsic* incentives to proceed with liberal reforms on public spending, debt, and inflation. In fact, in the short run, *extrinsic* incentives made convergence with the Maastricht criteria the absolute priority of the Simitis government. Within five years, inflation decreased from 14% to 2%. Fiscal gimmickry notwithstanding, the public deficit was slashed from 14% of GNP in 1993 to 3% in 1999. State subsidies were cut back, incentives to private entrepreneurship were reinforced, and most importantly, a new ('final') devaluation of the currency by 12.3% was decided in 1998. Eventually, this combination of *intrinsic* motivation for modernization and *extrinsic* incentives for reform earned Greece 'second wave' membership in the EMU from January 2001 onwards.

In the long run, however, it became apparent that *extrinsic* incentives had 'crowded out' *intrinsic* motivations for reform. Following the 2004 Olympics, the new conservative government denounced the socialists' fiscal gimmickry. Yet, prime minister Kostas Karamanlis ended up prioritizing a cut in public spending rather than structural reforms pertaining to tax collection, labor market regulation, or competition. After what most commentators describe as five lost years, the socialists returned to power in 2009, led by Andreas Papandreou's

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modernizing son, George. By that time Greece was already suffering the consequences of the financial crisis of 2008. Nevertheless, neither Papandreou's socialists' nor Karamanlis' conservatives sought to take ownership of necessary reforms. In fact, whereas Papandreou eventually resigned, Antonios Samaras, Karamanlis successor as head of the conservative party, flirted with outright euro-sceptic, nationalist theses. (Koliopoulos and Veremis 2007: 179-194)

It may be tempting to conclude that the Greeks were merely engaging in *morally hazardous* behavior in a rational (perhaps even cynical) way. Once accepted in the Eurozone, the *extrinsic* incentive to proceed with reforms almost vanished, leading to their backing down from previous modernizing efforts. Yet, a comparison with Spain shows that this is not necessarily the most factually accurate reading of history. Spain never really faced such high-powered incentives as Greece. First and foremost, unlike Greece, Portugal, and Ireland, at the time of writing it has not (yet) been bailed out. Moreover, the cost of a Spanish exit for the economies of Europe as a whole would be such that threats of forcing an Article 50 exit upon it are non-credible (i.e., in the parlance of game theory, not *subgame perfect*). And yet, Spain does press forward with structural reforms of the pensions and health care systems, spending cuts of the central and regional governments, and above all the labor markets. The most obvious explanation for this variation between Greece and Spain is consistent with the theoretical model outlined above: this is not a case where one government simply responds better to *extrinsic* incentives than another; rather, it is a case where the *intrinsic* motivations for reform of one government have been 'crowded out' by *extrinsic* incentives.

4   Conclusion

Why do some conditionality programmes work better than others? Within the same programme, are there any differences in the trajectories of target countries, or do they all follow

the exact same path? If, as it happens, there is variation, what accounts for it? Why, in other words, do some target countries perform better than others?

To answer these theoretically far-reaching and socially topical questions, this paper argues that, under certain conditions, external incentives 'crowd out' the target government's *intrinsic* motivations for reform. Where that effect is important enough, conditionality programmes 'shoot themselves in the foot'. To show how this 'crowding-out' effect may occur, we first develop an innovative theory of international incentive schemes. Building on path-breaking works in cognitive psychology and behavioral economics, we go beyond the dominant neo-classical conceptualization of incentives, whereby stronger incentives invariantly induce greater effort. We focus instead on the signaling value of *extrinsic* incentives. Just as different receptors can interpret identical signals in different ways according to where they stand, different countries (or governments) can interpret identical *extrinsic* incentive schemes in different ways according to where they believe to be.

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