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Reputation Sells -Compensation Payments in the Political Sphere

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Reputation Sells

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Abstract

Bargaining between different groups, which differ in objectives, preferences and interests, is at the core of political decision-making. Yet, it is logical to presume that negotiations involving more parties will lead to inertia and a slow pace in the legislative process. According to this hypothesis, political systems involving many veto-players such as federal countries or international organisations must be prone to a low activity. Oddly enough, a closer look on the European Unions' and Germany's legislation activity level shows that these are fairly high, although in both systems exist a considerably amount of opportunities to block or delay reforms. Decision-making in this framework is mostly brought about by side-payments, which are usually not reported to the public. This poses a question. If compensation payments are able to fuel the decision process by balancing interest and help to avoid reform deadlocks why are they frequently disguised? This paper addresses this question by suggesting that politicians do avoid openly paid compensation payments out of concerns over their reputation and that decision-making is rather a strategically action than showing majorities for a certain topic.

Keywords: Compensation, Logrolling, Side-Payments, Political Reform, Political Economy

1 Introduction

Delay seems to be a day-to-day business in politics, as the press frequently reports reform blockages or procrastination of reforms. This observation is also supported by the slow pace of national negotiations and negotiations in international organisations such as the European Union. For instance, in 2009 the European Union Member States are still bargaining over a constitution or a new treaty, the groundwork of which was laid in the treaty of Rome in October 2004. Due to frequent rejections by Member States in different referenda it has not yet been adopted.¹ But also on the national level, e.g. in Germany, political blockades do not seem to be unusual at all and include tax reforms or renewals of the health system (Schwarz 2006; Stuewe 2008). Even if legislation is adopted, the process seems to be very time-consuming. The adoption of the immigration law, for instance, and the reform of the inheritance tax took three and four years, respectively.² This is actually nothing in comparison to the property tax, which has been discussed at least since 40 years.

Maybe the most prominent example for delays in politics is the delayed stabilization of budget deficits in South American and OECD countries during the 80s. In consequence, Argentina experienced negative growth rates followed by hyperinflation (Alberola et al. 2004).

Based on these experiences, stalemate and reform delays seem prevalent. But taking a closer look at the decision-making process in the EU and the German political system, fewer cases of reform blockades are revealed than are assumed. The legislative process in both institutions is more active than is generally suggested. This is startling, since there are

¹ The negative referenda took place in the Netherlands: January 2005, France: May 2005, Ireland: June 2008. For more detailed information see the homepage of the EU.

The treaties can be found at: http://europa.eu/abc/treaties/index_en.htm, the process: http://europa.eu/institutional_reform/index_en.htm and the statement by president Barroso following the Irish referendum on the treaty of Lisbon: 2008 http://ec.europa.eu/commission_barroso/president/pdf/statement_20080613.pdf

² To pass the law on immigration (*Zuwanderungsgesetz*, 28.3.2007) it took about three years starting from the date it was first presented to the government (3.8.2001) to its acceptance by the second chamber (*Bundesrat* 9.7.2004). By the time the law was finally accepted it needed to be adapted to the new rules of the European Union. The adoption of the reform of the inheritance tax even took about four years. Bargaining started in March 2005 and ended in December 2009. Although both examples involve decisions of the highest court (*Bundesverfassungsgericht*), the usual time to accept and realize a reform that needs the consent of both chambers is quite long.

clearly plenty of opportunities to block decisions in both institutions. So why do we observe few blockades, although the potential of conflict is high?

In the literature, delays are mostly attributed to political fragmentation, namely the number of decisive agents and the distance between their ideological positions.³ Thus, decision-making in the European Union and in Germany is prone to delays as it involves many agents that not only have diverging interests, but also the power to veto-decisions. One can also observe several attempts to reduce the number of decisive agents. For instance, in Germany it was proposed to reduce the number of the *Länder*⁴ and thereby to lower the potential for conflicts in the second chamber representing the *Länder* (Lammers 2006). The European Union changed the voting rule for a large part of EU decisions from unanimity to a majority rule in the treaty of Lisbon (2008) and this reduced the number of decisive agents at least in some decisions.

Hence, there must be conflicts of interest. Otherwise, unions would not consider changing the voting rules or lowering the number of members. Accordingly, we expect conflicts to lead to higher rejection rates of legislative proposals. In fact, this is neither the case in the EU nor in Germany. This puzzle can be explained by various factors that may bias the statistic of rejection rates. Either the rejection rate is so low because no controversial proposal was finally brought to a decision or decision-making is pushed on by giving compensation payments.

The idea of compensation payments can be traced back to the roots of Public Choice (Riker 1972, pp. 49; Buchanan/Tullock 1984, pp. 133). In fact, there exists a vast literature on the topic, ranging from theoretical approaches (Riker/Brams 1973; Harstad 2005; Asheim et al. 2006; Harstad 2008) to more practical issues, such as the financing of presidential campaigns (Stratmann 2002; Kroszner/Stratmann 2005; Stratmann 2006) or focussing on the processes in certain institutions (Crombez 2000; Fenge/Wrede 2004; Schwarz 2006; Hagemann/DeClerk-Sachsse 2007; Dreher et al. 2009).

Alas, despite the efficacy of compensation payments to balance diverging interests, neither in the European Union nor in German politics is paying monetary compensations to reach

³ See Ahlfeld(2009) for a survey.

⁴ The term *Länder* refers to a lower level of government, meaning the same as the concept of a federal state.

Reputation Sells

a majority is common, at least at the first glance. However, one can observe that states do compensate each other for decisions by paying earmarked transfers or by vote trading. Yet, informal communication and disguising of compensations are inherent in the system. What motivates politicians to operate in the dark? One can argue that the choice of instruments is a constitutional necessity. Authorities rarely have the competence to give non-earmarked transfers, but actually, this cannot explain the whole story. The problem goes further. As predicted in the New Political Economy, the reputation of politicians as well as parties, countries or unions may be the most important motive. This prediction is also supported by recent insights of the literature on Behavioural Economics (Bolton/Ockenfels 2008). Applying these findings to the political sphere might at least partly explain why so few visible compensation payments are given and why reform blockades are avoided.

Taking this into account, the paper then asks what really drives politicians' decision-making. To this end, the decision-making processes in the European Union and the German political system are analyzed. The potential for conflicts as well as the opportunities to pay compensations allowed by constitutional restrictions are discussed and finally a comparison of the "real world" and rational actions is provided. The remainder of the paper is organized as follows: Section 2 reviews the various forms of paying compensations, emphasizing their differences and similarities and ends with a discussion on their efficiency. In section 3 a rough description of the decision-making processes in the European Union and the German political system follows. Section 0 aims at explaining the observations of few blockades in the European Union and the German political system. A major factor contributing to this puzzle appears to be the reputation of politicians, which can be damaged by blockades as well as by openly paid transfers. The last section draws some conclusions.

2 How to influence political decisions?

In general, there exist four different possibilities of influencing decisions. These are interest group activities which encompass lobbying and vote buying, the method of logrolling, side payments and consensus decisions.⁵ Their special characteristics are explained in the following.

2.1 Lobbying

Interest groups can influence political decisions in two ways: Lobbying and vote buying (Spiller/Liao 2006). While lobbying refers to a more general influence that is exerted by providing certain information, which may have an impact on political decisions, vote buying is a more concrete form of influence, trying to enforce the interest group's preferences by influencing politicians' votes. Both approaches, normally indirectly or directly, aim at a policy that correlates with the lobby's objectives. The relevant literature focuses on several issues. For instance, some research analyzes the effect of financial contributions by lobby groups on presidential campaigns, especially in the US (Levitt 1995). Apparently, this form of lobbying has some noticeable effects. For instance, the campaign of former US president George W. Bush was allegedly financed by oil interests. In return, his policy was marked by an oil friendly tendency (The New York Times 2000; Independent 2008).

Other research focuses on lobbying activities in parliaments or international organizations. Most prominent is the presence of the farm lobby in European politics. About 40% of the EU budget is spent on the agricultural sector (Fenge/Wrede 2004).⁶ The farm lobby has a direct influence on subjects such as milk quotas (Economist 2008a) or the discussions on trade policies with the aim of protecting domestic products (Economist 2008b). Apart from agriculture, the political sphere is also regularly said to serve the interests of energy lobbies or the automobile industry (Stokeman/Van den Bos 1994). In Germany for instance, the automobile industry succeeded in receiving subsidies from the government to prevent the

⁵ Actually illegal forms such as corruption or bribery, are not so far located from these legal instruments, but are neglected in this context.

⁶ The percentage can also be found on the official websites of the EU under http://ec.europa.eu/budget/documents/2008_en.htm. (retrieved: 07.07.2009).

loss of hundreds of jobs during the financial crisis that began in 2007 (Die Zeit 2009). Furthermore, in the European Council the position of the German ministry of environmental affairs changed with the domestic political situation. As minister of environmental affairs under chancellor Kohl, Angela Merkel strongly supported a sharp reduction of emission standards for cars in the Council. But after being elected as chancellor her position changed to rather focusing on the interests of the German automobile industry that concentrates on large cars with high CO₂ emissions (Die Zeit 2008).

Lobbying is always a reciprocal relationship between the lobby group and the involved politician. The interest groups profit from influencing politics in their favour while the benefit of the politician can take various forms. Lobby groups can offer personal benefits such as employment by the lobby group after the political career or provide certain information for politicians. In the case of a large lobby group they as well might have the power to influence public opinion on political issues. Lobby groups are not part of the actual decision-making process. They can only indirectly act via influencing an agent that is directly involved in the negotiation. A high level of political fragmentation involving many agents possessing relatively low voting power gives the interest group the opportunity to accurately influence the number of agents needed to reach a majority and thus to avoid overcompensation. A high level of fragmentation also allows the lobby group to compensate only those agents that are close to its own interests. This means that for lobby groups, fragmentation can have some advantages. However, activities of interest groups have an external character, as the lobby group itself is normally not directly involved in the negotiations. This stands in a stark contrast to the following types of compensation payments.

2.2 Logrolling

Logrolling is just another word for vote trading in a situation where two agents are both decisive for two decisions. When two decisions come up and the first agent is only interested in project A and the second agent only in project B, both projects can find a majority by vote trading. When the first agent votes for project B, that is of no interest to him, and the second agent in exchange accepts project A, both agents profit from the trade. To apply this form of transfer, at least two different projects are needed and the

preferences of the bargaining groups must diverge. However, as soon as more than two agents are involved, logrolling can become intricate and time-consuming as the search for the “right” partner with whom vote trading is possible becomes more complicated (Mueller 2003, pp. 104). In such a case logrolling might become inefficient. Thus, when transaction costs are included in the framework, fragmentation clearly has some negative effects on the frequency of logrolling.

In contrast to these negative properties of fragmentation a rising number of agents enhances the possibilities of building different coalitions with different sets of preferences. This is also known as the Hillinger Paradox (1971). For instance, in the European Union logrolling is frequently observed in spite of the large size of the Union. Selck (2005) states that this high frequency can be explained by the large variety of Member States and thus the wide range of issues that are discussed. Hence, the effects of fragmentation are not clear-cut and strongly depend on the level of transaction costs, especially with regard to the communication between the different agents.

2.3 Side payments

Side payments are closely related to the mechanisms of logrolling. They can be defined as monetary or non-monetary transfers that are directly connected with a specific decision. Hence, logrolling is just a special form of side payments, by which votes as non-monetary goods are traded. Apart from a consenting vote, side payments can take the form of subsidies, earmarked transfers dedicated to special projects, non-earmarked transfers or even promises of political support. All forms can be observed in the political sphere. In the year 2000, the German government gave 300 million Euros to the federal city state of Berlin to support various cultural projects. At the same time, the federal city state of Bremen was assured that the central government would support its status as a state. All these payments were closely connected to the states’ support of an upcoming decision about a tax reform (Die Zeit 2000).

Another example consists in the US government usually making side payments in the form of IMF (*International Monetary Fund*) credits or World Bank projects to influence the votes of developing countries in the UN security council (Kuziemko/Werker 2006; Dreher et al. 2009). Along the same lines, the EU pays transfers via its regional funds to poorer Member

States to ensure a deeper integration. If those payments are monetary and non-earmarked they have the unique advantage of exactly measuring the preferences of agents. This is not possible by giving non-monetary or earmarked transfers (Buchanan/Tullock 1984, pp. 133).

2.4 Consensus

The last type of compensation payment, the consensus, is not a transfer in a literal sense. A consensus is defined as the giving-up of particular demands by each side in the dispute to reach an agreement satisfying both sides to some extent. Giving up demands to a certain degree is nothing else than giving a compensation to the bargaining partner. A consensus differs from the other types of compensation payments in so far as it does not connect different topics but only applies to one issue. In general, a consensus helps to avoid reform deadlocks but has surely certain disadvantages. First, a consensus is likely to procrastinate a decision when an agreement is difficult to reach. This might depend on the distance between the agents' positions as well as on their number and their voting power. Additionally, reforms may be *deformed* by the mechanism itself and the original aim may be alienated (Stuewe 2008).

For instance, the health system reform (*Gesundheitsreform*) in Germany in 2008 is obviously a consensus between the governing parties, the Social Democrats (*SPD*) and the Christian Democrats (*CDU*)⁷. From the outset, both parties aimed at controversial health systems. However, in 2004 they agreed on a system that does not have much in common with their original models and in general, the resulting change of the system was not considered to be a progress (Richter 2008). However, minor changes can be found in every reform to either satisfy the members of the own or the opponent party. Detecting a consensus is quite difficult and requires a careful investigation of the original aims of agents and comparing them with the results of the actual decision. That task is even more intricate when the ideological distance between the negotiators is not very large or objectives change over time.

⁷ The Christian Democrats (*CDU*) usually build a coalition with the Christian Socialist (*CSU*), their "sister party". Henceforth the *CDU* encompasses the *CSU*, although this is an autonomous party.

2.5 Questions of efficiency

All possibilities of influencing the decision-making process that were discussed in the preceding sections (lobbying, logrolling, side payments and the consensus) vary in some important aspects such as institutional demands, the possible influence of the number of agents, the goods that are traded and their characteristics allowing to accurately balance different interests.

It is obvious that compensation payments can be an effective measure to avoid stalemates, but are they efficient? In fact, when decisions are unanimously taken, every form of compensation payment would have to be pareto-superior for everyone. Otherwise one or more negotiators would abstain from accepting the decision. But under a majority rule negative outcomes for groups that do not participate in the compensation deal are possible. Consider the following example: Three Projects are discussed A, B and C. Three agents (X, Y, Z) are involved in generating the following outcomes: X: (10,-1, -1), Y: (-1, 10,-1) and Z (-1, -1, 10). When vote trading takes place between agents X and Y and following that, projects A and B are realized, the utility of X (9) and Y (9) will be enhanced, while the utility of agent Z (-2) will be decreased. While the case can be efficient under the Kaldor-Hicks criterion, it is not pareto-superior compared to the status quo.⁸

In contrast, if it is assured that all agents are allowed to participate in the negotiation the situation may turn out to be efficient. Asheim et al.(2006) suppose that the coalition that will benefit from the reform as well as the coalition that would suffer losses from an adoption of the proposal will try to secure negating or consenting votes by side payments. Hence, if expected losses are higher than expected profits the losing parties are able to block the decision by buying the votes of the winners to prevent the upcoming change. In the same manner, the coalition of reform-beneficiaries will influence the votes of the opposition. The transfer of side payments among themselves continues until no winning or losing group is left to buy the votes of the opposition's groups and the majority rule turns out to be unanimous.

Apart from compensation payments, lobby activities can be an important factor in influencing politicians' positions. But the discussion above does not apply to this form of compensation payments, as these show some distinctive differences to other forms of

⁸ See Buchanan and Tullock (1984, pp. 133) for a survey.

influencing the position of a negotiator. First, lobby groups do not actively participate in the decision-making process but exert influence indirectly, which probably is the most important difference between lobby activities and other compensation schemes. Second, lobby activities do not aim at improving the population's situation but focus on their own interests. Thus, a decision pushed through with the help of an interest group mainly benefits the members of the interest group and not the general public. In fact, lobby groups prevented the EU from tightening the emission standards for cars or reducing the prices of agricultural products. But even in the absence of lobby activities it is not granted that every reform that passes the legislative body benefits all citizens. For instance, literature in Political Economies and Public Choice emphasizes that politicians' objectives will strongly differ from the voters' utility and that politicians are not perfect social planners (Drazen 2000, pp. 166; Mueller 2003, pp. 333). An overview is provided in Table 1.

Reputation Sells

Table 1: Overview of compensation payments

| | Lobbying | Logrolling | Side payments | Compromise |
|---|--|--|--|---|
| Number of issues demanded | One or more | Depends on the number of agents, at least two | One or more | One |
| Demands a package deal | Can but not necessarily | Yes | Can but not necessarily | Not possible |
| Aiming at a precise decision | Can but not necessarily | Yes | Yes | Yes |
| Exact weighing of the preferences | No | No | Only in the case of non earmarked monetary transfers | No |
| Effects of number of participating agents (fragmentation) | No systematic effect for general influence, but if a certain decision is aimed at fragmentation, it has positive effects (compensation decrease) | <u>Positive effect:</u> More options to reach a majority and avoid overcompensation (under a majority rule) and larger issue space <u>Negative effect:</u> Increasing transaction costs | <u>Positive effect:</u> More options to reach a majority and avoid overcompensation (under a majority rule) | <u>Negative effect:</u> In the case of transaction costs |

3 Blockades and compensation in the practice

The frequency of fostering decision-making through compensation payments can be influenced by institutional restrictions. First, the voting rule might affect compensation payments. Under unanimity rule, which is applied to some decisions made by the EU, the potential for dissents is large as every agent has a veto right and hence is pivotal. Under a majority rule this high potential of conflict decreases. In general, but depending on the situation a majority rule will lead to lower compensation costs than a unanimity rule. The following discussion concentrates on these two basic rules, neglecting the wide spectrum of voting arrangements between those extremes.⁹

As a second constraint for a successful compensation, the competence to assign transfers must be given to every negotiator. This condition is not always fulfilled or at least the competence is restricted. The constitution usually prescribes different competences to different levels of government. In addition, institutions on the same level normally have a different voting power as most decisions are made by using a weighed majority rule, where participants have different numbers of votes. For instance, in the EU council or in the second chamber in Germany (*Bundesrat*) the number of votes depends on the size of the state's population. Apart from that, the voting power of a state might hinge on history or its economic relevance. Dreher et al.(2009) mention that grants by the IMF and the World Bank that might be regarded as side payments are frequently initiated by the US. Other countries, especially developing countries, do not have this possibility.

Diverging voting powers do not prevent the opportunity to make compensation payments, but might have an effect on decisions and strategic behaviour. For instance, in the EU and the UN more powerful countries often try to influence the votes of less powerful countries(Matilla/Lane 2001; Steinberg 2002).

The strength of influence is also an important issue for interest groups. Large unions, such as labour unions or the car industry in Germany seem to have a stronger influence on politics, while smaller or poorer groups are less influential. Admittedly, small lobbies representing social issues such as environmental protection enjoy greater public support

⁹ For instance in the UN Security Council only the permanent members (U.S., U.K., France, China and Russia) have a veto right but this applies not to all members.

(Spiller/Liao 2006). In contrast, Olson (1965, pp. 55) states that small interest groups are more powerful due to better organization.

The voting power of an agent can be measured by so called power indices, such as the Banzhaf-Index which is based on the possible coalitions that can be formed by the particular country in a set of N countries. The index is regularly used in research on decisions such as the Maastricht criteria (Kandogan 2000; Sutter 2000), the EU eastern enlargement (Leech 2002), or the decisions to reallocate funds among the *Länder* in Germany (Pitlik et al. 2001).

In the following, the legislative process in the German bicameralistic system and the EU as an international union is analyzed. Regarding the latter, the main emphasis will be on the decision-making of the council of ministers. In both cases, interest groups are not separately taken into account, because they are not directly involved in the decision-making process. The discussion will focus on the possibilities to avoid a stalemate by making compensation payments in either institution and emphasize -what may be even more important - if and in what way they are given. Theory is quite clear about the use of compensation payments but the comparison between theory and practice will show that the theoretical assumptions must be amended and extended to integrate some important factors.

3.1 The German political system

Germany is a federation and thus government is executed on different levels. The legislative body on the national level is divided between two chambers: The first chamber (*Bundestag*) whose members are elected every four years by the whole population and the second chamber (*Bundesrat*), which consists of 69 representatives of the sixteen *Länder*. In the first chamber every incumbent has one vote and is elected for four years. These incumbents also elect the central government for the same period of time. Normally, members vote in line with party politics (party discipline) and so the party or the coalition that forms the government generally has a majority in the first chamber.

The second chamber consists of two representatives of the government of every *Land*, which is elected by the *Land's* population. Election periods differ from *Land* to *Land* but amount to an average of three or four years. Here, every *Land* has three to six votes depending on the size of its population. Large or densely populated states such as North Rhine Westphalia or Bavaria have six votes while small city-states such as Bremen or

Reputation Sells

Hamburg as well as states that are less densely populated have only three votes.¹⁰ Hence, it is obvious that voting power differs from state to state. When a *Land* is governed by a coalition consisting of two or more parties, it cannot split its votes in the second chamber. *Länder* must give their votes uniformly.¹¹ If coalitions in the *Länder* cannot agree on a decision they have to abstain from voting which is counted as a rejection of the legislative proposal.

Both chambers are involved in the legislative process, though not every law needs to pass both chambers. For some laws a majority in the first chamber suffices (*Einspruchsgesetze*). Other laws also require the approval of the second chamber (*Zustimmungsgesetze*). The double majority in both chambers is requested in the case of constitutional amendments, laws that have effects on the financial instruments of the *Länder* and laws that are to be carried out by the *Länder*.

The system contains some potential for conflict. On the one hand, dissent can arise within both chambers as legislative decisions are made under majority rule. In addition, a dispute can emerge between the two chambers reflecting the different interests of the federal and the federal state governments. However, during the past few years the conflict between the two chambers was not dominated by local versus central interests but by differing ideological positions. Controversies emerged between the governing coalition and the opposition even within the second chamber (Lhotta 2003; Leunig 2004; Stuewe 2004; Schwarz 2006). Thus, the following discussion will mainly concentrate on these ideological disputes.

The largest parties in Germany are the Social Democrats (*SPD*) and the Christian Democrats (*CDU*). Both often formed coalitions on the federal or the state level with smaller parties such as the Greens (*Bündnis 90/ die Grünen*), the Liberals (*FDP*) and the left party (*formerly PDS, now "Die Linke"*). In the first chamber the potential for disputes is quite low as the governing party (or coalition), which is mainly responsible for legislative proposals has a clear majority, unless there is a conflict of interest with the coalition partner or within the governing party itself. Usually, decisions become more intricate when

¹⁰ An overview about the federal states' vote can be found in the Appendix.

¹¹ This rule is defined by the constitution in article 51.3 *Grundgesetz*.

legislative proposals are submitted to the second chamber.¹² Due to the different voting mechanism, a majority in the first chamber does not necessarily induce a majority in the second chamber and thus blocking of legislative proposals is not uncommon. During the past few years, majorities usually differed in the two chambers as can be seen in Figure 1 , which shows the number of votes of the governing coalition in the second chamber on the one hand, and on the other hand the normal majority and the absolute majority required for decisions.

If the votes of the *Länder* that were governed by a coalition of a governing party and a party not belonging to the government coalition are not counted, the government did not have a single month of majority in both chambers in the period of 1999 to 2008. Clearly, this situation offered blocking opportunities and thus possibilities for transfers to the *Länder* that were governed by the opposing party which actually happened in 2000 under chancellor Schröder. The reform was already mentioned in a previous section.

The government had suggested a tax reform to reduce the tax burden for taxpayers in general and especially for corporate enterprises and private business. The government coalition of social democrats (*SPD*) and the Greens (*Bündnis 90/die Grünen*) only had a majority in the first chamber¹³, but not in the second chamber (see Figure 1). Nevertheless, the bill passed the second chamber in July 2000 due to positive votes from Bremen, Berlin, Brandenburg and Rhineland-Palatinate that were actually not ruled by the government coalition but by a coalition including at least one opposition party. At the same time, the federal government promised the city of Bremen to support its status as a state. The state of Berlin received an earmarked transfer to invest in some cultural projects. In Brandenburg, infrastructure projects were brought forward and finally Rhineland-Palatinate was assured of an amendment of the discussed tax reform. These favours by the federal government could be interpreted as compensation payments to push through the reform. The transfers were not paid in monetary non-earmarked ways, which could be ascribed to the constitutional restrictions concerning the government's transfer giving competences.

¹² It is also possible for the opposition to propose a law, but the thesis will refrain from discussing this possibility.

¹³ The government coalition had 345 seats in Parliament (*298 SPD and 47 Bündnis 90/die Grünen*) out of 669 seats altogether. Thus they had a majority of 52% in the first chamber.

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Figure 1: Votes in the second chamber

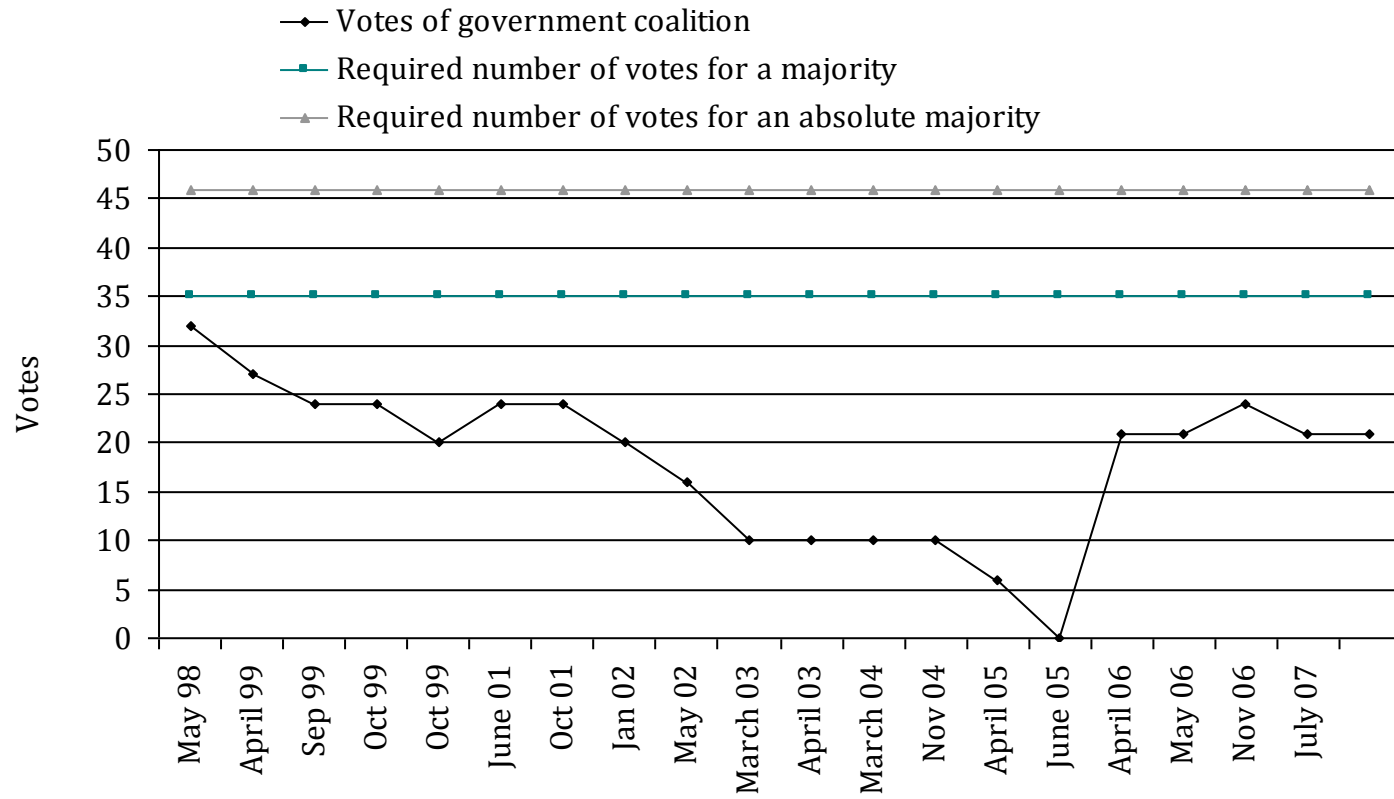


Figure 1: Votes of a government coalition only encompass those parties that are part of the coalition. Votes are not counted when ruling parties have a coalition with a party that does not belong to the federal government (e.g. votes of SPD/PDS in a state government are not counted as votes for SPD/Bündnis 90, die Grünen in the federal government). The data can be found in the Appendix.

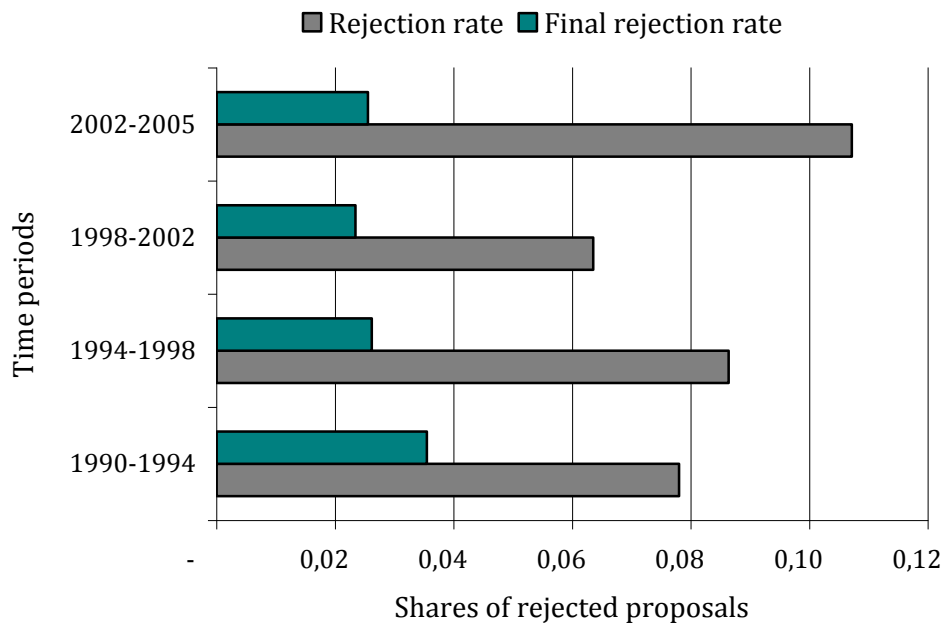
However, the government possesses the legislative power to initiate proposals that suit the groups whose votes it needs to reach a majority. It is also noteworthy that all states were governed by coalitions that apart from opposition parties also included one of the governing parties, what might have made them more likely to change their position (Schwarz 2006).¹⁴

It is notable that the government failed to avoid overcompensation and gave transfers to more *Länder* than was necessary to ensure a majority in the second chamber. The government did not obtain a narrow but a comfortable majority. While it needed only 35 votes to meet the benchmark it obtained 41. On the one hand, this overcompensation might be rooted in the difficulty to accurately meet the benchmark of 35 votes because of their distribution. On the other hand, the votes of some *Länder*, especially those that were governed by a coalition of liberals and conservatives, were practically impossible to buy due to political reasons. Therefore, winning exactly 35 votes was impossible. In addition, bargaining with more states than are needed to win the poll may help the government to keep the prices to buy a vote relatively low. Because it emphasizes that the government does not depend on the votes of particular states but it has some choice. This example shows that decisions can be reached via compensations but that possibilities are restricted.

Actually, the rejection rates of legislative proposals in periods when the two chambers were dominated by different majorities do not significantly differ from other periods. In the past few years, the rejection rates for proposals that needed the approval of the second chamber were quite low. The final rejection rate (after intervention of the mediation committee) of all proposals that entered the second chamber has always been under 5% (Stuewe 2004; Manow/Burkhart 2006; Schwarz 2006). However, Manow and Burkhart (2006) state that these low rejection rates are not a sign of cooperation. They underline that the real potential for blockades is better expressed by the number of legislative proposals that entered the second chamber. In times of different majorities this rate was in fact relatively low (Manow/Burkhart 2006).

¹⁴ The coalitions in the states were constituted as follows: In Brandenburg: Social Democrats/Christian Democrats, in Berlin: Social Democrats/Christian Democrats, in Bremen: Social Democrats/Christian Democrats, in Mecklenburg-Western-Pomerania: Social Democrats/Left, in Rhineland-Palatinate: Social Democrats/Liberals.

Figure 2: Rejection rates of proposals



Data provided by the German Bundesrat „Statistiken Parlamentsmaterialen Fortschreibung der Statistik“

To sum up it can be stated that under the German bicameralistic system opportunities to pay transfers do exist although they are rarely used or at least sparsely reported. It is also noteworthy that compensation payments can result in overcompensation.

3.2 The political system of the European Union

The three main decision bodies of the EU are the European Commission, the European Parliament and the Council of Ministers. The European Parliament is directly elected by the citizens of the EU for a period of five years. The number of representatives of a Member State in the European Parliament depends on the size of that Member's population. The Council of Ministers consists of the governments of the Member States or the minister in charge for the area in question. Therefore, the members of the council will

change over time.¹⁵ It finally decides on the composition of the European Commission following suggestions from the European Parliament.

While the Commission is the executive organ of the European Union, the European Parliament and the Council are the legislative organs and have the power to adopt community legislation on the basis of proposals made by the Commission. The Commission also prescribes the decision-making mechanisms to be used by the Council and the Parliament depending on which policy area is touched. There exist four different voting mechanisms: “Co-decision”, “cooperation”, “consultation” and finally the “assent” mechanism. The “co-decision” method requires that the Council and the European Parliament agree on a law before it is adopted. In this case the two organs have the same power with regard to acceptance or rejection. The “co-decision” procedure covers the largest proportion of European legislation, including topics such as the internal market, employment, social policy, public health, cohesion or education. The “cooperation” mechanism allows the European Parliament to accept or reject a proposal and suggest amendments. However, the final decision lies with the Council alone. A “consultation” means even less influence by the European Parliament as it merely has the right to comment on a proposal, whereas the Council is not even obliged to take the comments into account. This procedure only applies to topics not explicitly assigned to the “cooperation” or to the “co-decision” procedure. Finally, there is the “assent” mechanism, under which the Parliament is only allowed to reject or accept a proposal but it is not allowed to suggest any amendments. The “assent” procedure is used to decide on subjects such as the accession of a new Member State, human rights-issues, certain international agreements or enhanced cooperation. However, as in most cases the “co-decision” procedure is applied, the Parliament has a veto power in most decisions. Nevertheless, the Council is regarded as the most important legislative organ.¹⁶

However, the voting mechanisms in the European Union are quite complicated and offer a myriad of opportunities for blocking or procrastination and thus for compensation payments. First, Council and Parliament can block each other and delay any decision made

¹⁵ The council formation is divided in the following sections: General Affairs and External Relations, Economic and Financial Affairs, Justice and Home Affairs, Employment, Social Policy, Health and Consumer Affairs, Competition, Transport, Telecommunication and Energy, Agriculture and Fisheries, Environment and finally Education, Youth and Culture.

¹⁶ For a short review of EU processes and institutions see http://eurlex.europa.eu/en/droit_communaire.htm

under the “co-decision” procedure.¹⁷ The interests of both institutions may be due to the way they are elected. As the Parliament is directly elected by the citizens, party politics across European borders play a greater role than in the Council, which represents the Member States and thus is more motivated by national interests. Secondly, legislative proposals depend on the composition of the Council and the Commission. The agenda is proposed by the Commission and therefore is shaped by national aims and the interests of its president. Hence, it is common for the Commission to be elected in accordance to the agenda that is expected from it. For instance, under the presidency of France in 2008, especially agrarian topics were expected to be touched (The Economist 2008). Likewise, countries sometimes postpone proposals to periods, in which the Commission will be more likely to support their interests (Crombez 2000). As a last point, controversies may emerge within the institutions. Despite of the various opportunities for conflicts, the following analysis concentrates on the decision-making process of the Council, as it is the most important organ of the EU and also encompasses conflicts between countries instead of party positions as in the Parliament.

The decision procedure in the council depends on the subject in question. In certain areas that affect the fundamental sovereignty of the members such as the admission of a new Member State or the common foreign policy, unanimous decisions are required. This rule actually allows every Member State to veto legislation and thereby prolong the decision-making process. For instance, the population of Ireland rejected the proposal of a common European constitution in a referendum and thereby halted the process (2008). For other areas an absolute or qualified majority is sufficient. Here, blocking is more intricate. The votes of Member States differ as they depend to a certain degree on the number of citizens. An exact relationship between size and votes would not guarantee voting power for every Member State.¹⁸ For instance, in the first stage of the EU Luxembourg had no chance to be pivotal for any decision based on the number of its votes in the Council (Leech 2002;

¹⁷ See Kardasheva(2008) for an analysis of the relationship between the European Parliament and the Council.

¹⁸ The distribution of votes in the Council are as follows: Germany, France, Italy, UK: 29 votes, Spain and Poland: 27 votes, Romania: 14 votes, the Netherlands: 13 votes, Belgium, Czech Republic, Greece, Hungary and Portugal: 12 votes, Austria, Bulgaria and Sweden: 10 votes, Denmark, Ireland, Lithuania, Slovakia and Finland: 7 votes, Cyprus, Estonia, Latvia, Luxembourg and Slovenia: 4 votes, Malta: 3 votes, in total 345 votes. (6.7.2009)

source:<http://www.consilium.europa.eu/showPage.aspx?id=242&lang=de>, retrieved:09.07.2009

Irlenbusch et al. 2003). However, larger and densely populated countries have more executive power than smaller or less densely populated Member States. Thus, they could dominate smaller Member States in decisions. In the treaty of Lisbon this disadvantage was mitigated by the introduction of the double majority, which demands not only a majority in the Council including weighed votes but also a majority of the Member States without weighed votes to accept bills. This assigns greater voting power to smaller states and gives them the chance to exert a greater influence.

Irrespective of the various possibilities to delay reforms under the different decision-making mechanisms and differing strength of the Member States the system offers various opportunities to block reforms. However, as in Germany, although enough opportunities for blockade are given the data shows few rejections of laws on EU-level. This pattern did not even change after the first eastern enlargement in May 2004 which clearly increased the heterogeneity of interests (see **Table 2**). These results are supported by various investigations (Garrett 1992; Golub 1999; Crombez 2000; Matilla/Lane 2001; Heisenberg 2005; Selck 2005; Schneider 2008).

Reputation Sells

Table 2: Legislation activity in the EU

| | September December 2001 | January December 2002 | January December 2003 | January - April 2004 | May December 2004 | January December 2005 | January December 2006 |
|--------------------------|-------------------------------|-----------------------------|-----------------------------|-------------------------|-------------------------|-----------------------------|-----------------------------|
| Total leg. Passed | 46 | 164 | 163 | 139 | 86 | 121 | 153 |
| Contested 1 ^a | 16 | 29 | 36 | 11 | 9 | 13 | 34 |
| % ^b | 34.8 | 17.7 | 22.1 | 7.9 | 10.9 | 10.7 | 22.2 |
| Contested 2 ^c | 14 | 53 | 69 | 46 | 19 | 52 | 69 |
| % | 30.4 | 32.3 | 42.3 | 33.1 | 22.1 | 43.0 | 45.1 |

^a disagreement voiced through voting

^b percentage of legislation per year

^c disagreement voiced either through voting or formal statements are included in the minutes following the adoption of a proposal

Contested means here a rejection. (source: Hagemann/DeClerk-Sachsse 2007, p. 13)

For instance, in the first stage of the Monetary Union the southern Member States (Spain, Portugal and Greece) as well as Ireland did not seem to be able to meet the Maastricht criteria. But these criterions included some latitude, which offered the possibility to join the Monetary Union in spite of not meeting the Maastricht criteria. In these cases candidates were only allowed to participate if a majority of all Member States voted for their admission. Hence, it was feared that the four countries that would possibly not meet the criteria might build a blocking minority preventing the admission of other Member States who needed an acceptance by a majority vote. At the same time, the cohesion fund to foster economic integration and adjustment of living standards was established (Council Regulation (EC) No. 1164/94 of 16 May 1994). Not surprisingly, the four countries (Spain, Portugal, Greece, Ireland) benefit the most from the support by the fund. In consequence, they met the Maastricht criteria and thus the threat of a rejection of the admission of other Member States was banned (Krumm/Herz 1997).

The overall picture bears some resemblance to the German political system. Rejection rates are quite low compared with the opportunities to block legislation. In the EU Council, even issues that only require a majority of all votes are decided unanimously, which might suggest the existence of compensating activities. Anyway, such activities are rarely reported or mentioned in connection with decisions. If compensation payments are given, it can be observed that a vast overcompensation occurs. As in the case of the German political system this can be explained by constitutional restrictions. Compensations here as well as in Germany are mostly paid as earmarked transfers since non-earmarked transfers are not possible due to constitutional restrictions. These restrictions mostly prevent an accurate compensation of members whose votes are needed to meet a majority.

4 But why so few backlogs? - Strategic action and reputation

Despite these constitutional restrictions there is still one question that has to be asked. Why do we know so little about compensation payments although rejection rates are that low, whereas a certain amount of conflicts does exist? It is evident that despite of the blocking opportunities in the EU as well as in the German political system they are normally not exploited. In Germany, most proposals that have to pass the second chamber are finally not rejected. This also holds for the European Union. The decisions of the Council show even more consenting votes than are demanded by the voting rule. At first sight, this is actually not efficient according to the traditional idea of rationality, but perhaps the results might be explained by insights from the field of Political Economy. Some explanations for this puzzle are given in the literature.

Low rejection rates

Low rejection rates might stem from two sources. Either the method of consensus is too often applied, or the statistics do not reflect the true situation. For instance, proposals that have no chance of being accepted by either of both chambers in bicameralistic systems or by a majority in the Council are normally not put on the agenda from the very outset. In both institutions, communication is fluent so that these cases can be detected before any vote takes place. In addition, critical issues are likely to be postponed to a period that seems to be more convenient for a decision. This strategy can be observed in the EU as well as in German politics. For instance, Stuewe(2004) mentions that during the great coalition (starting in 2005) the reform of the federalist system and especially of the financial relationships between the central government and the *Länder* was postponed to the next legislative period due to its potential for conflict. In the Council, delaying certain decisions to the next presidency is also not unusual (Schneider 2008). These observations might lead to the conclusion that a law which would certainly or most likely be rejected does not appear in the statistics(Burkhart/Manow 2006; Schneider 2008; Stuewe 2008).

Strategic action

If every conflict is avoided in that way activities will decrease, which is actually the fact in Germany(Burkhart/Manow 2006). Alas, this prediction does not hold for the decisions of the EU. As shown in section 3.2, the number of laws passed is not influenced by possible conflicts by heterogeneous preferences. This can be illustrated by the legislative activity

after the second eastern enlargement that clearly initiated many discussions and enhanced differences between preferences. But this at least did not lead the activity to drop (Schneider 2008). This indicates that other methods are available to avoid blockades apart from putting off every critical proposal. These can be found in the Political Economy emphasising the interests of politicians. According to that line, a reform blockade can be politically disadvantageous as it harms the reputation of the political system and of the responsible agents. The damage of reputation clearly does not serve the politicians' objectives. For instance, Schwarz (2006) notes that it could be more beneficial for the opposition to agree on an unpopular reform than to block it because the public's reluctance normally concentrates on the government, not on the opposition. This can be seen in the reaction of the public towards the labour market reform (*HARTZ IV*) enacted by the Social Democrats under chancellor Schröder in Germany. Likewise, blocking a popular reform may harm the reputation of the initiator. These considerations show that decision-making is also influenced by tactical behaviour.

In the EU, motives for avoiding a stalemate may be different but are also connected to the reputation of the Union and the Member States. Avoiding public conflicts and making mutual decisions support the legitimacy of the Union to decide in this particular area. If Members disagree on important topics like the war in Iraq in 2003, it is disputable whether a Union actually should have the competence to speak for different countries that have different interests (The Economist 2002). In addition, bargaining in the EU is not a single-shot as cooperation among Member States is permanent and the time horizon is considerably longer than assumed in theory (Golub 1999; Heisenberg 2005). Member States evidently avoid rejecting every single proposal to demonstrate that they are not the "troublemakers" (Schneider 2008). Refraining from blockades and from obvious procrastination of reform may be due to a large number of motives but reputation remains the main consideration in both cases.

In consequence, against the background of a good reputation of politics and re-election chances, it becomes rational to avoid public conflicts or disguise them. Blockades can be circumvented by paying compensation or by refraining from discussing critical issues. However, giving transfers may be problematic due to the lack of legal bindings. Nevertheless, as communication between agents in the EU and in the German political sphere is fluent and time horizons are mostly rather long, this problem can be neglected. Moreover, party discipline that could lead to the existence of enduring and stable coalitions might be an additional restriction and seems to be an important problem (Matilla/Lane

2001; Parisi 2002). For instance, in Germany one can find stable coalitions between the Social Democrats and Greens or the Christian Democrats, the Christian Socialist and the Liberals, which hinder these parties to cooperate with the other side in general.

Disguising transfers

The supposed “bad” reputation of publicly granted transfers to the *Länder* as well as to Member States in the EU may reduce their frequency. The public perception of compensation payments is probably the most important factor for a politician. Giving transfers is not illegal, but at the same time is not regarded to be an adequate instrument to solve conflicts. Buchanan and Tullock(1984) state that “*Under our system open logrolling is normally publicly characterized as “bad”. Therefore openly offered transfers will not often take place...*”(p. 140). In addition, compensation payments have a negative image in the press and are regularly described as “horse-trading”. Thus, disguising or avoiding compensation payments is rational for politicians who aim at improving their reputation and at being re-elected. However, disguising transfers demands informal communication. In fact, literature on political decision-making states that most negotiations are led informally (Hagemann/DeClerk-Sachsse 2007; Schneider 2008).

The types of transfers discussed above have different characteristics that make it easier to conceal them. First, a non-earmarked monetary transfer is not capable of disguising any strategic payment, which would explain why this sort of transfer is not used in reality. Therefore, a rational politician should use other types of compensation payments. Side payments are normally given as an earmarked transfer dedicated to special projects. For instance, tying payments to a social project can help justify the transfer in public. Likewise, in the EU many subsidies provided out of the regional or cohesion funds are publicly communicated and widely accepted, although in the end, they have the potential to influence elections. Fenge and Wrede(2004) state that “*...it becomes clear that the funds system in regional policy is mainly an instrument for side payments among Member States that are linked to major changes in the EU*” (p. 1). Actually, the ratification of the treaty of Lisbon by Poland was helped by paying transfers to Polish shipyards. In addition to that, Ireland only agreed to the renewal of the referendum on the EU constitution under the condition that it be allowed to keep its permanent representative(Rheinische Post 2009). Of course, subsidies such as these are not solely meant to foster decisions. The launch of the cohesion fund certainly helped to establish an internal market and the Monetary Union, apart from winning the votes of the fund’s beneficiaries(Garrett 1992). These subsidies are probably accepted because they are connected with positive motives or mutual aims.

However, the side payments provided by German chancellor Schröder in 2001 to the city-state of Berlin to support cultural institutions were regarded as negative. This probably results from the obvious character of the payments' true objective – namely pushing through a tax reform.

Apart from side payments, logrolling is a good possibility to keep the public in the dark about compensation payments. Especially in the EU, it seems common practice on all levels to design package deals by connecting two decisions from totally different areas.¹⁹ For instance, in the early years EU policies were often “...*considered as trade-offs between Germany's industrial interests and France's agriculture concerns*” (Crombez 2000, p.708). In German politics, logrolling is also not uncommon. Granting longer financial support to parents was actually a trade between the government parties. The Christian Democrats (*CDU*) aimed at enhancing financial aid for parents, but their coalition partner - the Social Democrats (*SPD*) - would only accept the proposal under the condition of committing fathers to actively take part in the upbringing of children (Fried 2006; Rudzio 2008).

Nevertheless, these types of compensation payments may be more prevalent in the EU than in political systems on the national level because the latter are usually dominated by party discipline. Logrolling therefore mostly occurs in government coalitions or within parties.²⁰ Moreover, in the EU, Member States have common goals such as a functioning internal market or security policies and thus have a tradition for consensus decisions, which legitimise the Union's existence (Heisenberg 2005). In contrast to parties at a local or national level, Member States have no interest in stressing their diverging positions. For instance, if the opposition agrees to a proposal initiated by the governing party it partly loses its reputation as an independent political force, even if it was able to modify the proposal (Stuewe 2004). However, despite the strategic risk, consensus can also be found in German politics, either between coalition partners or, at least to a certain extent, between the government and the opposition. The probability of a consensus also depends on the importance of the proposal and its popularity.

Overcompensations

Up to now, we concentrated on explaining the infrequency of using compensation payments and what kind of transfers are likely to be realized in the political sphere, which

¹⁹ See Kardasheva (2008) for an analysis of package deals between the European Parliament and the Council.

²⁰ Zohlnhoefer (2003) discusses conflicts of interest between ideological wings in the Christian Democratic Party (*CDU*) and the Christian Socialist (*CSU*) during the Kohl era.

could be explained by theoretical approaches. But does that also hold for overcompensation? Asheim et al.(2006) suggest that unanimity will be prevalent even if a majority rule is applied. If that assumption holds, the voting rule and the number of negotiators do not influence the bargaining result. Moreover, uncertainty about the opponent's behaviour, which is also a major factor in experimental literature(Messick et al. 1997), may lead to overcompensation to ensure a majority. However, in institutions such as the EU and the German political system, uncertainty might not be the main cause for overcompensation because communication between the agents is fluent and bargaining cannot be seen as a single-shot game. Another approach to explain overcompensation points at constitutional restrictions which do not offer any opportunities to pay non-earmarked transfers and thus make it impossible to accurately compensate the groups, whose votes are needed to reach a majority. Finally, overcompensation can also be explained by strategic behaviour aimed at improving an agent's reputation by giving the impression of being generous. Especially in a permanent relationship, it will contribute to making bargaining a reciprocal action.

In conclusion, all "anomalies" in giving transfers such as their low frequency, the informal way they are given and their form and type, can be explained by considering the reputation of parties, politicians or countries. However, these ideas can only be partly applied to the activities of interest groups. Disguising interests to improve the reputation and to consequently have a higher chance to be re-elected will clearly not influence the behaviour of lobby groups. However, a lobby group must care about its reputation in the political sphere because its success will actually depend on politicians. Thus, considering politicians' objectives is imperative for every interest group. So in the end, politicians as well as lobby groups will act strategically to ensure a permanent cooperation with the population, other parties or politicians, lobby groups or countries.

5 Conclusion

The observations made in the political sphere suggest that reputation is a main factor in explaining the behaviour of politicians towards compensation payments. The analysis of the decision-making process in the EU and in Germany have shown that reform blockades due to disagreement between agents are strikingly rare, although the potential of conflict is given in both institutions. This can be well explained by selfish motives of politicians, which also are a crucial element of the New Political Economy. The main objective for politicians' behaviour is his individual profit, which is normally defined as the time he stays in office. Thus, re-election chances and his personal reputation might be important reasons to avoid either blockades or openly given compensation payments. This is rational, as among the general public compensation payments are usually considered to be "bad". Moreover, the literature on Behavioural Economics emphasizes the important effects of reputation on bargaining (Kagel/Roth 1995).

Apart from considerations on reputation, social norms themselves may dictate politicians' behaviour. For instance, in some experiments it was shown that irrespective of the setting, agents paid voluntary grants to participants that actually could not influence the result from the outset (Camerer 1998). Normally, compensation payments should not be granted because of the associated damage of the compensator's reputation. Nevertheless, transfers to avoid stalemates are paid but are disguised by granting earmarked transfers. Another method of concealing transfers can be seen in vote trading or agreeing to a consensus. However, these transfers are not made visible to the general public and thus, a valuable source of information is hidden from the voter. From an economic point of view, it is clearly inefficient and in addition to that, it prevents the voter from deciding rationally at the poll.

Whether compensation payments are really "bad", can be discussed. On the one hand, transfers may enhance decision-making and help to solve stalemates, which could generate disadvantageous situations. If Argentina would have managed to agree on stabilization earlier, perhaps hyperinflation could have been avoided. On the other hand, a reform is not always beneficial and does not necessarily serve public interests. The support of agrarian goods by public subsidies might not be a motive of every citizen. So procrastinating reforms or blocking them could have at least some justification as it demonstrates the effectivity of the system of checks and balances. However, these checks and balances can only be ensured if the voter who finally controls politics is not left in the dark about ongoing compensation payments.

Appendix

Votes of the Länder in the second chamber in Germany (Bundesrat)

| Bundesland | Votes |
|-------------------------------|-------|
| Baden-Wuerttemberg | 6 |
| Bavaria | 6 |
| Berlin | 4 |
| Brandenburg | 4 |
| Bremen | 3 |
| Hamburg | 3 |
| Hessia | 5 |
| Lower Saxony | 6 |
| Mecklenburg-Western Pomerania | 3 |
| North Rhine-Westphalia | 6 |
| Rhineland-Palatinate | 4 |
| Saarland | 3 |
| Saxony | 4 |
| Saxony-Anhalt | 4 |
| Schleswig Holstein | 4 |
| Thuringia | 4 |

Votes of the government coalition in the second chamber (Bundesrat)

| Year | Votes |
|----------|-------|
| May 1998 | 32 |
| Apr 99 | 27 |
| Sep 99 | 24 |
| Oct 99 | 24 |
| Oct 99 | 20 |
| June 01 | 24 |
| Oct 01 | 24 |
| Jan 02 | 20 |
| May 02 | 16 |
| March 03 | 10 |
| Apr 03 | 10 |
| March 04 | 10 |
| Nov 04 | 10 |
| Apr 05 | 6 |
| June 05 | 0 |
| Apr 06 | 21 |
| May 06 | 21 |
| Nov 06 | 24 |
| July 07 | 21 |
| May 08 | 21 |

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