

# Compliance in Theoretical Perspective: Cost-Benefit Calculus of National Agents

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## **Abstract**

Most recent research on the effects of domestic political factors on international compliance presents compelling arguments that democratic institutions do not universally increase the likelihood of compliance (see Dai, 2006 for a compelling discussion of this subject). Indeed, the empirical evidence showing broad variance in the compliance performance of democratic regimes indicates the need to develop a more refined mechanism that captures the exchange between domestic level actors and its effect on governments propensity to comply. This paper formally examines the interaction between the pressures of domestic constituency principals and national political agents consideration of benefits on their willingness to comply with the demands of international actors. The argument proposed here makes primary use of the political elites cost- benefit calculus and the notion of opportunity costs to capture the problem of the changing behavior of national governments when responding to different international demands and changes in support of domestic constituencies over time. We develop a formal model drawing on fundamentals of principal agent modelling to illustrate our argument.

## Introduction

The main aim in this project is to turn scholarly attention from institutional structures, and the proper design of international rules as the main drivers of successful compliance behavior, back to the underlying domestic incentives of political incumbents and the dynamics of domestic political exchange. As Filippov, Ordeshook and Shvetsova (2004) contend with respect to successful federations, “institutional incentives do not guarantee enforcement unless they are fortified by direct incentives for political participants to uphold them and they further maintain that clauses and constraints are important [B]ut they are not sufficient for the smooth operation of a federation” (Filippov, Ordeshook and Shvetsova, 2004, 4).

Focusing unanimously on institutional structure and instruments to foment international compliance, as is currently the case in compliance studies, presents a similar problem to that which generated Filippov et als claims about federal compliance. Designing the rules and instruments of compliance requires the understanding of the political incentives of domestic elites to comply. The recent destabilization of the Eurozone resulting from Greek, Irish and most recently Italian lack of compliance with EU’s strict budgetary rules adds urgency to the approach adopted in this paper. The story about the current crisis is in part told as a failure of EU’s ineffective monitoring system and the ingenious defective manoeuvring of the national governments. In the midst of the current crisis, less attention is paid to the incentives that led to concealing these numbers and defect on the rules imposed by the EU. However, this paper does not intend to present a model explaining the current crisis, it seeks to develop a general model of compliance that can also contribute to systematic understanding of what gave rise to the Eurozone’s compliance problems.

The argument rests on domestic political incumbents consideration of their opportunity costs. The decision of political incumbents is motivated by balancing their concern

with the immediate and long-term benefits of EU policies and the alternative costs of the rules and policies pushed by the EU in general. In this sense, political elites juxtapose the value of benefits incurred by adhering to the EUs rules and laws at present or the near future with their opportunities to incur benefits pursuing an alternative policy by other means. If the present and expected benefits from the EU are high, non-compliance with the EU will be associated with high opportunity costs.

The willingness to accept rules and policies outlined by the EU is to a significant degree determined by the extent to which the political benefits of national incumbents are better served if those policies were not implemented at all or delayed and adopted by the next government. It is a common observation that domestic political actors have preferences that may or may not be compatible with the demands stipulated in international rules and treaties. Most importantly, however, these preferences are not stable and are subject to change over time based on exclusively domestic factors, such as fluctuating public opinion and interest, or changing interest group coalitions that political incumbents rely on for re-election. Pre-existing conflicts can prevent successful compliance, as the salience of that issue is too high among domestic political actors and the public. In the case of the Working Time Directive in Portugal, for example, some observed that, “the government tried in vain to keep particularly controversial issues out of the transposition discussion (such as the question of what to count as effective working time and what time to consider as breaks). Since the employers and unions tried to interpret the Directive in a way that would support their position on this point, the governments could not prevent controversies and also later added, “[T]he Directives are important, but on the national level it is more the social partners, the internal politics, that are important” (Falkner et al, 2004: 12.)

The intensity and direction of public attention towards issues is often influenced by external shocks such as economic crises, environmental disasters or re-focused political

conflict re-orienting the essence of public discourse and debate in such a way that it inevitably increases the electoral stakes of failing to cater to the preferences of their respective constituent coalitions. Similarly, the long-term re-distributional consequences that changes in the international economy and trade bring on the domestic economic interests also alter the preferences of domestic political elites (Frieden, 1991; Frieden and Rogowski, 1996; Milner, 1988).

Such changes in public interest and preferences naturally induce different costs of compliance for these domestic political actors that must be, by definition, external to the demands of the international actor and will to a considerable degree shape their willingness to comply. Thus, the dynamics of domestic political exchange ensures that political incumbents are often forced to pit their domestic concerns against the demands of international rules and such friction should be systematically accounted for in the explanations of international compliance.

### **The Agents, the Principals and Multi-level Governance**

In general, the main challenge that governments face in multi-level governance structures, such as the EU or more loosely integrated international bodies, is finding the appropriate balance between reaping the advantages provided by these supranational or international institutions and, at the same time, avoiding the potential threats to their legitimacy that are in turn created by these organizations. As Filippov, Ordeshook and Shvetsova (2004) point out, EU integration decreases “the capacity of domestic political elites to intervene on certain issues notably economic redistribution, social policy, employment protection, and the protection of national industries” (Filippov, Ordeshook and Shvetsova, 2004, 325). However, such losses of control in specific policy areas must be offset by other short-term or long-term benefits available to them as a result of their membership in the EU. As suggested above, political incumbents often voluntarily tie their hands by

international legal obligations and use membership in international organizations to add legitimacy for difficult reforms or counteract private interests seeking disproportionate influence in specific policy areas.

The argument developed in this project relies on the basic structure of agency theory to illustrate the theoretical propositions regarding compliance and characterize the relationships in multi-level governance structures with respect to compliance problems. The argument requires that compliance behavior of national agents occur in a continuous space where these agents move incrementally towards, and away from, their two principals in response to each principals changes of preferences. While EU institutions are typically conceived of as agents of the national governments, in the context of compliance problems, their role is also that of a principal. In addition, this model fixes the EUs preferences as exogenously determined and expressed through their demands delivered uniformly to all national incumbents at each point in time. This assumption only simplifies the basic model and re-focuses attention on national governments as of primary theoretical importance and relegating the complexities of preference shifts and independence of international agents for later examination.

Domestic constituencies represent more typical principals of national political agents and their preferences vary over time and across countries. In other words, the preferences of domestic principals represent the main source of variation across individual countries or electoral districts. Unlike in the case of enforcement approaches, where the variation across time among the individual institutional instruments to induce compliance is rather low, changing preferences of domestic principals provides a more variant explanatory variable than is common in the predominant explanations of compliance.

The principal-agent framework offers two possible scenarios. First, the preferences of the international principals and domestic principals are aligned, and thus the national agent possesses minimal incentives to shirk and can easily act as perfect agents. Con-

sequently, in this scenario, we should observe high likelihood of compliance. On many occasions, the preference alignment between the agents and their principals has been noted in the case of the EU integration. It has become conventional wisdom in studies of public opinion in Europe that the relationship between the domestic elites and the European publics has been, until recently, characterized by the so called “permissive consensus” whereby the publics consistently high support for EU policies enabled domestic political elites to drive the integration efforts at full speed and relatively unconstrained by their domestic coalitions (Hooghe and Marks, 2005).

The second scenario is, however, equally plausible and undoubtedly more interesting. In recent years, researchers have noted the widening gap between the preferences of the European public and the domestic political elites towards the EU integration. In recent referendums, the European public has repeatedly demonstrated their opposition to more profound integration efforts, while political elites have officially maintained relatively pro-EU stance. Indeed, one of the more interesting implications of principal-agent theory is that more often than not the preference of the agent and the principal(s) are misaligned. As noted above, international integration produces notable short-term, as well as long-term, benefits that domestic incumbents choose to exploit for their own electoral advantage. Thus, the preservation of those benefits, or gaining access to additional economic and political resources, often provides incentives of national agents to shirk on the preferences of their primary principals domestic coalitions. There exists ample evidence that national governments on occasion ignore the preferences of their core constituencies and use their affiliation with a supranational body to push reforms that have been long held hostage to entrenched opposition (see K.M. Anderson en M. Kaeding, N.d.).

The split between the principals and agents implies a palpable agency loss and poses an interesting question about how national political incumbents manage to recon-

cile such differences while avoiding major electoral consequences. There are three main potential explanations. First, political elites can get away with occasional shirking due to the general inattention of the domestic constituencies to the issues dealt with at the supranational level. One can tell an alternative story about public opinion with the EU and the origins of the “permissive consensus” and attribute this symbiotic relationship to a lack of interest on the part of the voters towards EU matters. Thus, the issue of the EU membership, and further integration, is insufficiently salient for the principals (voters) to monitor and punish agents for shirking about. Instead, voters choose to focus their attention and threats of punishment on other policy dimensions that they perceive as more essential in their every day lives.

Second, an alternative answer to this question can be found in the literature dealing with the role of political parties in responding to voters about EU issues where political scientists have long argued that many political issues have been gradually shifted to the supranational level while the EU dimension has been kept muted in national, electoral campaigns (Mair, 2007; Taggart, 1998; Ray, 2003, 2007). These debates seem to provide plausible foundations for the claims that functionalists have made in their theoretical expositions of the increasing internationalization of domestic policies. As some issues are better dealt with at the supranational level in the long-run, and potentially produce much more effective policy outcomes in the future, political incumbents prefer to remove those issues from the national agenda. However, in order to deal with the presence of short-term negative externalities of pooling these policies at the supranational level, they also must de-emphasize these issues in their electoral campaigns. Thus, by de-emphasizing the EU issue dimension in national political competition, political incumbents are able to pursue unpopular policies without incurring major political costs.

Lastly, the principal agent approach provides useful theoretical foundations for yet another insight. In politics, the existence of collective principals means that individual

actors coordinate together to delegate to the agent, but are likely to possess divergent interests that their agent may be able to exploit to her benefit and temporarily shirk without substantial consequences. Broad coalitions of voters as well as special interests elect national governments. However, each of these coalitions possesses a divergent preference regarding specific aspects of policy-making and, depending on the size of the groups of societal supporters and their ability to organize, they are able to carry a disproportionate influence over policy outcomes and the level of compliance with the demands of the international actor. Eventually, the challenge that the agent faces is that she must choose to reconcile the often contrary demands of the individual actors composing the collective principal by aligning oneself with policy preferences of one over another. As in the case of Sweden's non-compliance with the Maastricht treaty regarding the accession rules towards the EMU, for example, the public's unfavorable stance towards the EU at the time led the governing parties to disregard their obligations as a member state of the EU and align themselves closer with their respective voter coalitions. However, at the same time the Swedish government also hastily adopted specific interim provisions for Sweden's exporters to conduct trade and report their balance sheets using the Euro instead of the krona accompanied by assurances of future full adoption of Euro.

### **The Role of Opportunity Costs**

The argument introduced in this study centers around the notion of incumbents cost-benefit calculus to understand the behavior of national agents responding to changing preferences of their international and domestic principals simultaneously. The agents are conceptualized as national incumbents that are primarily concerned with their re-election and make their decisions solely to maximize their chances of maintaining public office.

To capture the nature of the trade-offs between present and future benefits of international commitments and domestic costs that national incumbents are forced consider

in their cost-benefit calculation, we utilize the concept of opportunity costs. In this sense, the decision to comply can sometimes generate high opportunity costs as the demands constrain the national incumbents ability to sufficiently intervene in their domestic affairs in hopes of appeasing their respective domestic coalitions. Alternatively, the decision to not comply can induce high opportunity costs as incumbents surrender the opportunity to use international demands to more efficiently address domestic reforms on another occasion.

Generally, opportunity costs are defined as the value of the best available opportunity forgone. Economists generally refer to two types of costs associated with an individuals choice. The direct costs indicate all direct payments that are required for making a choice while additional costs or opportunity costs represent all the costs of the alternatives forgone that arise with the particular choice. Opportunity costs occupy an invaluable place in understanding individual decision-making. Indeed, as resources available for pursuing certain policies are limited, reflections over the “unseen” costs of a specific budgetary allocation by national governments, for example, are undoubtedly the main linchpin of political decision-making. In the most basic terms, the same resources expended on certain public projects cannot be alternatively spent on other public projects as well. Thus, in addition to the direct costs of a particular project in terms of the lump sum spent from the fixed budget, there are also the indirect costs of the opportunities to spend an equal amount on other projects.

In international politics the value in consideration of opportunity costs is a useful theoretical tool. The functional benefits of the international domain often allow incumbents to pursue policies more efficiently. These additional policy-making and career venues are likely to increase the opportunity costs that national incumbents face in case of non-compliance and thus increase their a priori incentive to comply. Thus, the demands of international principals may generate new policy opportunities that some national in-

incumbents will find hard to pass up. As a result, if we assume that among the incumbents most important reasons to enter into supranational or international bodies is their motive to utilize their membership to increase their domestic political fortune, then opportunity costs of non-compliance should be high while the likelihood of compliance will be high. In this model, however, national agents abilities to benefit from these new policy options are fundamentally limited by the amount of domestic pressure they are subjected to at any given time. As the public grows less tolerant of the domestic implications of conforming to the demands of the international organization, the domestic agents must carefully evaluate how their political fortunes can be served best.

In sum, the central tenet of this argument is that each political incumbent weighs the level of opportunity costs in addition to direct costs and benefits. The implications of the EUs policies domestically have observable and unobservable components. The conceptualization of costs in compliance studies have so far unanimously focused on the direct costs i.e. the amount of “membership fee” required from the members of the international body or the level of sanctions imposed on a member for non-defection. Similarly, attention was paid to the issue of direct benefits, that is the lump sum of resources available to domestic governments as a result of a re-distribution from the international body.

Focusing on opportunity costs, however, provides theoretical insight into the domestic mechanism of how direct costs and benefits of membership are assessed by domestic actors and impact their decision to comply. Domestically, the evaluation of opportunity costs associated with a decision to comply is influenced by the opportunities forgone. If we assume that domestic incumbents are concerned with re-election, then the opportunity costs imposed by EU policies are central to such calculations. If a decision to comply with EU rules and policies generates high opportunity costs, then we are unlikely to observe high levels of compliance. However, there are ample reasons to assume that

non-compliance might also create high levels of opportunity costs. Ultimately, the direct costs paid to obtain a certain good might represent only the tip of the iceberg of the total cost that incumbents need to forgo and these costs might eventually carry decisive weight in their choice to comply. Similarly, the effectiveness of direct benefits to induce compliance might be significantly hampered by the necessary “amount of goods forgone” in case of their decision to comply.

Interestingly, as the theory of collective action suggests, side-payments and selective incentives usually include direct benefits paid to maintain compliance and prevent free-riding. The consideration of opportunity costs, however, put the effectiveness of these private benefits into question if no particular attention is paid toward decreasing the opportunity costs with which the national agents are faced. From the perspective of compliance, it may turn out to be futile to offer selective incentives when the opportunity costs associated with the international principals demand are high. The systematic account of these costs thus represents a missing link in the current studies of international compliance.

## **The Theoretical Foundations of Incumbents Decision to Comply**

At the time of the submission, we are still working on solving the model. Thus, we resort to simply presenting the raw ingredients of the model without providing details on the mechanics of the model yet or the solutions. These items will be added with the next version of the paper.

The demands of supranational actors and domestic constituency coalitions provide two separate inputs into the decision-making process at the domestic level and politicians face a challenge to process these two separate inputs. Politicians are assumed to derive their utility from short-term re-election concerns as well as long-term career goals. As such, the international and national domains become effectively merged as part of a single

continuous policy space from the perspective of national decision-makers such that these political incumbents search for optimal policy solutions in this merged space so as to ensure their future political fortunes.

Political incumbents evaluate their choices based on direct costs and direct benefits through their anticipation of opportunity costs. The addition of opportunity costs is key and represents a departure from the majority of the compliance research. The inclusion of political opportunities provides a direct mechanism for understanding the cost-benefit calculation that the majority of the neoliberal and functionalist arguments implicitly and explicitly express. Each incumbent compares their utility from the decision to comply ( $U_c$ ) against their utility of non-compliance ( $U_{\sim c}$ ).

$$U_c = U_{\sim c}$$

In simple terms, as national incumbents gain more utility from compliant decision, the likelihood of compliance increases as well. Alternatively, more utility obtained from their decision to not comply will also decrease the likelihood of compliance. More specifically, the individual utility that national incumbents obtain from their decision is given by the following:

$$b_{eu} - c_{eu} = b_d - (c_d)\delta$$

where  $b_{eu}$  represents the expected benefits that incumbents receive from the EU as a result of their compliant behavior;  $b_d$  denotes the direct benefits they receive domestically in case of a non-compliance. Direct penalties that incumbents incur for non-compliance from the

EU are denoted by  $c_{eu}$  and the direct domestic costs incurred in the case of their decision to comply are expressed as  $c_d$ . Lastly, parameter ( $\delta$ ) denotes the weight that increasing public attention to the EU adds to the overall domestic costs that incumbents take into account. Increased public attention implies that national incumbents must proceed more cautiously and that the potential electoral repercussions for not following the changing preferences of the domestic principals more severe.

In sum, the likelihood of compliance increases when the combined benefits and costs of EU demands exceed the domestic costs and benefits. The opportunity costs increase as the value of all the alternatives that national incumbents are forced to give up with their decision to comply or not to comply increases. Thus, with each increase in domestic benefits and costs, national incumbents face more substantial opportunity costs if they choose their compliance with international demands. Alternatively, the likelihood of compliance decreases when the combined domestic costs and benefits exceed the costs and benefits of EU demands. However, the rising amount of benefits of EU demands will increase the opportunity costs those national incumbents incur, thus decreasing their incentive to defect.

### *Expected EU Benefits*

The model assumes that the incumbents reap substantive EU benefits. There exists ample anecdotal evidence regarding the many benefits that incumbents are able to access as a result of their membership in supranational political structures. Some researchers have emphasized the benefits of venue-shopping for the most effective level at which policies can be implemented (Baumgartner and Jones, 1993). Different policy issues can be most efficiently addressed at different governance levels, minimizing the costs for national policy-makers as well as special interests while improving their chances to obtain their preferred policies. Ultimately, the domestic elites enjoy the opportunity to claim

credit for the successful policies that result from assigning these policies to a supranational body.

Alternatively, “blame-game” arguments emphasize the convenience of relegating responsibility for unpopular policies to a democratically unaccountable or only partially accountable supranational body (Evans et al, 1993). Thus, benefits vary from direct monetary and re-distributive contributions to the member states to more conceptually abstract notions of benefits such as the possibility for more appropriate venue-selection for policy proposal as well as implementation. Similarly in the case of the EU, members also enjoy indirect benefits from the EU as a result of the economic rewards obtained from the increased intra-EU trade through a reduction in transaction costs by removing the barriers to movement of goods and services. Domestic coalitions that benefit from the removal of these barriers to trade will be pushing for increased support and speediness of the transposition of EU law regarding internal market rules into the national legislation and its diligent enforcement. However, domestic governments are able to enjoy direct benefits in the form of top down fiscal redistribution from the EU. The majority of direct resource redistribution is divided between 2 main policy areas: Common Agricultural Policy (CAP) and Structural Funds (Perkins and Neumayer, 2007, 188). Lastly, the indirect non-monetary benefits of the EU also mirror the discussion in international relations research on the advantages of smaller states to be able to punch above their weight in the international arena (Perkins and Neumayer, 2007, 190) and utilize this international influence to build their political capital.

### *Domestic Costs*

The central source of domestic costs is change in the salience and support for the EU among the voters since the political trajectory of political incumbents is anchored in a popular support. Unlike in previous discussions of public impact on compliance, this

argument emphasizes the necessity to look beyond public support or opposition. For individual political decisions to reflect on the public input, a general level of awareness to what is happening in politics by the public is essential. The salience of the EU among the public combines the public attention and the importance assigned to it at the same time. As the public increases the weight they put on the EU-related matters, the more carefully incumbents need to weigh their decisions to comply or not to comply.

The argument would be incomplete, however, if the consequences of salience were not further conditioned by the directionality of the public's position on the EU. In this sense, the strongly pro-EU public, paying a regular and visible degree of attention to EU issues, will not have the same effect on incumbents' behavior as an anti-EU public with increasing attentiveness to EU-related issues. In the first case, the incumbents decide in the context of a publicly unrestrained environment whereas in the second scenario the public's negative attention to the EU matters puts a larger burden on decisions that favor EU demands. By focusing on the consequences of public attention and support for the choices of political incumbents regarding their compliant behavior, the representational dimension of the argument becomes immediately obvious and will be examined in depth in the following section. This model explains the pattern of compliance or non-compliance in the EU and by doing so casts light on the level of representation of the public in the EU. As noted in the overview of current literature, such a connection is rare. The conventional wisdom argues that the problem of representation, in regard to compliance, is inconsequential as these political processes are too complex and thus withdrawn from the public's eye. However, each decision towards compliance with EU demands by the incumbents against the preferences of the public implies some degree of agency loss. For example, in the European Union context, certain policy areas such as agriculture and internal market issues are marked by a disproportionately higher compliance deficit (König and Luetgert, 2009). These two policy areas also regularly reveal a high degree of

salience among the European publics.

### *EU Sanctions*

Focusing on the national agents cost-benefits calculus also enables the incorporation of previous theoretical arguments into this framework as well. Institutional design alters the costs that domestic agents take into account. The EUs process of litigation publicly exposes the non-compliant country and increases reputation costs. Defection by one country increases the share of burden borne by the rest of the countries that continue to adhere to their international legal obligations. Long-term disproportionate burden-sharing on the part of the remaining countries, however, is politically unsustainable as domestic taxpayers refuse to support shirking on other countries international commitments. Thus, governments find themselves under additional pressure to coerce non-compliant parties to change their behavior.

Over the past two decades, the EU has developed a comprehensive system of sanctions for non-compliance. Currently, the EU deals with infringements of EU law in four stages. In the first stage, the EU presents the member state with a letter of formal notice demanding that a member state explain the reasons for the delay in the application of the community law. In the second stage, the European Commission produces a reasoned opinion demanding that the member state comply with the EC case law within a specific time limit. The litigation procedure commences with the European Commissions referral of the case to the European Court of Justice. The ECJ then provides a ruling on whether a member state in fact failed to comply by not implementing community law or incorrectly implementing the community law. Lastly, since the adoption of the Maastricht Treaty (article 228 of the EC Treaty), the ECJ also provides a decision on the penalties that will be imposed on the member state if it in fact failed to comply with the earlier ruling of the ECJ. Thus, financial penalties are only imposed in the instance

of non-compliance with the ECJ ruling following a three stage pre-litigation proceeding initiated by the European Commission. So far, financial penalties have been imposed in 8 cases since 1991. ECJ imposed penalties against Greece in 2000, 2005, 2007, and 2008, against France in 2005 and 2007, Portugal in 2006 and against Spain in 2003.

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