
Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach

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I. Introduction

The European Community (EC) is the most successful example of institutionalized international policy co-ordination in the modern world, yet there is little agreement about the proper explanation for its evolution. From the signing of the Treaty of Rome to the making of Maastricht, the EC has developed through a series of celebrated intergovernmental bargains, each of which set the agenda for an intervening period of consolidation. The most fundamental task facing a theoretical account of European integration is to explain these bargains. Today many would revive neo-functionalism's emphasis on *sui generis* characteristics of EC institutions, in particular the importance of unintended consequences of previous decisions and the capacity of supranational officials to provide leadership.

This article joins the debate by reasserting the self-critique, advanced almost two decades ago by Ernst Haas and other leading neo-functionalists, who

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suggested that European integration can only be explained with reference to *general* theories of international relations. The basic claim of this article is that the EC can be analysed as a successful intergovernmental regime designed to manage economic interdependence through negotiated policy co-ordination. Refinements and extensions of existing theories of foreign economic policy, intergovernmental negotiation, and international regimes provide a plausible and generalizable explanation of its evolution. Such theories rest on the assumption that state behaviour reflects the rational actions of governments constrained at home by domestic societal pressures and abroad by their strategic environment. An understanding of the preferences and power of its Member States is a logical starting point for analysis. Although the EC is a unique institution, it does not require a *sui generis* theory.

The article is divided into five sections. The first reviews the legacy and limitations of neo-functional theories of regional integration, and introduces an alternative approach, liberal intergovernmentalism, drawing on contemporary theories of international political economy. The second and third present the components of liberal intergovernmentalism: a liberal theory of how economic interdependence influences national interests, and an intergovernmentalist theory of international negotiation. The fourth suggests how international institutions augment, rather than restrict, the ability of governments to achieve domestic goals. Applications and extensions of theories of regimes and 'two-level games' predict the circumstances under which governments delegate and pool sovereignty. A brief conclusion summarizes the results.

II. From Pre-Theory to Theory

1. The Limitations of Neo-Functionalism

The theoretical core of scholarship on the EC is over a quarter of a century old. Neo-functionalism, developed and refined between 1955 and 1975 by Haas, Philippe Schmitter, Leon Lindberg, Stuart Scheingold, Donald Puchala, Joseph Nye and many others, remains the most comprehensive and sophisticated attempt to provide a general theory of European integration and a touchstone for subsequent scholarship (Haas, 1958; Lindberg, 1963; Lindberg and Scheingold, 1970; Nye, 1968; cf. Taylor, 1983; Pentland, 1973). Since 1975, despite many insightful case studies of specific issue-areas, overviews of EC history, and criticisms of neo-functionalism, no comparable theoretical synthesis has appeared (Wallace *et al.*, 1983; George, 1985, 1992; Bulmer, 1986).

The neo-functionalists' central prediction was that European economic integration would be self-sustaining. The theoretical basis for this prediction was the concept of 'spillover', whereby initial steps toward integration trigger

endogenous economic and political dynamics leading to further co-operation. Underlying spillover is a form of 'economic determinism' based on the 'end of ideology' and the advent of a world in which 'the technocrat has become the *eminence grise* of all government ... national and regional'. Economic planning at the regional level is an inevitable response to the complexity of modern economies. It is 'merely the adaptation ... of forms of social and economic organization which evolved historically at the national level' (Haas, 1964a, p. 62; Haas and Schmitter, 1964, p. 707; cf. Lindberg and Scheingold, 1970). Yet the same complexity is likely, over the longer term, to trap governments in a web of unintended consequences spun by their own previous commitments. Neo-functionalists identify two sorts of spillover, each of which deepens and widens integration by working through interest group pressure, public opinion, elite socialization or other domestic actors and processes (George, 1985).

The first, *functional spillover*, occurs when incomplete integration undermines the effectiveness of existing policies, both in areas that are already integrated and in related sectors of the economy, thereby creating pressure for deepening and widening policy co-ordination. Functional spillover is economic: it reflects the tightly interlinked nature of modern economies, in which government intervention in one sector engenders economic distortions elsewhere. Any 'halfway house' between sovereignty and integration is therefore unstable; without continuously strengthened policy co-ordination, the EC would fail to cope with 'complexly linked and highly controversial issues on the European agenda' and thus lose its legitimacy (Haas, in Caporaso and Keeler, 1993, p. 20).

The second, *political spillover*, occurs when the existence of supranational organizations sets in motion a self-reinforcing process of institution-building. The regulation of a modern integrated international economy requires technocratic oversight by supranational authorities. In the case of the EC, these are officials, judges and parliamentarians in Brussels, Luxembourg and Strasbourg. These authorities inevitably gain a certain measure of autonomous initiative. Neo-functionalists stress in particular the political role of the Commission, 'the archetype of an activist bureaucracy'. 'Administrators' in the Commission 'engineer integration' by 'seizing upon crises' to engage in 'creative personal action', articulating goals, recruiting and organizing officials, proposing new policies, or brokering bargains (George, 1993; Pentland, 1973, p. 117; Lindberg and Scheingold, 1970, pp. 82-95).

Despite the richness of its insights, neo-functionalism is today widely regarded as having offered an unsatisfactory account of European integration (Hoffmann, 1966; Hansen, 1969; Taylor, 1983; Haas, 1975; Keohane and Nye, 1975; Webb, 1983; Keohane and Hoffmann, 1991; Cornett and Caporaso, 1992). The most widely-cited reason is empirical: neo-functionalism appears to

mispredict both the trajectory and the process of EC evolution. Insofar as neo-functionalism advances a clear prediction about the trajectory of EC over time, it was that the technocratic imperative would lead to a 'gradual', 'automatic', and 'incremental' progression toward deeper integration and greater supranational influence (Haas, 1964a, p. 70; 1967, p. 327; 1976, p. 176). Instead, however, the process of Community-building has proceeded in fits and starts through a series of intergovernmental bargains. Nor has the process by which integration takes place supported the neo-functionalist view. Integration has only intermittently spilled over into related sectors and policies and, at least until recently, the autonomous influence of supranational officials has increased slowly and unevenly, if at all.

While empirical critiques of neo-functionalism are not without merit, they should not be overstated. To be sure, the empirical evidence does not seem to confirm the stress placed by neo-functionalism on political spillover and the autonomy of supranational officials. But other premises, particularly the focus on economic interests, may still be viable. It remains plausible, for example, to argue that integration is a distinctive policy response of modern welfare states to rising economic interdependence.

A more incisive criticism of neo-functionalism is theoretical, namely that it failed to generate an enduring research programme because it lacked a theoretical core clearly enough specified to provide a sound basis for precise empirical testing and improvement. Only the early variants of neo-functionalism predicted a steady development toward federalism. Faced with the failure of European integration to advance steadily, and variation in integration across issues, time-periods or countries ('spillback', 'spill-around', 'encapsulation'), however, neo-functionalism provided no clear direction for revision.¹

As a result, further development in neo-functionalist theory seemed to converge toward an increasingly complex and indeterminate ideal-typical description of the single case of the EC. Increasing numbers of epicyclical modifications and alternative causal mechanisms were introduced, until the predictions became so indeterminate as to preclude precise testing. Descriptions of alternative causal mechanisms proliferated, some diametrically opposed to the theory's initial focus on technocratic management and economic planning. The uneven development of the EC in the 1960s, for example, was interpreted as a result of the influence of 'dramatic political actors', of which de Gaulle was the archetype – an account theoretically unrelated to Haas's earlier predictions and, moreover, empirically unsatisfying, since the malaise outlasted de Gaulle's

¹ Haas (1976) p. 183. In Lindberg and Scheingold, there are five alternative models, only one of which is spillover; Nye expanded this to seven process mechanisms or 'actor strategies', only two (1 and 3) of which related to spillover. cf. Pentland (1973) p. 119; Lindberg and Scheingold (1970) pp. 134–9; Schmitter (1971) pp. 232–64. For an overview, see Nye (1971) pp. 64–75.

presidency. By the end of the 1960s, almost any process of decision-making among democratic states was consistent with the theory (Lindberg and Scheingold, 1971).

Underlying neo-functionalism's failure to develop predictions about variations in the evolution of the EC was its lack of grounding in underlying general theories of domestic and international political economy. In international political economy, as in other social phenomena, it is widely accepted that prediction and explanation, particularly over time, require theories that elaborate how self-interested actors form coalitions and alliances, domestically and internationally, and how conflicts among them are resolved. Such theories must be derived independently of the matter being studied, in the sense that they require a set of restrictive microfoundations – assumptions specifying the nature of the fundamental social actors, their preferences, and the constraints they face.² In this regard, neo-functionalism is both oddly apolitical and lacking in any aspiration to generality, in that it advances long-term predictions about the future of the EC without underlying, more specific theories that identify the decisive determinants of politicians' choices among competing alternatives. While stressing the domestic politics of economic policy co-ordination, neo-functionalism lacks an equivalent to modern theories of trade policy, which explain government choices on the basis of models of pressure from predictable distributional coalitions. Neo-functionalism, as Lindberg and Scheingold put it, describes domestic processes, but 'says little about *basic causes*' of variation in national demands for integration (Lindberg and Scheingold, 1970, p. 284, emphasis in original). Neo-functionalist analyses of international bargaining point to the existence of dynamics such as log-rolling, compromise, and upgrading the common interest through linkage and supranational mediation, but offer no explanation – except the variable skill of supranational leaders – of how governments choose among them.

Neo-functionalism's *ad hoc* approach eventually detached it from rich currents in general theories of international political economy over the past two decades (cf. Keohane and Nye, 1975). With the exception of a few studies of (largely unsuccessful) attempts at regional integration among developing countries, the EC came to be treated as a *sui generis* phenomenon, thereby impeding efforts at theoretical generalization.³ This was based in large part on the *a priori* expectation that Europe would develop in a federal direction, which led neo-functionalists to stress the uniqueness of its institutional structure, rather than analogies to other forms of interstate co-operation. The possibility of explaining integration in terms of theories of interdependence, regimes or other generaliz-

² For a general defence of this approach, see Coleman (1990).

³ An empirical exception is Haas (1966) pp. 93–130. Haas examines other international regimes, but his theoretical explanation is inductive, rather than grounded in micro-analysis of processes.

able phenomena was thereby lost, while the potential for useful comparison and theoretical development remained limited (Pentland, 1973, pp. 189–94). For this reason, neo-functionalism remains today an inductively derived ideal-type, rather than a general theory – in the words of its creator, a ‘pre-theory’ of regional integration.

2. The Legacy of Neo-Functionalism

The success of the EC in recent years has fuelled efforts among scholars to resurrect neo-functionalist models, in particular those that stress the unintended consequences for Member States of leadership exercised by supranational actors, including Commission officials and European parliamentarians (Ross, 1992; Peterson and Bomberg, 1993; Sandholtz, 1992; Pederson, 1992). This body of work repeats many neo-functionalist themes, if sometimes by other names. Yet current efforts to resurrect neo-functionalism rarely address the conclusions that neo-functionalists themselves drew about the weaknesses of their approach, nor do they consider the implications for current theory-building of theoretical developments in international relations theory over the intervening two decades. The functionalist legacy, combined with contemporary theories of international political economy, suggests at least three important conclusions.

First, by 1975 leading neo-functionalists were nearly unanimous in arguing that ‘regional integration theory’, which had sought to explain the progress of the EC along the *sui generis* path toward a future federalist endpoint, should be supplemented, perhaps supplanted, by a general theory of national policy responses to international interdependence. Rather than focusing on the future aspirations that make the EC unique, neo-functionalists argued that the emphasis should be on generalizable aspects of the current activities of the EC. Recognizing the central importance of economic management among those activities, Haas came to believe that ‘the study of regional integration should be both included in and subordinated to the study of changing patterns of interdependence’ (Haas, 1975).

In the language of modern theories of international political economy, this implies that the EC should be treated as an international regime designed to promote policy co-ordination. As Hoffmann, Haas’s erstwhile critic, asserted in 1982, ‘the best way of analyzing the EEC is ... as an international regime’ (Hoffmann, 1982, p. 33). International regimes promulgate ‘principles, norms, rules, and decision-making procedures around which actor expectations converge’ in given issue-areas, through which ‘the actions of separate individuals or organizations – which are not in pre-existing harmony – [are] brought into conformity with one another through a process of negotiation ... often referred

to as policy co-ordination’ (Krasner, 1983, p. 1; Keohane, 1984, p. 51). Regime theory provides a plausible starting point for analysis – a set of common conceptual and theoretical tools that can help structure comparisons with other international organizations, as well as internal comparisons among different cases of EC policy-making. At the same time, however, contemporary regime analysis requires refinement to take account of the unique institutional aspects of policy co-ordination within the EC, as evidenced by the depth of its purported goals, the richness of the networks it sustains, and, above all, the solidity of its supranational legal identity (Keohane and Hoffmann, 1991).

Second, the neo-functionalist legacy suggests that explanations of integration require stronger underlying theories of variation in substantive, as well as institutional, outcomes. The neo-functionalists were concerned overwhelmingly with ‘tracing progress toward a terminal condition called *political community* – the evolution of a unique, potentially federal political structure in Europe that would prevent war and guarantee peaceful change’ (Haas, 1966, p. 94; Lindberg and Scheingold, 1970, p. 99). Accordingly, they limited their definition of integration almost exclusively to institutional characteristics of the EC – the scope and institutional form of common decision-making. This discouraged attention to distributional conflicts in the EC over issues such as the level of external tariffs, agricultural prices, or regulatory harmonization, which require attention to the substantive measures of policy co-ordination. An instructive example is the creation of the CAP in the 1960s. While the neo-functionalists emphasize the Commission’s success in creating a policy *formally* under the control of the EC, they overlook the fact that it was a defeat for the Commission’s original *substantive* proposal, which foresaw a prudently limited, self-financing, relatively low-price regime.⁴

A broader definition of European integration might consider four dimensions of policy co-ordination: (1) the *geographical scope* of the regime; (2) the *range* of issues in which policies are co-ordinated; (3) the *institutions* of joint decision-making, implementation and enforcement; (4) the *direction and magnitude of substantive domestic policy adjustment*. These four elements may be thought of as different dimensions of the same underlying variable, namely policy co-ordination. While the first three are similar to those employed by neo-functionalists, the fourth – the direction and magnitude of substantive policy adjustment – is based on the view that policy co-ordination is most significant where it imposes greater adjustment on domestic policy. Since the costs and benefits of the necessary adjustments generally vary across countries, the measure also helps in the analysis of distributional conflict.

⁴Lindberg’s otherwise insightful analysis in *Political Dynamics* largely overlooks this distinction. See also Von der Groeben (1982).

Third, by the 1970s, many neo-functionalists had concluded that unicausal theories are unable to account for EC policy-making. More than one theory is required (Puchala, 1972; Pentland, 1973, pp. 189–94; Cornett and Caporaso, 1992). Modern theories of international political economy suggest a number of empirical, theoretical and philosophical reasons, discussed in more detail in the next section, to treat the need for multicausal explanation as a *general* principle. Empirically robust explanations of international policy co-ordination are likely to incorporate, at a minimum, theories of both national preference formation and intergovernmental negotiation, each grounded in explicit assumptions about actor preferences, constraints and choices (Moravcsik, 1992b). The vagueness of neo-functionalist predictions suggest, moreover, that only such theories can explain, rather than simply describe, the evolution of the EC. Only by meeting these criteria, most neo-functionalists felt, could scholars move from 'pre-theory' to theory.

3. Liberal Intergovernmentalism and the Rationality Assumption

Rather than resurrecting neo-functionalism, the approach introduced here takes seriously the self-criticisms of neo-functionalists examined above. They point toward a conception of the EC more closely in line with contemporary theories of international political economy. Such theories suggest that the EC is best seen as an international regime for policy co-ordination, the substantive and institutional development of which may be explained through the sequential analysis of national preference formation and intergovernmental strategic interaction.

This section proposes a framework within which to construct such an explanation, termed 'liberal intergovernmentalism'. Liberal intergovernmentalism builds on an earlier approach, 'intergovernmental institutionalism', by refining its theory of interstate bargaining and institutional compliance, and by adding an explicit theory of national preference formation grounded in liberal theories of international interdependence (Moravcsik, 1991). Various specific points seek to refine and extend the existing literature, but the result is broadly consistent with current theories of international political economy, in particular endogenous tariff theory, negotiation analysis, and functional explanations of international regimes.

At the core of liberal intergovernmentalism are three essential elements: the assumption of rational state behaviour, a liberal theory of national preference formation, and an intergovernmentalist analysis of interstate negotiation. The assumption of rational state behaviour provides a general framework of analysis, within which the costs and benefits of economic interdependence are the primary determinants of national preferences, while the relative intensity of national preferences, the existence of alternative coalitions, and the opportunity for issue linkages provide the basis for an intergovernmental analysis of the

resolution of distributional conflicts among governments. Regime theory is employed as a starting point for an analysis of conditions under which governments will delegate powers to international institutions.

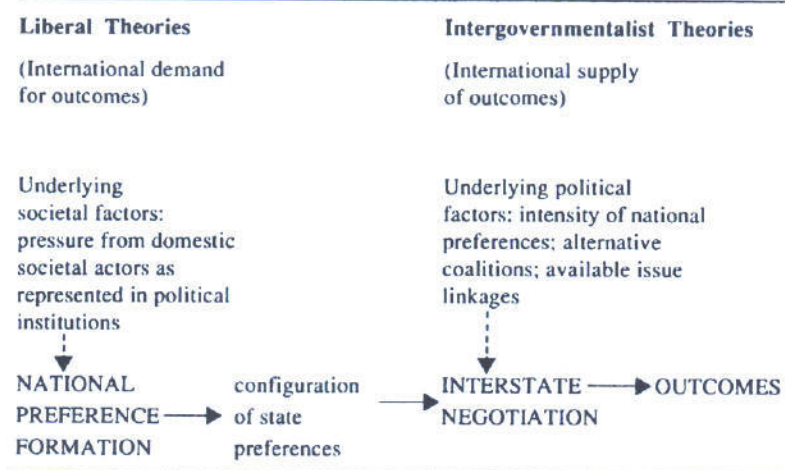
Much contemporary international relations theory is based on the assumption of state rationality. State action at any particular moment is assumed to be minimally rational, in that it is purposively directed toward the achievement of a set of consistently ordered goals or objectives.⁵ Governments evaluate alternative courses of action on the basis of a utility function. The approach taken here departs decisively, however, from those theories in international relations, most notably realist and neo-realist approaches, which treat states as 'billiard balls' or 'black boxes' with fixed preferences for wealth, security or power. Instead, governments are assumed to act purposively in the international arena, but on the basis of goals that are defined domestically. Following liberal theories of international relations, which focus on state–society relations, the foreign policy goals of national governments are viewed as varying in response to shifting pressure from domestic social groups, whose preferences are aggregated through political institutions. National interests are, therefore, neither invariant nor unimportant, but emerge through domestic political conflict as societal groups compete for political influence, national and transnational coalitions form, and new policy alternatives are recognized by governments. An understanding of domestic politics is a precondition for, not a supplement to, the analysis of the strategic interaction among states (Moravcsik, 1991, 1992b).

The model of rational state behaviour on the basis of domestically-constrained preferences implies that international conflict and co-operation can be modelled as a process that takes place in two successive stages: governments first define a set of interests, then bargain among themselves in an effort to realize those interests. Metaphorically, these two stages shape demand and supply functions for international co-operation. A domestic preference formation process identifies the potential benefits of policy co-ordination perceived by national governments (demand), while a process of interstate strategic interaction defines the possible political responses of the EC political system to pressures from those governments (supply). The interaction of demand and supply, of preference and strategic opportunities, shapes the foreign policy behaviour of states.⁶

⁵ Such goals are best seen not as defined across alternative policies or strategies (e.g. a free trade regime, fixed exchange rates), but across alternative future states of the world (e.g. higher levels of economic transactions, exchange rate stability). Rational choices among policies and strategies must generally take into account the expected reactions of other states and the resulting strategic interactions among them, while preference across future states of the world do not. The latter are 'pre-strategic' preferences. On this distinction more generally, see Elster (1986).

⁶ To avoid confusion, it is important to remember that nested within the domestic definition of the demand function is also a national process of societal demands for and governmental supply of policies. The domestic use of the metaphor of demand and supply is drawn from Shepsle's analyses of legislative politics (Shepsle, 1992).

Figure 1: The Liberal Intergovernmentalist Framework of Analysis



This conception of rationality suggests that parsimonious explanations of international conflict or co-operation can be constructed by employing two types of theory sequentially: a theory of national preference formation *and* a theory of interstate strategic interaction. Unicausal explanations of European integration, which seek to isolate either demand or supply, are at best incomplete and at worst misleading. 'Demand-side reductionism' – the narrow attention to variation in domestic preferences while ignoring the strategic context in which states interact – or 'supply-side reductionism' – exclusive emphasis on interstate bargaining or international institutions without considering the underlying distribution and variation in preferences – risk omitting essential variables and encouraging misleading inferences about those that remain. Explaining the emergence in 1978–9 of the European Monetary System, for example, requires that we understand both the convergence of macroeconomic policy preferences, which led European governments to favour monetary co-ordination, *and* the determinants of the outcomes of the tough interstate bargaining that took place over the precise terms under which it would take place.

Thus liberal intergovernmentalism integrates within a single framework two types of general international relations theory often seen as contradictory: a liberal theory of national preference formation and an intergovernmentalist analysis of interstate bargaining and institutional creation.⁷ In the sections that follow, these sequential components are developed in more detail.

⁷ Sections IV and V of this article deal respectively with two different aspects of interstate strategic interaction: distributional bargaining and the delegation or pooling of decision-making in international

III. Liberalism, National Preference Formation and the Demand for Integration

1. Liberalism and State–Society Relations

The theory of national preference formation set out in this section is liberal in inspiration. Liberal theories of international relations focus on the effect of state–society relations in shaping national preferences. They assume that private individuals and voluntary associations with autonomous interests, interacting in civil society, are the most fundamental actors in politics. State priorities and policies are determined by politicians at the head of the national government, who 'are embedded in domestic and transnational civil society, which decisively constrains their identities and purposes.'⁸ The most fundamental influences on foreign policy are, therefore, the identity of important societal groups, the nature of their interests, and their relative influence on domestic policy. Groups that stand to gain and lose a great deal *per capita* tend to be the most influential. The identity, interests, and influence of groups vary across time, place and, especially, issue-area, according to the net expected costs and benefits of potential foreign policies. The factors that determine the identity, interests and influence of domestic groups are themselves both domestic and transnational. In this sense, 'second image reversed' theories, which assume that international constraints create patterns of societal interests that influence governments via the 'transmission belt' of domestic politics, are characteristically liberal.⁹ But so are theories that stress purely domestic state–society relations, due to the nature of domestic political and socio-economic institutions.

Groups articulate preferences; governments aggregate them. For liberals, the relationship between society and the government is assumed to be one of principal–agent; societal principals delegate power to (or otherwise constrain) governmental agents. The primary interest of governments is to maintain themselves in office; in democratic societies, this requires the support of a coalition of domestic voters, parties, interest groups and bureaucracies, whose views are transmitted, directly or indirectly, through domestic institutions and practices of political representation. Through this process emerges the set of national interests or goals that states bring to international negotiations.

regimes. Regime theory is treated as a theory of strategic interaction, in the sense that the institutional measures for compliance shape the range of potential bargains. The latter might also be thought of not as an element of strategic interaction, but as a separate 'compliance' stage of policy co-ordination. For a model of this kind, see Moravcsik (1989).

⁸ Moravcsik (1992b) from which the argument in this section is drawn.

⁹ See Gourevitch (1978). To the extent that international factors, such as economic interdependence or external threats to national security influence preference formation, they must pass through the domestic polity.

This is not to say that all foreign policy proposals begin with direct pressure from pluralist groups, only that state leaders must construct governing coalitions out of influential groups with specific interests. Sometimes the influence of societal groups is indirect. In economic affairs, for example, some firms and groups, particularly those with fixed investments and assets, may seek to influence governments directly, exercising the option of 'voice'; others, particularly those with more mobile investments and assets, may find it less expensive to shift investments to alternative activities or jurisdictions, exercising the option of 'exit' (Hirschman, 1970; Magee *et al.*, 1989, pp. 13, 93, 102; Bates and Lien, 1985; Lindblom, 1977). In the liberal view, even the latter constraint ultimately rests on the desire of politicians to avoid imposing costs on – and thereby alienating – those social groups whose support maintains them in office.

Yet the interests of societal groups are not always sharply defined. Where societal pressure is ambiguous or divided, governments acquire a range of discretion. While domestic societal groups impose a basic constraint on governments, the nature and tightness of this constraint varies with the strength and unity of pressures from social groups. At times the principal–agent relationship between social pressures and state policies is tight; at times, 'agency slack' in the relationship permits rational governments to exercise greater discretion.¹⁰

The liberal focus on domestic interests and state–society relations is consistent with a number of plausible motivations for governments to support (or oppose) European integration. These include federalist (or nationalist) beliefs, national security concerns and economic interests. The *federalist* motivation views European integration as a cosmopolitan ideal, justified by a sense of a common European identity and purpose. (Ideological opponents of integration may be motivated by an equally ideological commitment to a conception of the nation that places value on the preservation of sovereignty.) The liberal *national security* motivation is premised on the view of economic interdependence and common institutions as means of reinforcing peaceful accommodation among democratic states with an historical legacy of conflict, assuring a common front against the anti-democratic Soviet Union, or guaranteeing political support for specific, democratically legitimate national projects, such as German unification.¹¹ The *economic interdependence* motivation views the EC as a means of co-ordinating policy to manage flows of goods, services, factors of production,

¹⁰ Here I do not mean to imply that all cases in which governments do not serve the interests of particularistic groups should be thought of as 'autonomous' action, but simply that the greater the 'slack' in the relationship between particularistic opponents of co-operation, the greater the possibility of pursuing a policy targeted at a larger domestic constituency or, in some cases, at realizing the preference of these in office.

¹¹ It is unhelpful to associate all national security arguments with realism. Liberalism and realism both place a high value on national security, but view threats as emanating from different sources. Realists highlight objective power and uncertainty, liberals the societal sources of aggressive intentions. Hence their differing predictions about the distribution of conflict and co-operation (Moravcsik, 1992b).

and economic externalities more effectively than unilateral policies. Elsewhere these alternative specifications of liberal theory are tested against one another (Moravcsik, 1992a); here the focus is on motivations that stem from economic interdependence and the ways in which they constrain governmental preferences in international negotiations.

2. *Interdependence, Externalities and Co-operation*

At the core of liberal theories of economic interdependence lies the claim that increasing transborder flows of goods, services, factors, or pollutants create 'international policy externalities' among nations, which in turn create incentives for policy co-ordination. International policy externalities arise where the policies of one government create costs and benefits for politically significant social groups outside its national jurisdiction. Where the achievement of domestic governmental goals depends on the policies of its foreign counterparts, national policies are interdependent and policy externalities can arise (Cooper, 1986, pp. 292–3).

National governments have an incentive to co-operate where policy co-ordination increases their control over domestic policy outcomes, permitting them to achieve goals that would not otherwise be possible. This situation arises most often where co-ordination eliminates *negative* international policy externalities. (A second motivation for co-operation whereby governments employ international institutions as part of a 'two-level game' strategy to increase the initiative of the government, is discussed in the final section of this article.) Negative policy externalities occur where the policies of one nation imposes costs on the domestic nationals of another, thereby undermining the goals of the second government's policies. Examples include protectionist barriers against flows of foreign goods and capital, competitive devaluation, and lax domestic environmental pollution standards. Each of these policies may impose costs on foreign nationals, thereby undermining the policy goals of foreign governments. (The opposite, positive policy externalities, occur when domestic policies confer benefits on foreign groups, thereby strengthening national policies. Unilateral openness, an overvalued currency, high domestic welfare standards, and strong regulations on industrial air pollution are typical examples.) Where externalities are negative, the possibility of ameliorating them through policy co-ordination generates an incentive for co-operation; where externalities are positive or insignificant, however, or where unilateral policies can be cost-effectively adjusted to counteract the effects of such a foreign government's policies, little incentive for co-operation exists.

In the modern international political economy, policy co-ordination has two major purposes, each of which aims at removing a negative policy externality. The first is the accommodation of economic interdependence through *recipro-*

cal market liberalization. Restrictions on imports and exports are not simply of interest to domestic societal groups, but to their counterparts abroad as well. The liberalization of the movement of goods, services and factors of production may promote modernization and a more efficient allocation of domestic resources, favouring producers in internationally competitive sectors and owners of internationally scarce factors of production. Restrictions on imports of goods and factors impose policy externalities on potential foreign exporters, investors and immigrants.

The second major purpose of economic policy co-ordination is *policy harmonization* in order to assure the continued provision of public goods for which the state is domestically responsible, such as socio-economic equality, macroeconomic stability and regulatory protection. National welfare provision, monetary policy, labour market controls, product regulation and many other domestic policies rely for their effectiveness on the separation of markets for goods, services, factors and pollutants. Where economic interdependence links jurisdictions, divergent national policies may undermine each other's effectiveness. Co-ordinated (or common) policies may therefore result in greater *de facto* control over domestic policy outcomes than unilateral efforts (Cooper, 1972).

Contrary to the beliefs often attributed to them, liberals do not argue that co-operation to achieve trade liberalization and the common provision of public goods is inevitably supported by all governments. The vulnerability of governments to negative externalities may vary greatly: some are able to sustain effective policies autonomously, others remain vulnerable to negative externalities from policies abroad. While the latter have an incentive to support international policy co-ordination, those that produce negative externalities or benefit from the positive externalities of others have an incentive to free ride on the domestic policies of their neighbours, rather than co-operate (Keohane and Nye, 1989, 12ff). Only where the policies of two or more governments create negative policy externalities for one another, and unilateral adjustment strategies are ineffective, inadequate or expensive, does economic interdependence create an unambiguous incentive to co-ordinate policy.¹²

3. The Distributional Consequences of Policy Co-ordination

Even where agreements are mutually beneficial, governments often have different preferences concerning the distribution of the benefits, leading to conflict over the precise terms of co-operation.¹³ The costs and benefits of

¹² This diverges from the common analysis of regimes as providing public goods. The institutional infrastructure of regimes itself may be thought of as a public good, as can some common goals of regimes. For the most part, however, the benefits of the EC are excludable and, to an extent, rival goods; co-operation stems from interdependence – the effects of national policies on the opportunities for foreigners.

¹³ This is overlooked by Grieco (1988), but captured by Keohane and Nye (1989), and Krasner (1991).

policy co-ordination are often unevenly distributed among and within nations, rendering nearly inevitable a measure of international and domestic conflict between winners and losers. To the extent that it takes domestic and international distributional conflict into account, liberal interdependence theory does not, as some have suggested, assume the existence of a harmony of interests or a simple correlation between potential transactions and co-operation. Nations and domestic groups that are disadvantaged by policy co-ordination are likely to oppose it. Only where governments can collectively overcome such opposition is co-operation possible. The distribution of expected net societal costs provides a means of predicting the nature of political conflict and co-operation in the EC, both internationally and domestically.¹⁴

Domestically, governments participating in international negotiations are both empowered and constrained by important societal groups, which calculate their interests in terms of the expected gains and losses from specific policies (Milner, 1988; Gourevitch, 1986; Frieden, 1991a; Odell, 1982). Powerful groups disadvantaged by co-operation will seek to obstruct government policy, even where such policies generate net gains for society as a whole. To understand and predict the likelihood of international co-operation in any given instance, therefore, requires a more precise specification of domestic societal interests in particular issue-areas and the ways in which those interests constrain governments.

Societal pressure on national governments reflects not only the expected magnitude of gains and losses, but also the uncertainty and risk involved. The magnitude, certainty and risk of domestic distributional effects of policy co-ordination determine not only the goals of respective governments, but the extent to which governments can afford to be flexible in negotiation. At one extreme, where the net costs and benefits of alternative policies are certain, significant and risky, individual citizens and firms have a strong incentive to mobilize politically. In such circumstances, unidirectional pressure from cohesive groups of producers or organized private interests imposes a strict constraint on government policy. The prospects for international agreement will depend almost entirely on the configuration of societal preferences; in negotiations, governments have little flexibility in making concessions, proposing linkages, managing adjustment or otherwise settling on the 'lowest common denominator'. International agreement requires that the interests of dominant domestic groups in different countries converge; where they diverge, co-ordination is precluded. Such conditions are approximated in EC negotiations over agricultural prices, and EC bargaining positions are dictated by pressures from interest groups.

¹⁴ The existence of such a predictive theory distinguishes liberalism from the neo-functional tradition of Haas and others (Haas, 1964).

At the other extreme, where the net costs and benefits of alternative policies are diffuse, ambiguous or insignificant, and the risk is low, the societal constraints on governments are looser (cf. Buchanan and Tullock, 1962, pp. 78–9). Under such circumstances, leading politicians enjoy a wider range of *de facto* choice in negotiating strategies and positions. More than one policy is likely to be consistent with the basic desire of politicians to remain in government. The slack in the principal–agent relationship between society and the state permits governments to assume more political risk by taking a more ‘enlightened’ or longer-term view, balancing winners and losers to construct broader coalitions, accepting short-term losses for long-term gains, or pursuing more ideologically controversial goals.

4. Policy Areas and National Preferences in the EC

Different policy areas engender characteristic distributions of costs and benefits for societal groups, from which follow variations in patterns of domestic political mobilization, opportunities for governments to circumvent domestic opposition, and motivations for international co-operation.¹⁵ EC policy areas can be divided into three categories on the basis of policy objectives: the liberalization of the exchange of private goods and services, the provision of socio-economic collective goods, and the provision of non-economic collective goods.

Commercial policy, market access and producer interests. At the core of the EC is its Internal Market. The most basic EC policies – including internal market policy, agricultural policy, competition policy, industrial policy, and research and development policy – are designed to liberalize or eliminate distortions in markets for private goods and services. Modern theories of commercial policy begin by assuming that individual and group support for liberalization and protection reflects, to a first approximation, the net expected costs and benefits of the policy change (Magee *et al.*, 1989; Hillman, 1989). Social groups with an intense interest in a given policy are more likely to mobilize than those with a weak interest, since higher *per capita* gains support the costs of locating, organizing, monitoring and representing concentrated groups. This tends to create a systematic political bias in favour of producers *vis-à-vis* those with more diffuse interests, such as tax-payers and individual consumers, or those with no direct access to the political process, such as foreign producers (Olson, 1965; Hillman, 1989). Following endogenous tariff theory, the approach employed here assumes that societal groups mobilized around commercial policy issues are composed almost exclusively of domestic producers, whether drawn from labour or capital, who organize by sector on the basis of calculations

¹⁵ A more detailed model would take variations in domestic institutions into account.

of net expected costs and benefits resulting from the introduction of new policies.¹⁶

Among producers, the net expected costs and benefits of liberalization reflect the following factors. First, *the extent to which individual producers profit from commercial liberalization depends most fundamentally on their competitive position in domestic and international markets.*¹⁷ Protectionist policies not only redistribute domestic wealth from consumers to sheltered producers, but also create negative policy externalities for exporters excluded from potential markets. Accordingly, exporters and multinational investors tend to support freer trade, which increases their profits; import-competing producers tend to oppose free trade, which undermines their profitability. Where adjustment is relatively costless or compensation between winners and losers can be arranged, distributional effects need not create opposition to free trade. Where adjustment and compensation are costly, however, a domestic prisoner’s dilemma among domestic veto groups – each of which seeks to be exempted from disadvantageous policy changes, leading to a suboptimal outcome for society as a whole – translates into an international prisoner’s dilemma, in which each government seeks to shelter its weakest sectors from international market pressure. Policy co-ordination helps overcome these dilemmas by balancing the gains and losses of free trade within and across countries, thereby creating viable domestic coalitions in favour of liberalization.¹⁸

Import-competing sectors and firms with low levels and profits and growth are particularly likely to press for protection. Sectors and firms that are sheltered or undiversified, that face chronic surplus capacity, cyclical downturn or long-term decline, or have large irreversible investments are more likely to press for protection; expanding, profitable, diversified industries are less likely to do so. For declining sectors with immobile investments, market adjustment by shifting future adjustment is more costly, benefits are more visible, while the possibility exists that rents will be competed away by the entry of new firms. The losers from liberalization, because they are more easily identifiable, tend to be over-represented, while the potential winners remain under-represented.

¹⁶ Under conditions of high domestic factor mobility, one would expect coalitions to form between capital and labour; according to the Stolper–Samuelson theory, protection will be sought by factors of production that are relatively scarce – capital in labour-abundant countries, and labour in capital-abundant countries. In the long term, this may be valid (see Rogowski, 1989). In the short and medium term, however, many factors are unable to move between industrial sectors, due in part to high fixed investments in human and physical capital. Hence a specific-factors (Ricardo–Viner) approach is more appropriate, in which owners of capital (or land) and labour work together to form sectoral coalitions (Magee *et al.*, 1989).

¹⁷ This is the cornerstone of most modern empirical studies of commercial policy. For empirical support, see Lavergne (1983).

¹⁸ Since protectionist policies can easily be implemented unilaterally, the incentive for international co-operation in these areas typically stems from opportunities to co-ordinate the liberalization of market access.

Second, *cross-cutting or balanced patterns of interests internalize the costs and benefits of trade liberalization* to the same sets of firms and sectors, creating a cross-cutting set of interests that undermines opposition to liberalization. Most importantly, intra-industry trade and investment patterns reduce the net effects on the positions of individual producers and sectors.¹⁹ Even producers facing substantial import-competition have an incentive to support free trade if loss of domestic market share is offset by exports, control over foreign producers, or receipts from foreign investments. The risk of a large loss is reduced as well. Producers of finished goods also form concentrated interest groups in favour of free trade in raw materials and intermediate inputs.

Third, *where the effects of policy changes are uncertain, organized opposition to government initiatives is diluted*. Uncertainty about the effects of co-operation arises where policies are stated vaguely, left to future negotiation, mediated by complex market processes, or applied in an unpredictable way across a population. Uncertain policies engender less opposition than those that are immediate, precise and targeted. Policies often become more controversial as specific provisions are negotiated and the real effects become evident – as occurred in implementing EC agricultural, transport and competition policy in the 1950s and 1960s.

In many cases, pressure from private economic interests is enough to convince governments to liberalize. Where the net expected costs and benefits to firms and sectors are significant, unambiguous and predictable for important segments of domestic producers, pressures from producer interests will impose a relatively tight constraint on state policy. Most agricultural sectors, as well as industries with chronic surplus capacity, are characterized by inter-industry trade patterns, uniform and calculable interests, and high fixed, irreversible investments and assets. Net commodity exporting countries demanded liberalization; net commodity importing countries resisted it. In the CAP, interstate bargains have been possible only on the basis of lowest common denominator log-rolling agreements in individual sectors, with the costs passed on to consumers and foreign producers. Direct pressure from producer interests in the EC has created and maintained a system of high agricultural prices and managed trade, regardless of the preferences of politicians.

In other cases, the decision to liberalize reflects not just pressure from narrow interests, but a broader calculation on the part of the government. When net expected costs are insignificant, ambiguous, balanced or uncertain, governments enjoy a greater autonomy from particularistic domestic groups that oppose co-operation, which they can employ to create support for broader societal goals. This they can do by negotiating international compromises and issue linkages, which creates viable coalitions by balancing winners against

¹⁹ Milner (1988) stresses intra-industry trade.

losers. By subsidizing the costs of adjustment, or by balancing losses of domestic market share with gains in foreign markets, they can also mute opposition to liberalization. Both agricultural trade liberalization in Germany and industrial trade liberalization in France were accompanied by large domestic subsidies to uncompetitive producers expressly designed to finance adjustment. The more governments are able to act independently of groups disadvantaged by a policy, thereby trading off gains and losses over a larger constituency, the more we should observe the compromises and 'upgrading the common interest' predicted by neo-functionalists. Whereas neo-functionalism stresses the autonomy of supranational officials, liberal intergovernmentalism stresses the autonomy of national leaders.

Governments independent of pressure from particular opponents of liberalization are able to pursue broader national industrial strategies. Such strategies, like narrower policies, may be designed in the long term to promote re-election through economic growth and socio-economic public goods provision. Neo-classical trade theory argues that even unilateral liberalization is wealth-maximizing, because it promotes the efficient allocation of resources and reinforces competition, domestically and internationally, thereby expanding consumption possibilities through specialization, which more fully exploits economies of scale and underlying international cost differentials. It is not simply pressure from domestic exporters that generates pressure for free trade, but also the desire of governments to employ international agreements to force adjustment on domestic producers in the interest of overall economic growth and efficiency – a 'two-level game' to which we shall return in the final section of this article. Inefficiency can become politically intolerable for numerous reasons. Often the desire to adopt such a policy is a response to broad underlying shifts in competitive position or manifest policy failure, signalled by a crisis of low investment and growth, unsustainable external disequilibria, or intolerable fiscal expenditures. In 1950 and 1958, for example, the perceived failure of French industrial strategies based on protection led to a push for pan-European liberalization (Institut Charles de Gaulle, 1992). In 1978 and 1985, a generalized sense of macroeconomic policy failure contributed to the acceptance of, respectively, the EMS and the Single European Act.

Socio-economic public goods provision. EC policies are not limited to the co-ordination of explicit market liberalization policies, but include also the co-ordination of domestic policies designed to redress market failures or provide public goods, such as those that assure macroeconomic stability, social security, environmental protection, public health and safety standards, and an acceptable distribution of income. Rising economic interdependence often exacerbates the tension between unco-ordinated national policies, the effectiveness of which

often requires that either national markets be separated or national policies be harmonized (Cooper, 1972). Transborder inflows of air and water pollution can undermine the effectiveness of national environmental policies; capital outflows can undermine the credibility of domestic monetary policy; 'social dumping' can undermine the competitiveness of industry and the viability of social compromises.

As with commercial policy, an incentive for international policy co-ordination exists when the configuration of domestic policies produces negative policy externalities – domestic problems that cannot be resolved through domestic regulation, because of interference from policies pursued by foreign governments – for more than one country. Negotiated policy co-ordination typically involves some surrender of domestic policy autonomy in exchange for a similar surrender on the part of other countries. Where domestic policy instruments remain effective, governments will continue to maintain them; but where governments have exhausted all cost-effective domestic means of achieving domestic policy targets, they have an incentive to turn to international co-ordination. Accordingly, policy co-ordination will typically be sought particularly by smaller governments, with little control over their domestic markets and high economic interdependence, and by those, generally with high levels of domestic public goods provision, whose policies are particularly vulnerable to disruption.

Many socio-economic public goods policies have important implications for international commerce. The effects of unco-ordinated policies – exchange rate shifts, disparate production and product standards, or divergent social welfare policies – may distort or obstruct international commerce. Therefore, in contrast to pure commercial liberalization, the international co-ordination of such policies raises a 'two-dimensional' issue, in that governments must strike a balance between two independently valued policy targets: flows of economic transactions and levels of public goods provision. To the extent that governments are concerned about trade liberalization, the incentives for international and domestic co-operation and conflict will resemble those in issues of pure commercial policy. However, where governments are primarily concerned with the provision of domestic public goods, the level of conflict and co-operation among governments depends on the extent to which national policy goals are compatible. When governments have divergent macroeconomic, environmental and social goals, then co-ordination is likely to be costly and difficult. International conflict emerges over the division of the burden of adjustment. The more divergent national policies are to begin with, the greater the costs of co-operation. Nonetheless, where these costs are outweighed by the interest in reducing negative policy externalities, international policy co-ordination can

help governments reach an optimal balance between increased market access and the maintenance of regulatory standards.²⁰

Due to the 'two-dimensional' nature of the public goods issues, the range of mobilized interests is typically broader than in commercial policy. Whereas in pure commercial policy, the 'public interest' is pursued almost entirely by national governments, backed by broad coalitions of interested parties, the public interest is represented in public goods concerns by pressure from public interest groups and mass publics. Where existing domestic policy reflects widespread popular support, domestic regulations are likely to be resistant to the changes required to achieve international harmonization. Alongside producer interests, non-producers may either influence policy directly, as when environmental interest groups mobilize opposition, or punish or reward the government for the results of policy, as when voters respond to recent macroeconomic performance.

As in commercial policy, the level of constraint on governments varies, depending on the intensity and calculability of private interests. Policies involving the direct regulation of goods and production processes tend to engender strong mobilization of producer groups, while the co-ordination of policies to provide macroeconomic public goods, including pollution, inflation, unemployment and the aggregate distribution of income, generates a more diffuse pattern of societal interests. Most producers have more ambiguous and variable interests in public goods provision – e.g. the value of the currency, the level of domestic inflation, or the aggregate level of pollution – than in issues of pure commercial policy. Where strong commercial or public interests are unified in their demands for policy co-ordination, governments will act accordingly. Often, however, the results of negative externalities and policy failure are more diffuse, leading to a more general economic or regulatory crisis. In the latter case, governments may act without direct pressure from interested parties.

Macroeconomic policy provides an illustrative example. While groups do organize around the trade-related costs and benefits of monetary management (Frieden, 1991b), these incentives are often offset by other concerns. While currency depreciation increases the competitiveness of domestically-produced tradeable goods, it also raises the costs of imported intermediate inputs and raw materials, as well as increasing the risk of longer-term inflation. Domestic monetary policy is influenced by the autonomy of domestic monetary institutions and the identity of the party in power, among other things. Recent steps toward European monetary integration, for example, reflect a set of national commitments to macroeconomic discipline imposed by the unsustainability of domestic policies in the face of increased international capital mobility. Only

²⁰ This is not to imply that the two are always in conflict. See the examples drawn from EC regulatory harmonization cited below.

once domestic policies had converged substantially did more intensive international co-operation become conceivable. When they diverged, the system once again came under pressure.

Political co-operation, EC institutions, and general income transfers. Some EC policies cannot be interpreted as direct responses to policy externalities imposed by economic interdependence. Some, such as a common foreign and security policy, aim to provide non-socio-economic collective goods; others, such as general European Community institutions and transnational (regional and structural) income transfers, exist either for their own sake or to facilitate other policies. Liberal theory suggests that fundamental constraints on national preferences will reflect the costs and benefits to societal actors; where these are weak, uncertain or diffuse, governments will be able to pursue broader or more idiosyncratic goals.

The costs and benefits created by *political co-operation* for private groups are diffuse and uncertain. Private producers take little interest in political co-operation, leaving domestic influence over the policy almost exclusively to partisan elites, with a secondary, intermittent constraint imposed by mass publics. The reasoning used to justify policies tends to be symbolic and ideological, rather than calculated and concrete. The inherent incalculability of gains and losses in these policy areas accounts for a troubling neo-functional anomaly, namely the manifest importance of ideologically motivated heads of state ('dramatic-political' actors) in matters of foreign policy and institutional reform. The difficulty of mobilizing interest groups under conditions of general uncertainty about specific winners and losers permits the positions of governments, particularly larger ones, on questions of European institutions and common foreign policy, to reflect the ideologies and personal commitments of leading executive and parliamentary politicians, as well as interest-based conceptions of the national interest. This may help explain the ability and willingness of nationalists like Charles de Gaulle and Margaret Thatcher to adopt an uncompromising position toward the dilution of national sovereignty, as well as support by various European leaders for direct elections to the European Parliament, the creation of the European Council, and the quiet development of European Political Co-operation – each an issue in which the costs and benefits to organized interest groups is near impossible to calculate.

Similarly, the politics of decisions about *EC institutions* vary widely, depending on the nature of the decision-making process to be institutionalized. Where the consequences of institutional decisions are calculable and concrete, national positions will be instrumental, reflecting the expected influence of institutional reforms on the realization of substantive interests. This is, for example, generally the case with decisions about majority voting on specific

Figure 2: Economic Interdependence and National Preferences

ISSUE AREA	PREDICTIONS	
	Sources of Societal Interests	Determinants of State Action
Commercial Liberalization (e.g. tariffs and quotas, agricultural price policy)	Overt pressure, mostly from producers, whose net expected gains and losses reflect competitive position in international markets, levels of intra-industry trade, and the certainty of policy outcomes	Where producer interests strong, unified and certain, governments will conform to them; otherwise, they are more likely to risk liberalization when faced with overt and intractable policy failure, signalled by low investment and growth, unsustainable external disequilibria, and/or intolerable fiscal compensation
Socio-economics Public Goods Provision (e.g. monetary, environmental, social and regulatory policies)	Two-dimensional pressure: from producers, based on the criteria above, and from the public in favour of public goods provision	When societal interests strong and unified, governments conform; when not, they co-ordinate actions to combat policy failure, judged on either of the two dimensions
Political, Institutional or Redistributive Policies (e.g. EPC, Euro-parliamentary affairs, structural funding)	Pressure from narrow groups only where the implications are calculable, otherwise only a loose public or elite opinion constraint	Except where implications are calculable, governments and parliamentary elites enjoy relatively broad autonomy to pursue symbolic goals or side payments

economic policies. Moreover, some delegations of power are viewed as necessary for the effective functioning of the EC. These institutions – to which we shall return in Section IV below – include common representation in international negotiation, the Commission's power of proposal under qualified majority voting, and enforcement of EC rules by the European Court of Justice and the Commission.

The more general and less predictable the implications of decisions on the relative power of institutions, the larger the space for leading politicians and partisan elites to act on the basis of ideological predilections. National interests

would lead one to expect large, self-sufficient and uncompetitive countries, as well as those that hold outlier preferences on questions of public goods provision, to be relatively unwilling to accept stronger supranational institutions, such as majority voting or a European Parliament. British and French policy provides some support for this view, but Italy's consistent federalism remains an exception. Similarly, smaller countries might be expected to support strong supranational power. The Benelux countries have indeed done so, yet Danish, Greek and Irish support has been less consistent. National parliamentary elites appear to play an important role in countries like Italy, Germany and the Netherlands, which support federalist institutions.

Regional and structural policies – since they are neither significant enough to provide major benefits to the donors, nor widely enough distributed to represent a policy of common interest – are most plausibly interpreted as side payments extended in exchange for other policies.

5. Conclusion

This section has employed and extended contemporary theories of international political economy to predict the national preferences of EC Member States across three types of issues: commercial policy, socio-economic public goods provision, and other institutional, political or structural policies. In each case, the magnitude, distribution and certainty of net expected costs and benefits to private groups were employed to predict policy preferences of governments, as well as their range of relative autonomy *vis-à-vis* those domestic groups that oppose co-operation (summarized in Figure 2). This defines the demand for international co-operation; in the next section, we turn to the capacity of the international system to supply co-operation.

IV. Intergovernmentalism, Interstate Bargaining, and the Supply of Integration

Intergovernmentalist theory seeks to analyse the EC as the result of strategies pursued by rational governments acting on the basis of their preferences and power. The major agenda-setting decisions in the history of the EC, in which common policies are created or reformed, are negotiated intergovernmentally, but can they be consistently explained in terms of a theory of interstate bargaining? Like many international negotiations, EC decisions of this kind can thus be thought of as a game of co-ordination with distributional consequences – in other words, a bargaining game over the terms of co-operation (Sebenius, 1991; Krasner, 1991; Garrett, 1992). The configuration of domestically determined national preferences defines a 'bargaining space' of potentially

viable agreements, each of which generates gains for one or more participants. Governments, if they are to pursue a common policy, must collectively select one. The choice between different agreements often has important distributional consequences; governments are therefore rarely indifferent among them. Negotiation is the process of collective choice through which conflicting interests are reconciled.

Bargaining games raise two analytical problems. Lax and Sebenius (1986) refers to these as problems of 'creating' and 'claiming' value. They might be thought of also as co-ordination and bargaining aspects of strategic interaction. The first problem concerns the efficiency of negotiations. Negotiations create value by facilitating mutually beneficial exchanges, but excessive costs of identifying, negotiating and enforcing bargains may obstruct co-operation. Strategic behaviour may lead governments to withhold information about mutually beneficial bargains, negotiation may require costly threats, enforcement may be expensive or impossible. International institutions can help to ameliorate some of these problems by proposing potential agreements, providing rules for decision-making, and the adjudication of disputes. The second problem concerns the distributional implications of interstate bargaining. The choice of a specific outcome from among many possible ones determines the distribution of expected costs and benefits among national governments. Governments bargain hard for advantage. In order to explain bargaining outcomes, it is necessary to understand the factors that account for the relative power.

Creating and claiming value often occur simultaneously, but they can be divided for analytical purposes. In the following section, the focus is on the distributional implications. Strategic interaction is assumed to be efficient, the choice of agreements is restricted to those along the Pareto-frontier, and the analysis focuses on the international distribution of gains and losses. In the following section, in which the role of supranational institutions in assuring efficient bargaining outcomes is addressed, these assumptions are then relaxed.

1. Bargaining Power and the Intensity of Preferences

Negotiation analysis has identified numerous factors that may influence the distributional outcomes of international bargaining, among them the nature of the alternative policies and coalitions, the level and symmetry of information, the extent of communication, the sequence of moves, the institutional setting, the potential for strategic misrepresentation of interests, the possibility of making credible commitments, the importance of reputation, the cost-effectiveness of threats and side-payments, and the relative preferences, risk-acceptance,

expectations, impatience, and skill of the negotiating parties (Raiffa, 1982; Harsanyi, 1977). In the abstract, any of these factors might be important predictors of bargaining outcomes.

To generate precise and accurate predictions about a set of comparable cases, such as major EC decisions, detailed assumptions must be made about the situation in which the parties are bargaining. In justifying the selection of assumptions, formal theory, while useful, cannot substitute for detailed empirical knowledge of the context in which bargaining takes place. Given the range of possible theoretical solutions to the bargaining problem and the difficulty of rigorous hypothesis-testing by the case study method, the use of congenial, convenient or conventional assumptions and concepts without contextual justification poses a high risk of generating irrelevant or illusory results. Assumptions lacking explicit empirical justification should therefore be viewed with scepticism.²¹

The following three assumptions about interstate bargaining offer a plausible starting point for analysis of EC decision-making. First, intergovernmental co-operation in the EC is voluntary, in the sense that neither military coercion nor economic sanctions are threatened or deployed to force agreement. Democratic governments are risk-averse and tend to avoid the high costs of conflict. Not only do they decline to ally or wage war against one another, but also the tactical use of economic sanctions (as opposed to the threat of exclusion that might occur through the self-interested pursuit of national interests), while occasionally employed in trade disputes among liberal capitalist states, tends to be relatively rare among the highly interdependent nations of the EC (cf. Martin, 1992). Thus, fundamental decisions in the EC can be viewed as taking place in a non-coercive unanimity voting system. Second, the environment in which EC governments bargain is relatively information-rich. National negotiators are able to communicate at low cost and possess information about the preferences and opportunities facing their foreign counterparts, as well as the technical implications of policies that are of the greatest interest to them (Moravcsik, 1993). Third, the transaction costs of intergovernmental bargaining are low. Negotiations within the EC take place over a protracted period of time, during which member governments can extend numerous offers and counter-offers at relatively little cost. Side-payments and linkages can be made. Governments

²¹ The specification of applied bargaining models generally requires information beyond the basic assumptions of all such models. Harsanyi, in his general theory of classical bargaining games, notes that 'a satisfactory definition of a given game will often require a specification of *additional parameters* to those which by traditional game theory would be included in the definition of the game ... if such parameters are left unspecified, any given game can have a wide *variety* of alternative outcomes' (emphasis in the original). Harsanyi (1977), p. 6; Binmore and Dasgupta (1987), ch. 1. For similar sentiments among international relations theorists, see Axelrod and Keohane (1986); Jervis (1988); Fearon (1991).

can credibly commit themselves to substantive policies through explicit institutional arrangements. Technically, it is possible to design efficient institutions to monitor and enforce any agreement at any desired level. (The assumption of low transaction costs is relaxed in a later section of this article.)

The assumption of a non-coercive, information-rich, deliberative, institutionalized setting may not be perfectly realized at all times during the history of the EC, but it is a reasonable first approximation of the context in which European governments typically negotiate. One implication of these assumptions is that bargaining outcomes should be efficient, in the sense that conflicts are generally resolved Pareto-optimally. Opportunities for useful bargains are exploited. Moreover, these assumptions reduce the importance of various factors that influence bargaining outcomes elsewhere, such as first mover advantages, strategic sequencing, strategic misrepresentation, the use of costly coercive threats, and the role of unilateral precommitments. EC negotiations can be viewed as a co-operative game in which the level of co-operation reflects patterns in the preferences of national governments.

Yet even in this relatively benign environment, relative power matters. Bargaining leverage stems most fundamentally from asymmetries in the relative intensity of national preferences, which reflect, according to the analysis in the previous section, the relative costs and benefits of agreements to remove negative externalities. In negotiating policy co-ordination, the terms will favour those governments able to remove negative externalities by opening markets to which others intensely desire access, modifying policies others intensely desire to change, or distributing resources others intensely desire to share. The more intensely governments desire agreement, the more concessions and the greater effort they will expend to achieve it. The greater the potential gains for a government from co-operation, as compared to its best alternative policy, the less risk of non-agreement it is willing to assume and, therefore, the weaker its bargaining power over the specific terms of agreement.

Theories of bargaining and negotiation suggest three likely determinants of interstate bargaining power under such circumstances: (1) unilateral policy alternatives ('threats of non-agreement'); (2) alternative coalitions ('threats of exclusion'); and (3) the potential for compromise and linkage.

Unilateral alternatives and threats of non-agreement. A necessary condition for negotiated agreement among rational governments is that each perceive the benefits of co-operation as preferable to the benefits of the best alternative available to it. Where there exists a policy more desirable than co-operation, a rational government will forgo agreement. *The simple, but credible threat of non-agreement – to reject co-operation in favour of a superior alternative – provides rational governments with their most fundamental form of bargaining*

power. The more attractive a government's policy alternatives – often termed 'outside options', 'reservation values', 'concession limits', or 'best alternatives to negotiated agreement (BATNAs)' – the less intense its preference for agreement and the greater its bargaining leverage.²² Governments with attractive alternatives will not tolerate inconvenient agreements, while governments with unattractive alternatives gain from co-operation even if they have to compromise.²³ Leaving aside for the moment alternative coalitions, linkages and side-payments, the 'threat of non-agreement' guarantees that the outcomes of rational bargaining must fall within a set of agreements, termed the 'feasible set', ranging from an outcome in which all the joint gains accrue to one country to those in which they accrue to another, that is, a set is bounded by the best policy alternatives available to governments. Only agreements within this set are viable.²⁴

The most basic type of alternative is simply the unilateral policy that a government is able to pursue without an agreement, that is, under the institutional *status quo*. When bargaining on the basis of unilateral alternatives, governments have only one threat, that of non-co-operation. In negotiations over trade liberalization, for example, the bargaining power of unilateral alternatives stems from asymmetrical interdependence: governments that are less dependent on internal trade than their negotiating partners, and therefore stand to gain less from agreement, enjoy greater bargaining leverage. Thus, even if democratic governments rarely apply tactical or punitive sanctions, *implicit* sanctions – the credible threat to retain protection as the best alternative to agreement – remain a fundamental source of bargaining power.²⁵ In negotiations over public goods policies, governments with greater domestic policy autonomy enjoy leverage over those whose policies are ineffective or vulnerable to external disruption. In both these bargaining situations, governments of large, prosperous, relatively self-sufficient countries tend to wield the most influence, because they gain relatively little from agreement, compared to their smaller, poorer, more open neighbours. The former can therefore afford to be more discriminating about the terms they will accept.

One implication of bargaining on the basis of the intensity of preferences is that the need to compromise with the least forthcoming government imposes the

binding constraint on the possibilities for greater co-operation, driving EC agreements toward the *lowest common denominator*. Let us assume, for example, that European governments are selecting by unanimity vote among a set of possible agreements, arrayed in order of increasing divergence from the *status quo*. If each government favours agreements closest to its preferred point and is willing to accept only those agreements that it prefers to the *status quo*, it is the government with a preferred point closest to the *status quo* whose veto ultimately limits the extent of reform. A 'lowest common denominator' outcome does *not* mean that final agreements perfectly reflect the preferences of the least forthcoming government – since it is generally in its interest to compromise somewhat rather than veto an agreement – but only that the range of possible agreements is decisively constrained by its preferences.

The evolution of the EC illustrates the importance, but also some important limitations, of unilateral alternatives as determinants of interstate bargaining outcomes. In negotiations over the terms of European monetary integration since the late 1970s, Germany's alternative to negotiated agreement – *de facto* monetary autonomy – has been more attractive than the alternative of its neighbours, which is increasing dependence on the Bundesbank. As a result, the German government has been able to demand that monetary integration take place through convergence to Germany's low-inflation standard, without which Germany would have had little incentive to depart from the institutional *status quo*. Similarly, Britain has traditionally been viewed as indispensable to the credibility of European Political Co-operation. Its interests have been accommodated by those whose unilateral foreign policy options are limited, including Germany, Italy and many smaller states.

Another example of this dynamic is the negotiation over agricultural prices in the 1960s. The German government's control over its lucrative, protected agricultural market, to which French producers desired access, afforded it considerable bargaining power *vis-à-vis* France. The German government employed this leverage to force common EC prices to high German levels, without which its participation would have probably been blocked domestically. French farmers gained the most from the agreement in absolute terms and, in part as a result, the final agreement was closest to the demands of German farmers. This was aided by the fact that while the French government preferred somewhat lower prices (and a correspondingly larger share of the German market), higher prices were not unwelcome to French farmers. By contrast, German markets for *industrial* goods, although lucrative, were already open and threats to close them were not credible. Germany gained little bargaining power from agreeing to keep its markets open, demonstrating that governments can activate the potential bargaining power of their markets best where the threat to

²² Raiffa (1982) pp. 252–5; Zartman (1991), pp. 69ff; Keeney and Raiffa (1991); Dixit and Nalebuff, (1991), pp. 290–2. Keohane and Nye (1988) refer to this as 'vulnerability'; Hirschman develops the same concept. I employed the phrase 'opportunity cost of non-agreement and exclusion' in Moravcsik (1992a) ch. 1. Garrett (1992) has applied this idea to the EC.

²³ The importance of opportunity costs in this context was pointed out by Haas (1993, p. 186).

²⁴ Sebenius (1991), pp. 332–4. Where a welfare-reducing agreement is reached, it is unlikely to be ratified or implemented. Putnam (1988).

²⁵ Hirschman (1945), p. 16, notes that 'the power to interrupt commercial or financial relations with any country ... is the root cause of the influence or power position which a country acquires'. See also Keohane and Nye (1977).

restrict market access constitutes a viable unilateral alternative, rather than a tactical expedient.

Agreement at the lowest common denominator does not, however, inevitably mean adoption of the lowest possible common standard. In numerous cases, less environmentally conscious governments in Britain, Spain and elsewhere have accepted environmental product standards far higher than those prevailing domestically. Relatively high environmental and public health standards, such as high air pollution and recycling standards, do not disconfirm the prediction of lowest common denominator agreements. Some of these decisions reflect the dynamics of qualified majority voting, yet even under unanimity, these apparent anomalies are quite consistent with the model of bargaining on the basis of preference intensity, *if preferences are specified properly*. In the EC context, regulatory issues are often 'two-dimensional', linking commercial and public welfare concerns. High national standards operate as permissible non-tariff barriers under Article 36 of the Treaty of Rome. Often the regulation of environmental product standards creates unexpected alliances, as illustrated by the cases of auto emissions standards, recycling laws for bottles and packaging, and standards for toxic chemicals (Vogel, 1992; Majone, 1992; Levy, 1991). Such regulations are thus more acceptable to business in Germany, Denmark and the Netherlands than they otherwise might be. Better yet, however, from the perspective of business in these high standard countries, much of which is multinational, would be an integrated market with high EC environmental standards. Producers in low standard countries would gain as well, since access to markets with high standards, cut off by unilateral barriers, would thereby be assured. Far from sparking a race to the bottom, the creation of a single market under 'lowest common denominator' bargaining often creates incentives for the EC to harmonize at a high level.²⁶

Alternative coalitions and the threat of exclusion. Where the only alternatives to agreement are unilateral policies, EC negotiations over major reforms can be thought of as taking place within a unanimity voting system in which agreement requires that the minimal demands of each country be satisfied. Sometimes, however, the best alternative to agreement is not unilateral action, but the formation of an alternative coalition from which certain states are excluded. Where alternative coalitions are possible, a government must calculate the value of an agreement by comparing it not to unilateral policy options, but to its gains from alternative coalitions it could join or from 'going it alone ... as [it] faces various coalitions' (Raiffa, 1982, p. 253). *The existence of opportunities to form attractive alternative coalitions (or deepen existing ones), while excluding*

other parties, strengthens the bargaining power of potential coalition members vis-à-vis those threatened with exclusion. In the EC context, such bargaining power may result either from the threat to co-operate with non-EC countries or, more common today, from the possibility of forming or deepening alternative institutions within Europe, while leaving some members behind – a 'two-track' or 'multi-speed' Europe (Moravcsik, 1991). Such coalitional dynamics tend to favour large states, whose participation is necessary for viable coalitions, and governments with preferences close to the median of the EC, since they are potential members of more viable coalitions.

By creating negative policy externalities, the formation of an alternative coalition creates an incentive for recalcitrant governments to compromise. Due to the much greater market power involved, the threat of exclusion from a coalition is a more powerful incentive to co-operation than a single state's threat of non-agreement. To a much greater extent than unco-ordinated policies, alternative coalitions – for example an exclusive free trade arrangement – can create negative policy externalities for those left outside it. By diverting investment, credit, trade, political influence, or market confidence, exclusion from an alternative coalition may impose significant costs, even in the absence of military and economic coercion (Binmore and Dasgupta, 1987, p. 9). Under these conditions, a government may seek to avoid exclusion by agreeing to terms of co-operation that leave it *worse off in absolute terms than the status quo ante* – although, of course, the agreement is Pareto-improving in the sense that the government is better off as compared to its position if the failure to reach agreement had led to the formation of an alternative coalition.

A number of major events in the history of the EC can be interpreted as responses to the threat of exclusion from an alternative coalition. The initial British response to the formation of the Common Market in the 1950s and 1960s is an illustrative example. The British government initially sought to undermine European integration by proposing an alternative free trade area. When this failed, the British sought to dilute the Common Market by negotiating a free trade deal directly with it, and subsequently formed a parallel organization, the European Free Trade Association (EFTA). Only when each of these strategies had failed did Britain finally apply for membership of the EC – only to find that the adjustment of other countries to the Common Market had shifted relative bargaining power even further against it. This is a case in which Britain, while it would have gained from membership, would nevertheless have preferred the *status quo ante*.

History repeated itself in the negotiations over the Single European Act, when the French and German governments publicly threatened to move ahead without Britain if the British government failed to accept formal treaty revisions to mandate majority voting – a threat clearly understood as such at high levels

²⁶ The European Parliament's role was also important in this case. See Aizenman (1993).

in the British government. Britain, it was thought at the time, would be doubly disadvantaged by exclusion, not only renouncing the material advantages of reform, but also losing its voice in decisions about their precise form. Since reform was in the interest of all other Member States, even if Britain were excluded, the threat was credible (Moravcsik, 1991).

Yet alternative coalitions do not always create negative externalities for excluded states and, therefore, pressure for geographical spillover. Where a policy of exclusion has *positive* externalities, a contrary dynamic occurs. Where free trade is assured, for example, governments with low social standards often have a clear incentive to free ride, rather than to compromise on common harmonized standards. This helps explain why the threat of exclusion was powerless to block the British government's striking last-minute 'opt-out' of social policy at Maastricht. Exclusion from the social policy provisions of the Maastricht Treaty, insofar as it had any effect at all, promised to make British firms *more* competitive on a European market from which they cannot be excluded. The adoption of high EC social protection standards is thus likely to be possible only through linkage or side payments, which play such an important role in cementing co-operation with the Mediterranean countries.

The distinction between positive and negative externalities provides a means of predicting which policies are 'inherently expansive' – thus resolving an ambiguity in neo-functional theory. Where policy externalities are negative, non-members have an incentive to join the organization, which will lead them to compromise on common standards. Where policy externalities are positive, non-members have an incentive to free ride, rather than compromise, and agreements above the lowest common denominator are possible only through linkages and side payments, to which we now turn.²⁷ This not only helps to explain the dynamics of geographical expansion in the EC, but also the dynamics of current bargaining over regulatory issues.

Compromise, side-payments and linkage at the margin. Unilateral and coalitional policy alternatives define a range of viable agreements which all participants prefer to the *status quo*. Within that range, the precise point at which negotiators will compromise is more difficult to predict, particularly when more than two states are involved. In general, bargaining power will depend on the intensity of preference at the margin. Where uncertainty exists about the breakdown of negotiations or time pressure, concessions tend to come dispro-

²⁷ While the existence of alternative coalitions has been presented here as a source of power in broad negotiations over the future scope of the EC, it is relevant also to qualified majority voting on more specific issues. In bargaining among themselves over the precise terms of a directive or regulation, national governments weigh the costs of compromise, which results in a winning coalition of which they are a member and an outcome closer to their preferred point, against the risks of intransigence, which may result in exclusion from the winning coalition and an outcome more uncongenial to them.

portionately from governments for which the failure to reach agreement would be least attractive – that is, from those governments which stand to lose the most if agreement is not reached. Where such uncertainty does not exist, the terms of the final agreement will reflect the relative intensity of preferences at the margin, which defines the shape of the feasible set: governments that place a greater value on concession at the margin will gain more from negotiations.²⁸

More importantly for our purposes here, governments often have differential preference intensities across issues, with marginal gains in some issue-areas being more important to them than to other governments. Under these circumstances, it may be to the advantage of both parties to exchange concessions in issue-areas about which their preferences are relatively weak for concessions in other areas about which they care more. Even where a set of agreements, taken individually, would each be rejected by at least one national government, they may generate net advantages for all if adopted as a 'package deal'. Such linkages can increase the welfare of both parties, thereby helping to overcome one of the major disadvantages of bargaining on the basis of unilateral and coalitional alternatives, namely that governments tend to have the least bargaining power on precisely those issues which are relatively most important to them. Issue linkages are most advantageous where two countries have highly asymmetrical interests in various issues, which permit each to make concessions valuable to the other at relatively low cost.

The major limitation on linkage strategies is domestic opposition. Linkages have important domestic distributional consequences. They tie together into 'package deals' issues in which domestic groups benefit with those in which domestic groups lose. Package deals tend to create winners and losers in *all* countries that are party to them. Where domestic gains and losses produced by linkage are only imperfectly fungible through compensation across issues, linkage becomes a complex and politically risky strategy. Since losers tend to generate more political pressure than winners, for a domestic trade-off to be tolerable, adjustment costs to important domestic groups must be moderate, or substantial compensation must be paid.

The importance of domestic costs and benefits suggests a number of predictions about linkage. First, linkages are most likely in areas where the preferences of domestic groups are not intense. Minor issues are more likely to be sacrificed to a linkage. Wherever possible, therefore, financial or symbolic side-payments between states, rather than linkages between substantive issues are employed. The Maastricht agreement was typical, in that issues implicitly

²⁸ This is the Nash bargaining solution, whereby a marginal redistribution in either direction between two actors with concave utility functions would lead to an equal percentage change in their utility. This is also the equilibrium of an offer-counteroffer game in which both sides are assumed to be equal in all respects other than their preferences. See Binmore and Dasgupta (1987).

linked to monetary policy included highly fungible resources, such as increases in structural funds, or symbolic issues, such as deletion of 'federalist' language and increased powers to the European Parliament. Second, package deals are most likely in the final stage of bargaining – that is, at the margin to balance gains and losses among issues in which all parties are close to being net beneficiaries – rather than among issues in which nations are large net winners and losers. Third, linkages are most likely between closely related issues – within, rather than between, sectors. Where the costs and benefits are internalized to sectors or firms, there is more possibility for producers to adjust, diversify, or to balance gains and losses, just as in the case of intra-industry trade. Sectoral organizations may neutralize opposition by aggregating sectoral support and opposition into a single position. Linkages between disparate sectors are most likely to occur where the possibilities for intra-issue compromise or linkage between related issues have been exhausted. Fourth, if linkages do impose real losses on domestic sectors, they are more likely to be effective when accompanied by domestic side-payments from governments to disadvantaged private groups. In the 1960s and 1970s, industrial subsidies in France and agricultural subsidies in Germany were explicitly designed to ease adjustment to liberalization.

Linkage is thus a politically costly, second-best strategy for integration. Linkages that attempt too much – such as the linkage between the Common Agricultural Policy and strong supranational institutions in the 1960s – are often unstable and are circumvented at a later stage. The limitations on linkage are illustrated by the purported linkage on which the EC is said to be founded, namely that between German access to French industrial markets and French access to German agricultural markets. While such a linkage existed on the margin, it was less central than is often asserted. Industrialists and farmers in both countries gained. French industry's objections to the Common Market were in fact relatively minor; by 1959, before tariff reductions had begun in earnest, they were already among the strongest supporters of acceleration. Opposition to a common agricultural policy came primarily from economic liberals in the German government, who opposed high prices, and farmers, who feared low prices. The final agreement left farmers in every country, including Germany, with higher average support prices than they had enjoyed previously. Those elements of the CAP price structure that most disadvantaged certain farmers were offset by domestic compensation and adjustment assistance. In the 1970s, any residual loss to German farmers was more than offset by the compensation for currency movements and the subsequent 'renationalization' of the CAP, leaving only division of the much smaller budgetary expenditures as an outstanding issue. In contrast to neo-functionalism, which viewed linkage as the core of the EC, it is seen here as a strategy best pursued on the margin and

of lesser importance than intra-sectoral trade-offs. Linkages that impose large losses on important domestic groups are unstable.

So far this analysis has focused primarily on the sources of national preferences and the distributional outcomes of intergovernmental negotiations over commercial liberalization, domestic public goods provision, and general political and institutional questions. We turn now from an analysis of the distributional outcomes of intergovernmental bargaining to an analysis of its efficiency. Modern regime theory views international institutions as deliberate instruments to improve the efficiency of bargaining between states.

V. Supranational Institutions and the Efficiency of Decision-Making

Strong supranational institutions are often seen as the antithesis of intergovernmentalism. Wrongly so. The decision to join all but the most minimalist of regimes involves some sacrifice of national autonomy, which increases the political risk to each Member State, in exchange for certain advantages. In the intergovernmentalist view, the unique institutional structure of the EC is acceptable to national governments only insofar as it strengthens, rather than weakens, their control over domestic affairs, permitting them to attain goals otherwise unachievable.

EC institutions strengthen the power of governments in two ways. First, they increase the efficiency of interstate bargaining. The existence of a common negotiating forum, decision-making procedures, and monitoring of compliance reduce the costs of identifying, making and keeping agreements, thereby making possible a greater range of co-operative arrangements. This explanation relies on the functional theory of regimes, which focuses on the role of regimes in reducing transaction costs (Keohane, 1984). However, in order to explain the unique level of institutionalization found in the EC, this body of theory must be extended to include the delegation and pooling of sovereignty. Second, EC institutions strengthen the autonomy of national political leaders *vis-à-vis* particularistic social groups within their domestic polity. By augmenting the legitimacy and credibility of common policies, and by strengthening domestic agenda-setting power, the EC structures a 'two-level game' that enhances the autonomy and initiative of national political leaders – often, as noted above, a prerequisite for successful market liberalization. With a few important exceptions, EC institutions appear to be explicable as the result of conscious calculations by Member States to strike a balance between greater efficiency and domestic influence, on the one hand, and acceptable levels of political risk, on the other.

1. Supranational Institutions and Functional Regime Theory

Much of the institutional structure of the EC can be readily explained by the functional theory of regimes, which argues that where transaction costs – the costs of identifying issues, negotiating bargains, codifying agreements, and monitoring and enforcing compliance – are significant, international institutions may promote greater co-operation by providing information and reducing uncertainty. In the conventional regime-theoretical view, EC institutions serve as a passive structure, providing a contractual environment conducive to efficient intergovernmental bargaining. As compared to *ad hoc* negotiation, they increase the efficiency of bargaining, facilitating agreements that would not otherwise be reached (Buchanan and Tullock, 1962; Keohane, 1984; Levy *et al.*, 1992).

The functional regime theory view of international institutions as passive, transaction-cost reducing sets of rules readily explains the role of EC institutions as a framework for negotiating major decisions, from the Treaty of Rome to Maastricht. The *acquis communautaire* of the EC functions to stabilize a constantly evolving set of rules and expectations, which can only be altered by unanimous consent. Institutions promote international co-operation by providing a negotiating forum with bureaucratic institutions that disseminate information and policy ideas; a locus for representatives of business, political parties, national bureaucracies, and interest groups to discuss issues of common concern; joint decision-making procedures; a common set of underlying legal and political norms; and institutions for monitoring and defining national compliance. Greater information and predictability reduce the cost of bargaining and the risk of unilateral non-compliance. Like the GATT, the G-7 and other international regimes, EC institutions provide fora in which to craft linkages and side-payments that render policy co-ordination more viable domestically. Package deals linking regional funds and British entry or structural funds and the Single European Act were surely easier to reach within a common international institution. Yet the large political risk inherent in open-ended decisions about the future scope of EC activities means that Member States remain hesitant to delegate authority to supranational or majoritarian institutions.²⁹ The essence of the EC as a body for reaching major decisions remains its transaction-cost reducing function, as explicated by contemporary regime theory.

When we turn from major constitutional decision-making to the process of 'everyday' legislation, administration and enforcement, however, the EC seems to be a far more unusual international institution – more than a passive set of

²⁹ This is akin to the problem of designing constitutional protection of minority rights (Buchanan and Tullock, 1962, pp. 129–30).

rules codifying previous decisions. The EC differs from nearly all other international regimes in at least two salient ways: by *pooling* national sovereignty through qualified majority voting rules and by *delegating* sovereign powers to semi-autonomous central institutions. These two forms of transferring national sovereignty are closely related. Qualified majority voting, for example, not only makes the formal decision-making of any single government more dependent on the votes of its foreign counterparts, but also more dependent on agenda-setting by the Commission.

In order to understand the conditions under which Member States will forgo *ad hoc* decision-making under the unanimity rule in favour of a common agreement to pool or delegate sovereignty, contemporary regime theory must be extended. An insightful starting point, suggested by Garrett and Weingast in their analysis of the European Court of Justice, is to view delegation as a response to the problem of incomplete contracting. Predicting the circumstances under which future contingencies will occur is often difficult and costly, sometimes impossible (Garrett and Weingast, 1991). Where member governments have shared goals, but are unable or unwilling to foresee all future contingencies involved in the realization of common goals, they may have an incentive to establish common decision-making procedures or to empower neutral agents to propose, mediate, implement, interpret and enforce agreements.

The metaphor of incomplete contracting *per se*, while a useful starting assumption, fails to explain variation in either the level or the form of delegation (or pooling) of sovereignty. Delegation is, after all, only one of a number of possible responses to future uncertainty. Many unpredictable EC decisions – including the annual determination of CAP prices and the definition of new issues under Art. 235 – are neither delegated nor pooled; others – the determination of international negotiating positions and administered protection against third countries – are pooled, but not delegated. Elsewhere in the international system, delegation is even rarer, despite many cases of incomplete contracting. Even within the EC, governments often refuse to assume the political risk of delegation, preferring instead imperfect enforcement and inefficient decision-making, to the surrender of sovereignty. Incomplete contracting appears to be neither a necessary, nor a sufficient, condition for delegation.

What, then, distinguishes cases of delegation or pooling from cases of *ad hoc* unanimity voting? Following public choice analyses of domestic constitutional choice, intergovernmentalist theory views the decision to adopt qualified majority voting or delegation to common institutions as the result of a cost-benefit analysis of the stream of future substantive decisions expected to follow from alternative institutional designs. For individual Member States carrying out such a cost-benefit calculation, the decision to delegate or pool sovereignty

signals the willingness of national governments to accept an increased political risk of being outvoted or overruled on any individual issue in exchange for more efficient collective decision-making on the average.³⁰ Movement beyond unanimous voting and *ad hoc* negotiation for a class of decisions can thus be thought of as a means of deliberately encouraging implicit linkages across various related issues within an iterated game among governments. By facilitating linkages, delegation or pooling is likely to produce more decisions at a lower cost in time and energy than the laborious negotiation of *ad hoc* package deals. Compared to unanimity voting, delegation and pooling of sovereignty are more efficient, but less controlled forms of collective decision-making. Of the two, delegation involves greater political risk and more efficient decision-making, while pooling through qualified majority voting involves less risk, but correspondingly less efficiency.

Examining this trade-off more precisely, the following three conditions should encourage national governments to support a movement from unanimity to delegated or pooled decision-making: (1) *The potential gains from co-operation.* Where time pressure, previous failures to reach agreement, the desire to implement a prior decision, or a shift in national preferences requires more rapid decision-making, delegation or pooling is more likely. *Ceteris paribus*, the less attractive the *status quo* and the greater the expected gains from increased co-operation, the greater the corresponding incentive to pool or delegate. Levels of economic transactions and, in particular, intra-industry trade, which are higher among the EC countries than among any comparable set of industrialized countries, are likely to lead eventually to pressure for greater delegation and pooling of sovereignty. Where large numbers of similar decisions are involved, the efficiency gains are correspondingly greater (cf. Keohane, 1983).

(2) *The level of uncertainty regarding the details of specific delegated or pooled decisions.* Lack of precise knowledge about the form, details and outcome of future decisions not only precludes more explicit contracts, as noted above, but also helps defuse potential opposition from those who would be disadvantaged by the implicit linkages. Where agreements can be foreseen, some governments and domestic groups would have more reason to prefer direct bargaining under unanimity, as occurred in setting the initial levels of the Common External Tariff and agricultural prices, in order to block policies disadvantageous to them.

³⁰ This analysis assumes that the transaction costs of institutional creation and reform are relatively low, but the transaction costs of individual decision-making are high. The limitations to more 'optimal' international institutions stem not from transaction costs of creating them, but from the interests of governments in reducing domestic political risk. This leads them to promote a set of decision-making rules consistent with a specific trade-off between efficiency and risk.

(3) *The level of political risk for individual governments or interest groups with intense preferences.* Political risk can be understood as the probability of a large downside loss to a government or interest group. Risk-averse governments will assent to procedures where the scope and magnitude of expected and potential losses are minimized, given the goals of co-operation. Governments have an incentive to delegate authority only when there is little probability that the cumulative distributional effects of delegated or pooled decisions will be biased in an unforeseen way against the interests of any national government or major domestic group.³¹ The form of third-party representation, agenda-setting and enforcement should involve the minimal transfer of sovereignty needed to achieve desired outcomes. One way to limit the scope of delegation and pooling, often employed in the EC, is to nest specific decisions inside a set of larger decisions already reached by unanimity, thereby both diversifying and limiting political risk.

Each of the three most important instances in which the Treaty of Rome delegates Member State authority to supranational officials – external representation, agenda-setting and enforcement – appears to fulfil these conditions.

External representation: Since the EC is a customs union with a common external tariff, negotiations with third countries require a single agent to represent common positions. In order for national governments to trust the agent, it must be perceived as neutral. While this requires that an agent be delegated, only limited independent decision-making for short periods of time is required to carry out designated tasks. Close monitoring and oversight by national governments is to be expected. In the common commercial policy of the EC, for example, the Commission represents the Community, but tight control is maintained by the Article 113 Committee. Only where time pressure in the midst of negotiations forces a rapid decision and national governments are deadlocked can supranational officials advance independent initiatives. These are still subject to *ex post* approval, but may transfer some marginal power to the Commission. In European Political Co-operation, where fewer decisions are taken and a common external position is viewed as less imperative, the EC is generally represented by the foreign ministers of its Member States.

Agenda-setting: Where a wide consensus exists on a broad substantive agenda, it can often be realized more efficiently by granting a measure of agenda-setting power to a supranational institution, in this case the Commission. As a reliable source of independent proposals, the Commission assures that technical information necessary for decision is available. More importantly, as a neutral arbiter, it provides an authoritative means of reducing the number of proposals to be considered. Majorities may exist for a number of alternative

³¹ Some institutions may be biased in a predictable manner, for which a rational government would demand compensation in negotiations.

proposals on a single issue, with governments unable to reduce them to a compromise through their vetoes. This is particularly important where governments have sought to increase the efficiency of bargaining by employing qualified majority voting (QMV). In such circumstances, agenda-setting power can be decisive in deciding which proposal prevails. In the EC, delegating the power of proposal to the Commission provides a means of setting the agenda, thereby avoiding time-consuming or inconclusive 'cycling' between difficult proposals or an arbitrary means of proposal selection.³² Most states are likely to consider a supranational body to be more neutral than even a randomly chosen national government. Delegating the preparation of proposals to the Commission thereby reduces the risk to national governments that decisions will be delayed by an inconclusive struggle among competing proposals or that the final decision will be grossly unfair – a matter of particular importance to small countries, which often lack the administrative means to prepare or assess proposals.

Yet the ability to select among viable proposals grants the Commission considerable formal agenda-setting power, at least in theory. The power is particularly decisive when the *status quo* is unattractive, creating general support for joint action, yet there is considerable disagreement between national governments over what should replace it. Often a number of proposals might gain majority support, among which the Commission's choice is decisive. The most controversial cases of implementing the White Paper agenda, including a number in telecommunications, environmental and social policy, stand as examples. (For a similar analysis of parliamentary power, see Tsebelis, 1992.)

Enforcement: The possibilities for co-operation are enhanced when neutral procedures exist to monitor, interpret and enforce compliance. Neutral enforcement permit governments to extend credible commitments, thus helping to overcome the almost inevitable interstate prisoner's dilemma of enforcement, whereby individual governments seek to evade inconvenient responsibilities, thereby undermining the integrity of the entire system. By taking the definition of compliance outside of the hands of national governments, a supranational legal system strengthens the credibility of national commitments to the institution. The cost of such delegation, which goes beyond the monitoring functions of classical international regimes, is increased political risk. Functions of this type in the EC include competition policy, administered by the Commission, and the interpretation and application of EC law, carried out by the European Court of Justice (Garrett and Weingast, 1991).

³² Under unanimity voting, this is less of a problem: each government can compel compromise by vetoing any proposal that does not accommodate its views, leading to a compromise among proposals. Hence the sequence in which proposals are voted upon is less essential.

In each of these three cases, there is a substantive commitment to the achievement of broad goals, while the political risk is small, insofar as each delegated decision is relatively insignificant. Perhaps most important, the scope of delegation is explicitly limited by national governments. The scope of representation in third-party negotiations is constrained by close oversight, the scope of legislative agenda-setting power by the Council's previous delegation of power and ultimate decision, and the scope of enforcement by existing EC law, as well as the willingness of national governments and their courts to comply with ECJ and Commission decisions.

Of the three types of delegation, only the enforcement power of the ECJ appears to have resulted in a grant of independent initiative to supranational bodies beyond that which is minimally necessary to perform its functions – and beyond that which appears to have been foreseen by governments. The ECJ has constitutionalized the Treaty of Rome, built alliances with domestic courts and interest groups, pre-empted national law in important areas, and opened new avenues for Commission initiative, as in cases like *ERTA* in common commercial policy, and *Cassis de Dijon* in technical harmonization.

The expansion of judicial power in the EC presents an anomaly for the functional explanation of delegation as a deliberate means by national governments of increasing the efficiency of collective decision-making. While supranational delegation undoubtedly creates benefits for governments, the decisions of the Court clearly transcend what was initially foreseen and desired by most national governments (Burley and Mattli, 1993). The 'constitutionalization' of the Treaty of Rome was unexpected. It is implausible, moreover, to argue that the current system is the one to which all national governments would currently consent, as recent explicit limitations on the Court in the Maastricht Treaty demonstrate. Nor is the current institutional form of the Court functionally necessary. Supranational dispute resolution need not take the form, almost unique among international organizations, of a semi-autonomous legal system. Such a system is not *a priori* more appropriate for settling disputes between rival interpretations and applications of a statute than a dispute resolution panel, as exists in the GATT, or the Council of Ministers acting under qualified majority, as exists in EFTA. The Member States might simply have reserved the right to pass legislation to clarify ambiguities. Neither incomplete contracting nor functional analysis can account for the precise form or historical evolution of the ECJ.

The unique role the ECJ has come to play may reflect instead, as Burley and Mattli argue, a number of factors idiosyncratic to the EC. First, the technical complexity of EC law made it difficult to foresee the consequences of early Court decisions, giving those who favoured a strong ECJ some leeway in drafting the treaty (Pescatore, 1981). Second, the referral of cases by domestic

courts, and their subsequent enforceability in the same forum, renders ECJ judgments difficult to ignore. Finally, and most importantly, unanimous consent of Member States would now be required to curb its power. Over the years, the Court has pursued a sophisticated strategy, remaining just within a negative consensus that protects it. Any attempt to alter the current arrangements might be challenged by European federalists, by those who favour strong enforcement, and by smaller countries, which would be less well served by a system in which qualified majority voting was employed to adjudicate disputes (Burley and Mattli, 1993).

While the creation of common rules and procedures in functional regime theory alters only the information and expectations of national governments, the EC goes further, pooling decision-making through arrangements for qualified majority voting and delegating authority over representation, formal agenda-setting and enforcement to semi-autonomous institutions. Yet the delegation and pooling of authority in the EC, like the construction of common norms and principles in other regimes, can be explained by extending the central insight of functional regime theory, namely that institutions are means of reducing the transaction costs of identifying, negotiating and enforcing intergovernmental agreements under uncertainty. National governments strike a balance between increased decision-making efficiency and the political risk of uncontrolled issue linkage. The greater the potential gains, the greater the uncertainty about specific decisions, and the lower the political risk, the more likely governments are to delegate power in these ways.

Viewed in light of this trade-off, independent actions by the Commission or outcomes that contravene the interests of a single Member State, taken in isolation, do not constitute decisive evidence against the intergovernmentalist view that the EC is grounded fundamentally in the preferences and power of Member States. Only where the actions of supranational leaders *systematically* bias outcomes away from the long-term self-interest of Member States can we speak of serious challenge to an intergovernmentalist view. While some cases of supranational autonomy, such as certain actions of the European Court of Justice, may pose such a challenge, most fit comfortably within it.

2. *Supranational Institutions and 'Two-Level Games'*

Traditional regime theory focuses primarily on the role of regimes in reducing the transaction costs of collective decision-making for national governments. Yet EC institutions perform a second function as well, namely to shift the balance of domestic initiative and influence. On balance, this shift has strengthened the policy autonomy of national governments at the expense of particular

groups (for a dissenting view, see Marks, 1991).³³ Particularly where domestic interests are weak or divided, EC institutions have been deliberately designed to assist national governments in overcoming domestic opposition. Where institutions did not initially serve this purpose in the Treaty of Rome, new institutions were created in order to strengthen this function – the strengthening of the Council bureaucracy in the 1960s, the genesis of the European Council in the 1970s, and the reservation of powers over political co-operation to the Member States being prime examples.

National governments employ EC institutions as part of a 'two-level' strategy with the aim of permitting them to overcome domestic opposition more successfully (cf. Putnam, 1988). The EC fulfils this function in two ways: by according governmental policy initiatives greater domestic political legitimacy and by granting them greater domestic agenda-setting power. Let us briefly consider each. The mantle of the European Community adds legitimacy and credibility to Member State initiatives. Domestic coalitions can be mobilized more easily in favour of policy co-ordination. This adds weight in domestic debates to both major reforms and everyday decisions emanating from the EC. Second, the institutional structure of the EC strengthens the initiative and influence of national governments by insulating the policy process and generating domestic agenda-setting power for national politicians. National governments are able to take initiatives and reach bargains in Council negotiations with relatively little constraint. The EC provides information to governments that is not generally available. Intergovernmental discussions take place in secrecy; national votes are not publicized. Domestically, parliaments and publics generally have little legal opportunity to ratify EC agreements and decisions; where they do, there is rarely an opportunity to amend or revise them. National leaders undermine potential opposition by reaching bargains in Brussels first and presenting domestic groups with an 'up or down' choice – just as 'fast track' procedures are employed to speed trade agreements through the US Senate (Destler, 1986). Greater domestic agenda-setting power in the hands of national political leaders increases the ability of governments to reach agreements by strengthening the ability of governments to gain domestic ratification for compromises or tactical issue linkages. Whereas governments might be pressured for exemptions, oversight over implementation is placed instead in the hands of the more credible European and national court systems. Ironically, the EC's 'democratic deficit' may be a fundamental source of its success.

From the very beginning, much EC decision-making has been difficult to explain except as a two-level game. The reflexive support of both committed

³³ Marks argues, on the basis of an analysis of the structural and regional funds, that the EC is catalysing a process of diffusion, whereby the 'decisional powers' of the state are being shifted both to subnational and supranational authorities.

European federalists and those who favour the general economic goals of the EC greatly assisted the early development of specific EC policies. In the initial negotiation of the Treaty of Rome, the liberalization of French industrial trade offers a striking example. In the 1950s Germany, the hub of the European trading system, was engaging in *unilateral* tariff reductions. French exports to Germany were increasing rapidly with little evidence of any protectionist reaction across the Rhine (Milward, 1992). The major incentive for France to accept the EC was not to solve an international prisoner's dilemma by assuring access to the German market, as much modern trade theory would have it. Instead, as French leaders made clear at the time and de Gaulle was to reiterate even more forcefully, it was to employ the legitimacy of the EC to force French firms to modernize – a goal that French governments had been promoting for almost a decade without success (Institut Charles de Gaulle, 1986).

Today we are witnessing an analogous phenomenon, as the credibility of efforts to achieve macroeconomic convergence in countries like Italy and Spain is bolstered by the impression, deliberately exploited by member governments, that the imposition of anti-inflationary discipline is necessary for full involvement in Europe. To be sure, there is little evidence that member governments actually pursue macroeconomic stabilization for 'federalist' reasons, nor that European rhetoric actually reduces the economic cost of macroeconomic stabilization, nor that other EC policies are critically dependent on the achievement of monetary integration. It is plausible to argue, however, that the legitimacy of the EC may reduce the domestic *political* costs of imposing economic discipline. It follows that appeals to Europe should be less efficacious in countries, like the UK, where popular support for the EC is weaker, and more efficacious in countries, like Italy, where the EC enjoys legitimacy. Even among those countries more hostile to current EC policy, supranational institutions may play an important role as scapegoat for unpopular policies or undemocratic processes supported by member governments at the European level.

The proposed independent Eurofed offers a more recent example of the advantages of insulating agenda-setting policy implementation from domestic pressures – to an extent that has been widely criticized – in order to achieve goals that would otherwise be unachievable. Domestic control over exchange rate policy (as well as the legitimacy of European integration), has permitted German Chancellor Helmut Kohl to pursue a policy of monetary integration without the strong backing of either business or the Bundesbank, although the limits imposed by domestic consensus have subsequently become clear. In addition, the proposed European Central Bank will be doubly insulated from domestic pressures in a way designed to make the common European policy credible on domestic and international markets. The Maastricht referendum in France is an exception that proves the importance of secrecy and agenda-setting

power, in that it demonstrates the potential consequences when governments lose firm control of domestic agendas or take needless risks in ratification.

VI. Conclusion: Beyond Liberal Intergovernmentalism

The liberal intergovernmentalist view seeks to account for major decisions in the history of the EC by positing a two-stage approach. In the first stage, national preferences are primarily determined by the constraints and opportunities imposed by economic interdependence. In the second stage, the outcomes of intergovernmental negotiations are determined by the relative bargaining power of governments and the functional incentives for institutionalization created by high transaction costs and the desire to control domestic agendas. This approach is grounded in fundamental concepts of international political economy, negotiation analysis, and regime theory.

The net economic interests of producers and popular preferences for public goods provide a solid foundation for explaining agricultural policy and industrial trade liberalization, as well as socio-economic public goods provision, within the EC. These preferences tell us the goals of states, their alternatives, and – through the level of societal constraint on governments – the extent to which governments are willing to compromise. The distributional outcomes of intergovernmental negotiations are shaped by the unilateral and coalitional alternatives to agreement, as well as the opportunities for compromise and linkage.

Like other international regimes, EC institutions increase the efficiency of bargaining by providing a set of passive, transaction-cost reducing rules. But EC institutions cannot be explained entirely on the basis of existing regime theory. Instead, at least two other functions of international institutions need to be taken into account. First, EC institutions delegate and pool sovereignty, taking key decisions about linkage out of the hands of national governments. The delegation and pooling of authority in the EC can be explained by extending existing functional regime theory, which focuses on the reduction of transaction costs. Governments delegate authority and provide for qualified majority voting in order to increase the efficiency of bargaining at the expense of slightly increased political risk for domestic groups. While existing regime theory focuses on the risk of defection, the major concern of EC states tends to be the risk that the consequences of the agreement, even if all comply, will turn out to be less advantageous for key domestic groups than expected. Thus governments weigh the potential gains from co-operation against the domestic political risk. Second, EC institutions structure a 'two-level game', which increases the initiative and influence of national governments by providing legitimacy and domestic agenda-setting power for their initiatives. To explain this function,

regime theory must be supplemented by theories of domestic politics and two-level games.

By bringing together theories of preferences, bargaining and regimes, liberal intergovernmentalism provides plausible accounts for many aspects of the major decisions in the history of the EC in a way that is sharply distinct from neo-functionalism. Where neo-functionalism emphasizes domestic technocratic consensus, liberal intergovernmentalism looks to domestic coalitional struggles. Where neo-functionalism emphasizes opportunities to upgrade the common interest, liberal intergovernmentalism stresses the role of relative power. Where neo-functionalism emphasizes the active role of supranational officials in shaping bargaining outcomes, liberal intergovernmentalism stresses instead passive institutions and the autonomy of national leaders. Ironically, the EC's 'democratic deficit' may be a fundamental source of its success.

Moreover, liberal intergovernmentalism provides explanations for some nagging anomalies inherited from neo-functionalism. Variation in the tightness of domestic societal constraints is employed to explain the disruptive role of dramatic-political actors and the distinction between those issues where linkage or compromise is possible and those in which log-rolling or lowest common denominator solution prevails. The distinction between positive and negative externalities helps explain which issues generate common solutions and spark geographical spillover, and which do not. The introduction of a 'two-level game' analysis explains why France sought industrial trade liberalization with Germany in the 1950s, despite the unilateral openness of the German economy at the time.

Critics may challenge the approach proposed here in three ways. First, they may dispute the basic framework, arguing that state behaviour is not purposive and instrumental, that preference formation does not precede the formulation of strategies, or that national preference and intergovernmental bargaining are so completely manipulated by supranational officials as to be meaningless categories. Second, they may challenge the liberal understanding of state preferences employed here, which draws on contemporary theories of economic interdependence to explain national preferences. Alternative conceptions of economic interest are certainly possible, as are (liberal and non-liberal) explanations based on ideology or geopolitics. Third, they may question the intergovernmental theory of bargaining, with its stress on bargaining power rooted in unilateral alternatives, competing coalitions, the possibilities for linkage, and the controlled delegation of power to supranational institutions under conditions specified by functional theories of regimes and 'two-level' games views of domestic politics. Such debate is to be welcomed.

Yet few would go so far as to deny the importance of preferences and power altogether. Indeed, a strong liberal intergovernmentalist theory is widely seen as

a precondition for the development of more complex theories of integration, such as neo-functionalism. Without explicit theories of state interests, interstate bargaining, and international regimes, it is impossible to determine when consequences are truly unintended, the common interest is truly being upgraded, or supranational officials are truly acting autonomously. This vindicates Haas's judgement that debate between *general* theories of domestic and international politics is necessary. Such a debate is surely preferable to a clash between 'intergovernmentalist' and 'supranationalist' ideal-types, without any specification of the conditions under which each might be expected to apply.

It is certainly true that liberal intergovernmentalism accords supranational institutions and officials less weight and prominence than neo-functionalism once did. Committed integrationists typically read such conclusions as a disparagement of the unique achievement and future potential of the EC. Yet the real achievement and hope of the Community may lie not in the transcendence of traditional state preferences and power, but in the underlying domestic and international forces that have shaped national preferences and power in the direction of greater co-operation. Liberal intergovernmentalism assimilates the EC to models of politics potentially applicable to all states, thereby specifying the conditions under which a similar process of integration may occur elsewhere.

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Corporate Strategies and European Challenges Post-1992

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I. Introduction

According to the 1987 Cecchini Report on the cost of non-Europe (Cecchini, 1987; Emerson *et al.*, 1988) the potential gains from completing the Internal Market rely on three expected effects, in addition to direct cost saving through lower real trade costs: greater production efficiency achieved through the enlargement of the market; reallocation of resources between enterprises and activities; and reduction in monopoly power. The Report also underlined several conditions for these effects to materialize at micro and macroeconomic level. One is the assumption that economic agents will change their behaviour, knowing that adjustment to the new conditions will give rise to major costs.¹

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¹From a macro perspective, it was argued that completion of the Internal Market will produce increased interdependence between Member States, since it is based on an expansion of intra-Community trade and free movement of people and capital. 'Observation of economic factors shows that any inconsistency in macroeconomic objectives between highly interdependent countries or any external disequilibrium in one of them is frequently resolved by downward adjustment, the correction being made through recessionary rather than expansionary measures' (p. 221). It was added that 'early 1988 sees a weakening of the world and European business cycle and a much higher level of European exchange rates against the US dollar and other currencies linked to it. ... These trends hold out obvious dangers' (p. 9).