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

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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 to accept the conditionality package and implement the necessary reforms for accession..

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We corroborate our predictions with anecdotal evidence and case studies from the EU's Eastern enlargement and the Eurozone's debt crisis.

1 Introduction

> "We do not want to intimidate others or to force our ideas onto them, but we stand by our experiences and we would like to share them." (German President Joachim Gauck)

One of the lessons of the ongoing Eurozone debt crisis is that the long sought-after goal of real convergence within an economic and monetary union remains elusive. Although there were clear signs of nominal convergence in the booming 2000s, that proved to be rather ephemeral and unsustainable in the face of asymmetric economic shocks. The inexorable forces of the global capitalist system shed light on the underlying imbalances of the European unification project, giving rise to a *de facto* differentiation between the surplus countries of the European 'North' (core) and the deficit countries of the European 'South' (periphery). These labels go beyond instantaneous measures of a country's fiscal position. The process of regional integration suffers from a deeper structural imbalance with respect to countries' innate capacity to reform their political and economic institutions. Unlike fiscal deficits and trade imbalances that can be corrected over the medium-term, this so-called 'institutional deficit' appears much more persistent and inextricably linked to the logic of union accession, redistribution, and disintegration.

In an increasingly globalized world, the process of institutional reform is heavily conditioned by the external environment, which in turn generates a certain (positive or negative) 'institutional balance'. Some countries seem to reform in an organic, piece-meal manner in response to societal pressures and external trends, acting in the process as innovators and pioneers of global benchmarking standards; others take on a more adaptive approach by em-

ulating diffuse policy standards and institutions, internalizing them, and tailoring them to the local environment; yet others imitate and import them in uncritical and unquestioning fashion and in conformity to the conditional obligations of international union membership. The former then are like the 'top students' who earn critical praise for their perspicacity and original thinking, while the latter are like the 'unmotivated students' who do just enough by means of memorizing and regurgitating the material in order to pass the class. In this paper, we extend this 'learning' analogy to account for the differential impact of external material incentives and international benchmarking on the domestic political economy of reform. More specifically, we provide a theoretical analysis of the informational content inherent in high-powered and low-powered supranational mechanisms of conditionality and compliance and how that affects short- and long-term institutional quality and performance.

Since the 1950s, numerous organizations, including the government of the United States, the World Trade Organization (WTO), 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 the 'principal', while the government of the target country is the 'agent'. Following a central theme in neoclassical economics, such policies assume that incentives (i.e., the combination of 'sticks' and 'carrots') offered by the principal uniformly 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.

Why do apparently similar countries respond so differently to external incentives schemes linked to union membership? Why, for example, does the Czech Republic so often fail to

transpose and implement EU directives, while Lithuania systematically ranks among the ‘top students’ (Maniokas, 2009)? 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?

Greece provides a characteristic example of extrinsically motivated stop-go reform cycles centered around national strategic goals or *grands projets*, such as accession to the EU or membership in the Eurozone. Yet, once the goal of international union membership has been achieved, the pro-reform impetus starts to subside to the extent that many of the pre-ordained reforms are subverted or rescinded. Policy conditionality of course does not only work in the form of a promised boon (e.g., union accession with all its perks) but also as a threatened bane (e.g., expulsion from a union), as illustrated by the various reactions to the aptly named ’Grexit’ (i.e., Greece’s exit from the Eurozone). Greece has only begrudgingly agreed to bite the bullet of extreme austerity and fiscal adjustment in deference to the dangling threat of exit and its anticipated costs. What are then the lessons learned from this ’pedagogical’ exercise and how does the shape of this extrinsic incentive package affect the long-term sustainability and desirability of reforms? Or, counterfactually speaking, what would have been the impact on Greece’s willingness to reform had it rejected the offer and effectively chosen to leave the Eurozone?

In the same vein, we seek to analyze the informational content of the explicit conditionality package attached to the Eastern enlargement of the EU. How is the post-accession performance of new EU member-states from Central and Eastern Europe (CEEC) influenced by the conditional membership contract offered to them by the Union? The evidence so far on the transposition and implementation/application behavior of CEECs is mixed. Even

though their rate of transposition of new EU rules and directives significantly outpaces that of older member states, arguably as a result of the continued effectiveness of the bureaucratic infrastructure and administrative capacity put in place for accession (Dimitrova and Toshkov, 2009), the actual on-the-ground implementation and application of these new rules (e.g., with respect to the protection of minority rights or the elimination of non-tariff barriers to trade) is all in all lagging behind. The intrinsic motivation (or political will) to achieve the intended policy outcomes of political and economic liberalization is not there for local politicians to take full ownership of such reforms and to implement them in pursuit of their originally intended effects. That is when we enter a world of weak compliers, moral hazard, 'feet-dragging', and 'muddling though'.

In other words, we show that 'institutional deficits' remain persistent over time as a result of the information transmitted through the contractual arrangements of union membership. We seek to explain pre-accession conditionality and post-accession compliance within a single dynamic and strategically intertwined theoretical framework. We rely on a principal-agent signaling model with asymmetric information to highlight the unobservable effects of (high-powered) accession conditionality and (low-powered) policy compliance mechanisms on the short- and long- term performance of peripheral union members. We find that, although in the short run countries do respond positively to extrinsic incentive schemes (high-powered conditionality) in accordance with classical economic theory, once these (low-powered) extrinsic incentives (financial aid, non-pecuniary accession benefits) get locked in, they will 'crowd out' intrinsic incentives (political will) for reform. So, 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 that

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. By making a distinction between *intrinsic* and *extrinsic* motivation, we thus derive a backward-bending long-run supply curve of structural reform policies in response to 'stick-and-carrot' conditionality packages. As part of the same equilibrium of a Bayesian game, we also show how conditional union membership contracts offered by the principal are shaped by the interplay of *intrinsic* and *extrinsic* incentives for reform, the observability of reforms at different stages of implementation, and the possibility for hidden action and moral hazard.[1]

Our contribution speaks to various strands of the academic literature. On the one hand, there is a burgeoning literature in economics, law, and political science that analyzes political principal-agent models of delegation and bureaucratization (e.g., Pollack, 2003; Franchino, 2007), oversight and implementation (e.g., Steunenberg, 2010), and conditionality (Stone, 2008). Building upon it, a number of sophisticated works on EU enlargement 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 direct function of the power of the incentives facing these countries (Böhmelt and Freyburg, 2013; Falkner and Treib, 2008; Schimmelfennig and Sedelmeier, 2005; Sedelmeier 2008, 2011; 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). What we essentially seek to do is to provide a more sophisticated and powerful version of

[1] One may think of the EMU, for example, as a contract shaped by high-powered (e.g., Maastricht convergence criteria, Memoranda of Understanding, automatic sanctions) and low-powered (e.g., Growth and Stability Pact, Fiscal Compact (?)) incentive schemes. See Winkler (1999) for a related analysis.

the external incentives governance model. We should note here that our emphasis is on the contractual aspects of union accession and membership, unlike the strand of the literature that examines the distributive considerations of EU enlargement negotiations both among existing member-states and between member-states and candidate-members (e.g., Plümper, Schneider, and Tröger, 2006; Schneider, 2009). We assume that the principal makes a single 'take-it-or-leave-it' offer to the agent, who then has to decide whether to accept it or not. This is in keeping with the notion that European integration is the 'only game in town'.

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. Differential responses constitute an empirical fact documented both in the literature on IMF conditionality (Burnside and Dollar, 2000; Mosley, Hudson, and Verschoor, 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.

There is also an extensive literature on the political economy of reforms motivated by the reform experiences of Latin American countries in the 80s and the transition economies of Central and Eastern Europe in the 90s.[2] Their emphasis is on the domestic political economy factors that reinforce the status quo bias (Fernández and Rodrik, 1991), contribute

[2] For comprehensive surveys of that literature, see Tommasi and Velasco (1995) and Rodrik (1996).

to the delay of stabilization efforts (Alesina and Drazen, 1991), or shape the size of the reform package and the pace of implementation (Dewatripont and Roland, 1992, 1995; Rodrik, 1996). Our contribution to that literature highlights the international component of international union membership and gauges the real impact of these international commitments on a country's short- and long-term reform potential.

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 characteristic of human nature. Yet, this assumption clashes with important findings in cognitive social 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, 1975; Deci, Koestner, and Ryan, 1999). This motivation 'crowding-out' effect has been well established in economic theory (e.g., Frey, 1997; Bénabou and Tirole, 2002, 2003) and documented in behavioral and experimental economics (e.g., Gneezy and Rustichini, 2000). 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.

2 A Model of Intrinsic and Extrinsic Incentives for Reform

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, our paper 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 may 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 to (and/or expulsion from) an international union. 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., $r_i = \Delta l_i$.[3] 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 relation-

[3]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.

ship.

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 $W(l_{it})$.[4] 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 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, Angeloni, and Etro, 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.[5] This rule certainly applies to existing members alike.

We find that under certain conditions agent i's *intrinsic* incentives to reform will be

[4] Since the focus of our analysis is on the contractual rather than the distributive aspects of enlargement, we assume that the principal is a unitary actor that acts in pursuit of either its own distinct agency interests, e.g., the European Commission, or the harmonious interests of existing member-states. In that sense, we abstract away from the distributive considerations of enlargement negotiations analyzed by Schneider (2009) for example. In accordance with Bénabou and Tirole's (2003) terminology, we focus on the *trust* effect of the principal's offer on the agent's motivation and we ignore the so-called *profitability* effect that would arise if the principal's gains from the agent's actions were also conditional on the latter's type, i.e., $W(l_{it}; \alpha_{it})$.

[5] 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.

'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 'discriminatory membership', whereby c can make use of several legal instruments (opt-out and derogation clauses, phase-in of membership rights and obligations, 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. A conditional union membership contract then amounts to $(A, t_i; m_i = 1)$, where m_i is an indicator function that takes the value of unity *if and only if* country i becomes or remains a full member of the union. Furthermore, the principal c derives some non-pecuniary political benefits $b_i \geq 0$ from the accession of country i, that can be conceptualized as either enhanced spillovers or a wider remit for the supranational authority.[6] Therefore, c's preferences are represented by the following utility function:

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

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

[6]The assumption of non-pecuniary benefits of enlargement to the principal guarantees that for any $t_i \leq b_i$ the contract will be renegotiation-proof, i.e., the principal will not be able to renege once the required reforms in the target country have been implemented and the adoption costs are sunk. Another argument against the potential opportunism of the principal is the notion of 'rhetorical entrapment' (Schimmelfennig, 2001) and audience costs as it relates to member-states' avowed commitment to enlargement. The fact that accession happens with probability one subject to the fulfillment of the accession criteria implies that candidate-members will do just enough to satify those criteria, i.e., they can only be extrinsically motivated to liberalize just up the level of the *acquis* A.

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., $\frac{\partial^2 V(l_{it};\alpha_{it})}{\partial l_{it} \partial \alpha_{it}} \geq 0$. 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 $\kappa(l_{it})$, where $\kappa(\cdot)$ 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. The extrinsic net transfers of union membership are assumed to be fully fungible and may be used either to empower and mobilize integration-prone groups (e.g., export-oriented industries) or to buy off the support of recalcitrant special interests and veto players opposed to further liberalization (e.g., state-dependent farmers). In addition to these monetary benefits, acceding countries also stand to gain in terms of political influence and security to the degree of $B_i > 0$.

Putting all of the above components together yields the following utility function for the agent i:

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

The first two components of the utility function $V(l_{it};\alpha_{it}) - \kappa(l_{it})$ 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,[7] 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 $\alpha_{i1} = \alpha_{i0} + \varepsilon$.[8] To rule out unintuitive equilibria, we further assume that the signal technology enjoys the following Monotone Likelihood Ratio Property (MLRP):

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

[7] 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.

[8] 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.

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 $\underline{r_i} = A - l_{i0}^*$.[9] 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 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,

[9] 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, yet it seems rather plausible in light of the uneven bargaining leverage between members-states and candidate-members in EU enlargement negotiations. Moreover, it allows us to focus on the contractual aspects of conditionality.

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

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 $V'\left(\widetilde{l}_{i1}; \widehat{\alpha}_{i1}(\sigma_i, t_i; \alpha_{i0})\right) = \kappa'\left(\widetilde{l}_{i1}\right)$ and $\widetilde{l}_{i1} = \widetilde{l}_{i1}(\cdot)$ is an increasing function of $\widehat{\alpha}_{i1}(\sigma_i, t_i; \alpha_{i0})$. This *autarchic* 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*

$$\begin{aligned} V(A; \widehat{\alpha}_{i1}(\sigma_i, t_i; \alpha_{i0})) - \kappa(A) + t_i + B_i &\geq V\left(\widetilde{l}_{i1}; \widehat{\alpha}_{i1}(\sigma_i, t_i; \alpha_{i0})\right) - \kappa\left(\widetilde{l}_{i1}\right) = \overline{U}_i \\ V(A; \widehat{\alpha}_{i1}(\sigma_i, t_i; \alpha_{i0})) - V\left(\widetilde{l}_{i1}; \widehat{\alpha}_{i1}(\sigma_i, t_i; \alpha_{i0})\right) &\geq \kappa(A) - \kappa\left(\widetilde{l}_{i1}\right) - t_i - B_i \qquad (3) \end{aligned}$$

Given that the first difference of the aggregate benefit function $V(\cdot)$ 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 $\sigma^*_i(t_i; \alpha_{i0})$ such that inequality 3 holds *if and only if* $\sigma_i \geq \sigma^*_i(t_i; \alpha_{i0})$. 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:

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

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., $\frac{\partial \sigma^*_i(\cdot)}{\partial \alpha_{i0}} < 0$. *All else equal* 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:

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

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 incentives, they sap the country's willingness to 'keep the foot on the gas' in the long-run or else to comply with the dynamically evolving *acquis* post-accession ('chasing a moving

target').[10] 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 $\sigma_i^*(t_i^*; \alpha_{i0}) > \sigma_i^*(t_i^{*\prime}; \alpha_{i0})$, i.e., the extrinsic distributive transfers of membership are positive short-term reinforcers of reform efforts,

(ii) if $\alpha_{i1} < \alpha_{i1}^{\prime}$, 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 implies that, for given $\varepsilon_i \in [\underline{\varepsilon}, \overline{\varepsilon}]$, if $\alpha_{i0} < \alpha_{i0}^{\prime}$ 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 $\sigma_i, \sigma_i^{\prime} \in [0,1]$ and $t_i^* < t_i^{*\prime} \in T_i^*$, then $E(\alpha_{i1}|\sigma_i, t_i^*, \alpha_{i0}) > E(\alpha_{i1}|\sigma_i^{\prime}, t_i^{*\prime}, \alpha_{i0})$, 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 $\alpha_{i0} < \alpha_{i0}^{\prime}$, then $\sigma_i^*(t_i^*; \alpha_{i0}) > \sigma_i^*(t_i^*; \alpha_{i0}^{\prime})$, 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.

Proof. See above. ■

[10] The mechanism described here bears eerie resemblance to the academic tenure problem. The stricter the criteria for tenure, the more confident the department can be in its selection of the best people (adverse selection) and, yet, the higher the probability of a post-tenure slump in effort (moral hazard). We thank Simon Hix for bringing this interesting comparison to our attention.

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, 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. 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 both *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 unequivocally signal to these types that they belong to the category of countries that are both *willing* to liberalize over and beyond the existing *acquis* and *able* to join the union unconditionally. 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 $t_i = -B_i$.[11]

Summing up the above *semi-pooling* equilibrium, we find that the principal c will pool on intervals of true competitiveness types $\left[\alpha_{i1}^1, \alpha_{i1}^2\right], \ldots, [\widetilde{\alpha}_{i1}, \overline{\alpha}_{i1}]$ offering decreasing levels of distributive transfers t_i^{j*} for higher values of j. The principal will also distinguish between aspiring candidate-members whose intrinsically motivated *autarchic* levels of liberalization are below (e.g., CEECs) or above (e.g., Scandinavian countries) the existing *acquis*. In equilibrium, liberalization *laggards* ($\alpha_{i1} < \widetilde{\alpha}_{i1}$) will receive a semi-pooled conditional membership contract $(A, t_i^*; m_i = 1)$ with positive net budgetary *receipts* ($t_i^* > 0$) and liberalization *pace-setters* ($\alpha_{i1} \geq \widetilde{\alpha}_{i1}$) will receive a pooled unconditional membership contract $(t_i^*; m_i = 1)$ with negative net budgetary *contributions* ($t_i^* = -B_i < 0$).

A closer look at the agent i's participation and incentive-compatibility constraints reveals an endogenous classification of non-members with respect to equilibrium contract on offer and their prospects of accession. As noted before, countries will accept any contract with $t_i \geq -B_i$; weakly negative net transfers $t_i^* \leq 0$ denote net *contributor* status (e.g., Nordic enlargement) and positive net transfers $t_i^* > 0$ denote net *recipient* status (e.g., Southern and Eastern enlargement). Countries that are *able* ($\alpha_{i1} \geq \widetilde{\alpha}_{i1}$) but *not willing* ($B_i < 0$) to join the union will reject a contract with $t_i^* \leq 0$ (e.g., Norway, Switzerland). Countries that are *willing* ($t_i^* \geq -B_i$) but *not able* ($\sigma_i < \sigma^* (t^*, \alpha_{i0})$) to join the union will reject a contract with $t_i^* > 0$ (e.g., Bulgaria, Romania in 2004 or Greece joining Stage III of EMU in 1999).

Moreover, the principal c will not seek to renegotiate or renege on the contract *ex post if*

[11] 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).

and only if $t_i \leq b_i$; hence, the interval $[-B_i, b_i]$ delimits the range of incentive-compatible high-powered incentive schemes or else the union's absorption capacity. The shrinking size of this interval over time in the case of the EU has been the main cause of its so-called 'enlargement fatigue'. Finally, there is an upper bound $\bar{t}$ such that, for any $t_i^* > \bar{t}$, the principal will find it too costly in equilibrium to offer full membership, but may instead choose to offer a lower-powered association contract $(N, t_i^* > 0; m_i = 0)$ inducing liberalization reforms up to level N in exchange for development aid $t_i^* > 0$ (e.g., EU's Stabilization and Association Process and European Neighborhood Policy).

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, Lassen, and Wehner, 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 $E(\alpha_{i1}|\sigma_i, t_i, \alpha_{i0})$. 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 seek to extract the entire surplus of accession and offer the same equilibrium accession package of $t_i^* = -B_i$ 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 on all productivity types* $[\underline{\alpha}_{i1}, \overline{\alpha}_{i1}]$ *with the same conditional membership contract of* $(A, t_i^*; m_i = 1)$*, where* $t_i^* = -B_i$*; country* i *will liberalize only to the extent of its self-perceived intrinsic motivation* $E\left(\alpha_{i1}|\sigma_i, \alpha_{i0}\right)$*.*

Of course, this version of the model constitutes the polar opposite of the benchmark case with perfectly observable reforms. A more realistic version would have to account for finite limits to the permissible size of implementation discretion, imperfect monitoring, and contract renegotiability.

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 relation to Europe's Economic and Monetary Union (EMU).

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.[12] Despite the extraordinarily high-powered nature of those incentives, 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. As a result, we think of Greece as an example of a country with a persistent 'institutional deficit', whereby a range of institutions regulating its markets have been imported or externally imposed without being internalized or locally adapted, thus giving rise to implementation drifts and second-order distortions (Kalyvas, Pagoulatos, and Tsoukas, 2012).

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, which Papandreou managed to extract in the form of the so-called Mediterranean Programs by assuming a tough bargaining stance and feigning disinterest in the benefits of membership, 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.

In the run-up to the Maastricht Treaty, Greeks' preferences underwent a dramatic change around 1989-1990, converting the country into an extrinsically-motivated reformer with extraordinary potential for economic growth. In 1990, the conservative party was elected to power with a neoliberal reformist agenda. Its economic priorities included liberalizing the

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

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'. 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 1996, extrinsic incentives were added to the intrinsic motivation for reform. The combination of (a) progress on Stage III 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 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.

When viewed within the context of their immediate international environment, the reform

trajectory of Greece and Spain, among others, highlights the salience of the contractual aspects of their relationship with their international sponsors. Liberalization reforms never take place in an vacuum; they constitute a form of policy experimentation (Callander and Harstad, 2012), a 'learning' exercise in 'trial and error' informed by the diffuse experiences of others who have come before them. Against this clutter of information-rich signals, the streams of ideas and self-perceived incentives often flow in opposite directions. We argue that the governance structure of the European Monetary Union is a telling example of this phenomenon.

On one hand, the EMU's institutional design and scope were primarily driven by the interests of the high-credibility countries of the European 'North', intent on maintaining low interest rates, currency stability, and a low-inflation monetarist policy. Yet, the success of this very ambitious endeavor of monetary unification between a number of heterogeneous national economies very much hinged on the *type* and *behavior* of all its participants. Such a union would only be sustainable and mutually beneficial if it were to consist of members that were both *able* to and *willing* to achieve a modicum of fiscal coordination and economic convergence. The existence of uncertainty and asymmetric information over countries' *ability* (adverse selection) and *willingness* (moral hazard) were two key notions that dominated the discussions over the design of the EMU's governance structure. In that sense, the EMU may be viewed as a supranational contract shaped by high-powered (e.g., Maastricht convergence criteria, Memoranda of Understanding, automatic sanctions) and low-powered (e.g., Growth and Stability Pact, Fiscal Compact (?)) incentive schemes operating both as a screening device (regulating membership in EMU) and a disciplining device (enforcing post-accession fiscal rectitude and compliance). The Growth and Stability Pact (GSP) and its Excessive Deficit Procedures (EDP) proved to be rather unsuccessful in terms of enforcing fiscal coordination across members of the EMU; in fact, the credibility of GSP as a disciplining

mechanism was effectively undermined by the fact that the first countries to violate its provisions were its two biggest signatories, i.e., France and Germany in 2004. So far, the more effective incentive schemes for fiscal adjustment and structural reforms have been those that contain an explicit promise of accession to (or threat of expulsion from) EMU conditional on the domestic implementation (or failure thereof) of a well-specified set of reform policies and measures.[13] In this paper, we have shown why this is true in the short run and what the implications are for long-term real convergence.

We have also argued how the weak observability and verifiability of effective reforms has created room for moral hazard under the guise of fiscal profligacy, gimmickry, and opportunism (Alt, Lassen, and Wehner, 2012). In that event, we show why contract designers (principals) opted for policy uniformity and pooling of monetary policy to a supranational, independent European Central Bank (ECB). The existence of moral hazard would also explain the commonality of the Maastricht convergence criteria as coordinating mechanisms benchmarking the reform efforts of heterogeneous national government (Winkler, 1999). As explained above, any attempt to differentiate and adjust the yardstick of membership to each government's intrinsic capacity for reform would result in a counter-productive effect and a less than desired supply of convergence reform efforts.

[13]Additional considerations that affect the negotiation and execution of such a complex contract include the credibility of those threats and promises, the problem of time inconsistency and renegotiability once the conditionality criteria have been fulfilled, and the question of reversibility of union formation and the negative spillover effects of exit from an international union. These are all noteworthy elements of the contractual negotiations between a principal and an agent that fall beyond the scope of this paper. In Greece, for example, the left-wing main opposition party SYRIZA has been advocating the abrogation of the Memorandum and the renegotiation of the Bailout Agreement effectively banking on the country's 'too-big-to-fail' status and the deep and prolonged recessionary effects of austerity.

4 Conclusions and Implications

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, we focus on the informational content of conditionality packages as extrinsic incentive schemes and thereby try to explain the variation in the liberalization trajectories of target countries. This paper argues that under certain conditions *extrinsic* 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.

The proposed theoretical mechanism has several interesting implications with respect to other aspects of regional integration, such as cohesion and regional policy. Our theory poses a clear challenge to the conventional wisdom about the role of Cohesion and Structural Funds in the EU. Even though the cross-subsidization of physical (e.g., transportation infrastructure) and human (e.g., training and job skills programs) may contribute towards real long-term convergence across regions by boosting their overall competitiveness, it may also have the adverse effect of undermining member-states' willingness for capital investments and market

reforms. In the absence of an explicit 'matching grants' scheme, net recipient peripheral countries will develop a form of 'addiction' and grow increasingly dependent on these transfers from richer member-states. The more funds they receive over time, the less confident they become in their intrinsic capacity to reform and converge towards the policies, incomes, and competitiveness levels of the core. Taking the 'addiction' analogy further, the more peripheral countries lie at the receiving end of these redistribution schemes, the bigger the 'hangover' will be if and when these transfers are withdrawn. As a matter of fact, Ireland is the only case of a peripheral country that has shifted from net *recipient* to net *contributor* status (mostly on account of a substantial rise in Foreign Direct Investment from outside the EU) only to come back to the receiving end of Bailout Funds in the aftermath of the Global Financial Crisis in 2008.

A more sophisticated analysis of the role of incentives as applied to the political economy of reforms is necessary for the study of the effects and implications of conditionality, compliance, and redistribution in the context of regional integration. Even more so as the EU is far from a federal entity and, therefore, the policymaking discretion of its constituent member-states remains significant, we need to understand how the contractual elements of the relationship between *core* and *periphery* members of an international union impinge upon their respective incentives to liberalize and coordinate their policies towards a common *acquis*. The complex interaction between information, ideas, and incentives is an important research project that can inform current debates on the governance structure of the EU in the midst of its unraveling debt crisis.

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