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## KNOWING THE LIMITS

**It seems impossible to define “vital interests” in legal terms or to list a number of cases in which the vital interests of a state would be considered in jeopardy . . . . So who decides whether a member state’s vital interests are at stake? I’m not sure there is a solution to this problem.**

—A senior official in the German Foreign Ministry, January 1965

The EU legislative process is governed by a norm of discretion, which prescribes that governments facing unmanageable domestic pressure ought to be accommodated. The norm of discretion manifests itself in collective informal governance practices at every step of the EU’s legislative procedure. However, the norm’s precise boundaries are vague; they are also prone to abuse when it is difficult to verify that legitimate demands are being made for the use of informal governance. This means that the actual use of informal governance is fraught with difficulties, since the governments are bound to disagree about its necessity. Disagreements about the necessity of informal governance, however, cast more general doubts about the credibility of one another’s actual commitment to cooperation. There is, consequently, a tension between formal rules and informal governance, since doubts about the legitimacy of the latter erode the effectiveness of the former.

The chapter-opening quote by a senior official in the German Foreign Ministry demonstrates that the member states have been remarkably aware of this problem from the outset. The note was written in the context of the 1965 “empty chair crisis” following De Gaulle’s demand to codify the right of a national veto in situations where “vital interests” are at stake. Although consensus decision making had been the norm in the Council from the outset, since all member states agreed about the necessity to refrain from majority voting for political reasons, France’s cooperating partners feared that the legalization of this norm would in fact undermine the commitment that the formal voting rules represented. The German official goes on to explain:

Although majority voting is legally justified, its actual use has to be a political decision. No state should be overruled if this puts its vital interests in jeopardy... However, if we refrained from voting each time a member state declares its vital interests to be at stake without having to justify this assertion or obtain the other member states' approval, this would in fact result in the abdication of the principle of majority voting. (Auswärtiges Amt 1965)

To resolve the tension between formal commitments and informal flexibility, the member states have had to find a way to determine in each situation whether formal rules apply or whether informal governance is pertinent. The purpose of this and the following two chapters is to show how the EU member states manage this problem.

The central argument in this chapter is that states meet this challenge by delegating this decision to a trustworthy actor who elicits information about the actual demand for informal governance in each situation. This argument is developed in six steps. As a first step, we explain how the informal norm of discretion brings about a demand for additional institutions to cope with the classical problem of moral hazard. Drawing on the economic literature on insurance markets, the second step discusses several solutions for the problem such as penalties and investigation. The third step argues that the solutions that are commonly invoked in the rational institutional design and international law literature are, in fact, ill suited for the problem at hand. The fourth step develops this insight further: we argue that, in order to guarantee that a sufficient level of discretion is granted, governments delegate the authority to adjudicate the use of informal governance to another member government that is biased against the demand for accommodation. The fifth section specifies this hypothesis in the empirical context of the EU, arguing that the member states holding the EU's Council presidency may under certain circumstances wield adjudicatory authority, and explains how this hypothesis can be tested against rival theories. This exercise sets the stage for the empirical analysis, which traces the theories' predictions regarding the development of the Council presidency's adjudicatory practices and prerogatives (chapter 7) and its role in the negotiation of the EU's Working Time Directive (chapter 8). This chapter concludes with a look ahead to the findings of this empirical analysis.

## **Informal Discretion, Ambiguity, and Moral Hazard**

Informal governance adds flexibility to otherwise rigid formal rules where governments might face excessive domestic pressure to defy their commitment. Let

us assume for one moment that all member governments are perfectly able to observe the nature and extent of the domestic pressure on their cooperating partner. In this situation, all states have an incentive to accommodate this government even without an explicit quid pro quo, because they all want to prevent this government from defying its commitment in order to uphold the highly beneficial level of integration among them.

Yet these conditions do not hold in reality. In some situations, it may be obvious to all governments that informal governance is necessary. Borderline cases, however, are bound to generate conflicts among governments. The problem is aggravated when the governments, as they usually are, are better informed about their own domestic situation than their cooperating partners, since this informational advantage creates incentives to abuse the norm. To once again draw a comparison between the norm of discretion and car insurance: the probability of car accidents is not entirely beyond our control, but it is to some extent influenced by our driving behavior. Comprehensive coverage for accidents may then induce me to drive more recklessly or to fake an accident in order to claim the full insurance sum. The informal norm of discretion, just like car insurance, may also induce behavior that undermines the very purpose of the norm in that governments have an incentive to exaggerate the domestic pressure they are under in order to, for example, protect special interests or manipulate the terms of trade in their favor (Feenstra and Lewis 1991, 1288; Goldstein and Martin 2000, 621). Put differently, the informal norm of discretion creates a classical problem of moral hazard.

This problem casts doubt on the feasibility of informal governance in practice. If states are aware of the fact that the norm of discretion is prone to abuse, then the credibility of the formal commitment that this norm is supposed to protect sustains damage after all. It consequently creates a demand for additional institutions that allow the governments to collectively discriminate between false or exaggerated and legitimate demands for informal governance.

## **Alternative Solutions for Problems of Moral Hazard**

How can states resolve the problem of moral hazard? The economic literature on insurance offers two suggestions (Shavell 1979), both of which have found their way into the literature on institutional design.

*Coinsurance*, or incomplete coverage, prevents moral hazard by making the insured bear some costs of a claim. Making the driver share the costs of an accident, for instance, induces him to drive less recklessly. Accordingly, making a

government pay a penalty for the use of informal governance should induce it to be less susceptible to domestic pressure for defection. This solution underpins a number of formal models on flexibility mechanisms in trade agreements. For example, George Downs and David Rocke (1995, 77) argue that sanctions in response to defection have to be low enough to allow politicians, in response to domestic pressure, to break the agreement from time to time, but still just high enough to prevent states from caving in to domestic pressure all the time. Peter Rosendorff and Helen Milner (2001, 835), among others, argue that coinsurance is the rationale behind the design of escape clauses. For example, Article XIX of the General Agreement on Tariffs and Trade authorizes temporary protection in the event that import surges threaten to cause serious damage to an industry. In order to discourage overuse of this escape clause, governments must pay a penalty for invoking it. Similarly, Randall Stone (2011, 35) argues that large states pay a fixed cost to the small states when taking informal unilateral control of an international organization—a cost that prevents the large state from using informal governance excessively.

Another commonly invoked solution for the problem of moral hazard is *observation*, which prevents the abuse of insurance by using situational information to determine whether an event is covered by an insurance policy. In the case of car insurance, for instance, companies often pay experts to gather information about the actual cause and severity of an accident. Competition and certification schemes are supposed to prevent conflicts of interest and induce the expert to report truthfully. In international politics, this translates into third-party adjudication about the legitimacy of demands for flexibility. According to B. Peter Rosendorff, this rationale underpins the GATT Dispute Settlement Procedure. This procedure delegates to a panel the task of adjudicating on rule violations and setting a level of sanctions, the payment of which permits the violator to signal its willingness to stick to its commitment in normal times:

The institution then serves a crucial information-providing role. It establishes the facts, adjudicates on a violation, estimates the damages, and reports a successful completion of the process. It is this informational role of the DSP [Dispute Settlement Procedure] that determines its effectiveness in the world trading system. (Rosendorff 2005, 391)

## **Moral Hazard Solutions and Political Uncertainty**

How adequate are these solutions for the problem of moral hazard in the context of an informal norm of discretion? Coinsurance on the basis of a preset penalty

is in fact inadequate for our purposes. Insurance companies usually know quite well how, for example, full coverage will affect their clients' driving behavior. However, political uncertainty, against which states "insure" themselves through the norm of discretion, lies by definition beyond the realm of things that states know when designing institutions. They are consequently unable to determine the optimal size of a preset penalty that would discourage the abuse of the norm. If states nevertheless made the use of informal governance conditional on the payment of such a penalty, this would lead to several economic inefficiencies<sup>1</sup> and generate intense conflict about the legitimacy of informal governance in practice. Unsurprisingly, states often invoke escape clauses without requiring the beneficiary to pay a penalty for using them (Pelc 2009). Similarly, there is little evidence that the United States pays any kind of costs when it makes use of informal governance in the International Monetary Fund. In fact, Stone (2011, 217) shows that United States does abuse informal governance, and that these practices have weakened the IMF.

Observation seems a more promising candidate than coinsurance. However, not all actors are equally adequate for this purpose in the context of the norm of discretion. Recall that the norm of discretion remains deliberately informal, since the accommodation of excessive domestic pressure per se seems to betray the institution's purpose. Consequently, institutional actors such as courts and bureaucracies that are pledged to upholding the rule of law cannot adjudicate on the use of informal governance. Although legal bodies are often given broad discretion in the interpretation of rules, the rule of law requires these bodies to do so in a consistent manner. Yet, as the chapter-opening quote notes, this is not possible in the case of political uncertainty. Institutional actors that derive their authority from their pledge to enforce the rule of law would consequently jeopardize their reputation if they were to recommend the use of informal governance. This is, after all, a political decision that needs to be made by political actors.

## **Final Adjudicatory Authority**

If coinsurance in the form of preset penalties is inadequate, and observation in the form of third-party adjudication also seems ill suited for our purposes, how do governments elicit the information that is necessary to determine whether formal rules apply or whether informal governance is pertinent? In principle, the governments themselves are best placed to assess whether imminent damage to the commitment justifies the use of informal governance. However, decisions to accommodate a cooperating partner through informal governance may also have nonnegligible distributional effects that create conflicts of interest.

Thus, the authority to decide the use of informal governance cannot lie with the government (the claimant) that says it is facing excessive domestic pressure, since its incentives to exaggerate the case for its personal benefit gives rise to the problem of moral hazard to begin with. In formal language, one would say that if the claimant's ideal point is located far away from the law in question, it has no incentive to report truthfully the actual pressure it is facing at home. For the same reason, the authority to decide on the use of informal governance also cannot lie with a government with a similar ideal point that would personally gain from the accommodation of another government, because it has an incentive to collude with the claimant and recommend the use of informal governance in order to change the law in question even if it is not necessary.

However, states can trust the judgment of a government that does not personally gain from recommending concessions to the claimants. If the claimant opposes the law in question, whereas the adjudicating government supports it, then the only reason for the latter to recommend the accommodation of the former through informal governance is to prevent a costly disruption of the international organization. Again in a more formal language, one would say that the adjudicating government's ideal point is located close to the law in question, but far away from the claimant. In this situation, the adjudicating government's bias against the claimant makes its judgment about the need to move closer to the claimant trustworthy in the eyes of other member states (Calvert 1985, 552).<sup>2</sup>

Interestingly, for the adjudicating government to make an informed decision, it need not actively collect information about the claimant's motives. Since there are various ways to provide flexibility, all of which have different distributional consequences (Pelc 2011), its authority alone induces actors with a stake in the outcome to increase the level of available information about the situation in order to prevent a false, unfavorable judgment (Dai 2002, 413–15; McCubbins and Schwartz 1984).

## **Testable Implications and Alternative Explanations**

The theory of informal governance elucidated above is more explicit than other theories about the source of final authority over the use of the norm of discretion. This section therefore draws on existing studies in the tradition of power-based institutionalism and classical regime theory, and then seeks to derive testable implications of our theory and rival theories about this authority in the EU context.

## Liberal Regime Theory

What would an arrangement for fair adjudication of a claim for informal governance look like in the institutional context of the EU?

There are, in principle, two ways to accomplish the delegation of adjudicatory authority to a member government that is biased against the claimant. One is the delegation of adjudicatory authority on each issue under negotiation to a government that supports the legislative proposal in question and is, therefore, biased against claimants that demand to change this proposal through informal governance. One might object that the member states cannot know one another's preferences at the beginning of a negotiation. In the EU, however, the broad contours of states' preferences in the Council of Ministers are common knowledge, even if they are usually better informed about their susceptibility to domestic interests than about another government's breaking point.<sup>3</sup> Yet this solution seems impractical in light of the fact that the EU adopts hundreds of legal acts each year; it would be quite cumbersome to choose a different suitable adjudicator for each and every legal dossier under discussion.

A second solution seems more appropriate for the specific context of the EU. The treaty envisages that the country holding the presidency of the Council of Ministers, which is an office rotating on a six-month basis among governments, convenes and organizes Council meetings. Thus, the member states could also just delegate adjudicatory authority to the Council presidency. To make sure they can trust the presidency's judgment, they would have to compel the government in office to drop those legislative proposals from the legislative agenda that it opposes and keep those that it endorses on the agenda. If this was not the case and the government holding the presidency recommended the use of informal governance in the case of a legislative proposal it opposes, other member states would not be able to trust and defer to its judgment.

Two testable implications follow. First, because the norm of discretion gives rise to a demand for adjudication, the informal governance practices that we have described coevolve with adjudication practices and prerogatives on the part of the Council presidency. Second, because other member states will only trust the judgment of a government that is not suspected of colluding with the claimant, they defer to the presidency only when the government in office is biased against the claimant. *Ceteris paribus*, they defy the presidency's judgment when the government in office and the claimant share similar preferences. Anticipating this reaction, the government in office will keep legislative proposals like this off the agenda, even if the claimant's demands are justified.

## Power-Based Institutionalism

Conceiving of informal governance as a means for powerful states to eschew formal rules in issue areas that are particularly sensitive, a power-based theory of informal governance would not expect dominant states to make their use of informal governance dependent on the judgment of another government. In Stone's model of informal governance, for example, it is the dominant state that, after the payment of a fixed cost, decides to take informal control of an institution when urgent strategic objectives override its long-term interest in the institution (Stone 2011, 35).

The model implies that an existing institution like the Council presidency will wield informal authority only when a dominant state assumes this office. Accordingly, there is no intrinsic connection between the practices of informal governance and the Council presidency's informal authority. Nor can we expect dominant states to pay deference to the adverse judgment of a small state holding the presidency.

## Classical Regime Theory

For classical regime theory, informal governance is the result of uncodified institutions that states design to reduce the relative costs of transactions among them. In a brilliant book, Jonas Tallberg (2006, 3) interpreted the emergence of the Council presidency along these lines. In his view, multilateral decision making among governments in the Council is fraught with various problems that bring about a demand for leadership. For example, when agendas are "unstable, overcrowded, or underdeveloped" (Tallberg 2006, 21), states delegate agenda-management power to the presidency. In addition, when governments lack complete information about one another's preferences on an issue, they delegate to the presidency the task of brokering among them (Tallberg 2006, 24–27).<sup>4</sup> In other words, the presidency is vested with a number of procedural prerogatives that allow it to raise the overall efficiency of negotiations in the Council. It therefore wields authority by virtue of its office, not its power or its stance on an issue, and may well use it in order to manipulate the agenda and decisions in its favor (Tallberg 2006, 31–33).

This implies that the presidency's practices and prerogatives emerge systematically with increasingly intense bargaining problems, and not with political uncertainty. Therefore, according to Tallberg, the presidency gained in prominence in response to the sudden leap in legislative activity and the accession of three more members to the EU from the late 1960s onward. Furthermore, since the presidency enjoys authority by virtue of its office, other governments, small and large, generally pay deference to its decisions.

**TABLE 8** Summary of specific hypotheses about adjudication

IMPLICATION	THEORY		
	LIBERAL REGIME	POWER-BASED INSTITUTIONALISM	CLASSICAL REGIME
<b>PRESIDENCY PREROGATIVES</b>	Emerges systematically in parallel to other practices of informal governance.	Emerges independently of other practices of informal governance.	In response to an increase in the complexity of decision making.
<b>ADJUDICATORY AUTHORITY</b>	The presidency wields authority when it is biased against the claimant. Member states deny deference when this is not the case.	Powerful states wield authority, but do not pay deference to unfavorable judgments by small-state presidencies.	All governments in charge wield authority by virtue of the office.

## A Look Ahead to Subsequent Chapters

The following two chapters trace the theories' implications using various qualitative data. Altogether, the collective evidence of chapters 7 and 8 provide strong support for Liberal Regime Theory's second hypothesis concerning adjudication on informal governance.

Drawing on archival material and practitioner reports, chapter 7 evaluates the claim that the development of informal governance that we have described is directly related to the development of adjudicatory practices on the part of the presidency. Thus, it shows that the member states' practice of consensus decision making went hand in hand with the presidency's prerogatives to call a vote in the event that a government's demands for accommodation were found unjustified. Similarly, the practice of sending the Commission's proposals straight to the informal Council substructure before discussing them officially among ministers afforded the Council presidency the ability to restructure the legislative agenda according to new priorities. A mini case study on the negotiation of the End-of-Life Vehicles Directive between 1997 and 2000 that tackles the problem of automotive waste indicates that other member states typically compel the government holding the presidency to drop legislative proposals from the agenda when they cannot trust its judgment.

Chapter 8 presents a case study of the negotiation of the Working Time Directive from 1991 until 1993 under six different presidencies. This study assesses in depth the conditions under which other governments defer to the presidency's judgments on the use of informal governance and formal voting rules. In this

case, a legislative proposal on the Europe-wide mandatory regulation of working time threatened to impose excessive adjustment costs on British employers. The proposal immediately caused strong resistance from numerous domestic groups, causing the UK government to appeal to its cooperating partners to refrain from majority voting and to alleviate British adjustment costs. However, the legitimacy of the UK government's demand to be accommodated through informal governance was dubious. It consequently took six successive presidencies to determine whether they should call a majority vote on the proposal or alternatively include the UK in formulating a consensus around a modified proposal. The analysis shows that governments holding the presidencies enjoy adjudicatory authority only when it is biased against a claimant—that is, its authority is critically dependent on its trustworthiness, not the office itself or power asymmetries.

In sum, the following chapters suggest that the Council presidency serves to resolve the tension between formal and informal institutional elements that builds up when there remain doubts about the legitimate use of informal governance. By rendering informed judgments about the true demand for informal governance, the member states are able to add situational flexibility to the formal rules without necessarily undermining the credibility of the commitment that these rules embody.