Globalisation and Regional Integration – Theoretical Links and Policy Implications: The Case of Tax Policy Co-ordination in the EU

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Introduction

The current debate on globalisation and regional integration tends to focus on three interrelated issues: (i) the compatibility of regional integration with globalisation; (ii) the implications of globalisation and regional integration for public policy; and (iii) the extent of policy convergence within and between regional blocs in a globalising world economy. These are pertinent questions given that about half of the 125 regional integration arrangements (RIAs) concluded since 1948 were concluded in the first half of the 1990s. The answers, however, vary and are far from being systematic. This paper aims to contribute to the ongoing debate by developing a political economy approach to globalisation and regional integration, which would allow for capturing the similarities/ distinctions between both processes and generating testable hypotheses about their implications for public policy.

In the proposed approach, globalisation and regional integration share a common feature: they reflect the extent of policy convergence induced by the tendency of non-state actors to move between policy jurisdictions in an attempt to maximise the utility that they derive from loyalty to a given jurisdiction. The main distinction between globalisation and regional integration, however, is that policy convergence is generally un-negotiated in the context of globalisation whereas it is negotiated and institutionalised in the context of deep regional integration. Also, the proposed approach departs from the existing tendency to measure the extent of globalisation or regional integration in terms of factor (capital, technology, labour) mobility or trade flows. Instead, it measures globalisation and regional integration in terms of policy convergence generated by the extent of factor mobility or trade flows. This measure is preferred here because it enables us to demonstrate the extent to which: (i) globalisation and regionalisation are similar/distinct responses to the same dynamic described as centrifugal societal tendencies (i.e., the tendency of non-state actors to move between policy jurisdictions); (ii) policy convergence may or may not lead to reduced policy autonomy/innovation; and (iii) externalities generated by centrifugal societal tendencies can be internalised and regulated effectively without the need to erect barriers against cross-border movements of goods and/or people. Finally, the proposed approach qualifies the convergence literature by treating convergence as a product of strategic interaction not only between policy jurisdictions but also between national policy-makers and non-state actors.

To work out these points, the paper is organised in three sections. Section 1 reviews the debate on globalisation and regional integration. The aim here is twofold. On the one hand, we wish demonstrate that the current debate tends to focus on either the state or societal actors ('state-centrism' vs. 'society-centrism') rather than state-society interaction. State- or society-centric approaches tend to be reductionist in that they treat the public policy output as a reflection of state or societal preferences. If the focus is shifted to strategic interaction between the state and society, however, it may be seen that the public policy output may or may not be in line with the preferences of either the state or society who may trigger the process towards a policy decision in the first instance. On the other hand, we will try to show that the existing literature tends to either misinterpret the link between globalisation and regional integration or to make backward-looking policy prescriptions inspired by a view that presents regional integration as a reaction to globalisation.

In section 2, we draw on Hotelling's (1929) theory of locational competition to derive three inter-related propositions. First, we will develop the argument that policy convergence generated by centrifugal societal tendencies may or may not reflect the preferences of societal actors who try to maximise their utilities by moving between policy jurisdictions. Secondly, globalisation and regional integration can be measured in terms of policy convergence rather than the extent of centrifugal societal tendencies (i.e., factor movement, trade or financial flows). We think that policy convergence is a more reliable measure of globalisation and regional integration for two reasons. On the one hand, and unlike the existing literature which takes the link between centrifugal societal tendencies and policy convergence as given, it is based on explicit theorisation about the way in which the former generates the latter. On the other hand, convergence indicators reflect all the information that can be derived from the focus on factor mobility or trade as indicators of globalisation and regional integration. The third proposition developed in section 2 is that deep (i.e., highly institutionalised) regional integration not only leads to higher levels of policy convergence when compared to globalisation but also enables policy-makers to engage in policy innovation. Therefore, deep regional integration may be an optimal arrangement for resolving the conflict between increased centrifugal societal tendencies on the one hand and the scope for policy autonomy/innovation on the other.

Following from this analytical exposition, section 3 examines the issue of tax policy co-ordination in the European Union (EU) - a policy area where public policy choices are constrained by high levels of mobility between jurisdictions. Given this characteristic of this policy area, the existing literature on globalisation and regional integration would make three predictions: (i) the policy autonomy of EU member-states would decline given the constraints imposed by the centrifugal tendency of the societal actors trying to increase the returns on jurisdictional loyalty (the 'hypreglobalisation' thesis); (ii) EU member states would make use of the regional integration framework to drive a wedge between the global system and the EU itself in an attempt to maintain a degree of policy autonomy (the 'comparative regionalism' thesis); and (iii) EU member states would not necessarily have reduced policy autonomy because the state is not a reactive actor but a 'shaper' in the process of globalisation and regionalisation (the 'state-centric' thesis).

The evidence examined in section 3 demonstrates that these predictions are either incompatible with the dynamics of the EU policy-making process or backward-looking in terms of their policy prescriptions. This section will show that institutionalised policy convergence induced by high levels of capital mobility can go hand in hand with policy autonomy and innovation for two reasons. First, the convergence of policies approximates the rates of return on jurisdictional loyalty and reduces the incentives for one-way capital flows. In other words, it has an effect of stabilising constituent loyalties. Under this condition, the scope for societal actors to demand (and, more significantly, secure) special treatment may be reduced and the constraint on public policy choices may be weakened. Secondly, EU institutions may facilitate the distribution of the costs and benefits associated with policy co-ordination. In other words, deep integration may reduce the probability of competitive bidding and free-riding - leading to a lower incidence of sub-optimal outcomes and/or or reduced incentive for member-states to use their veto power in the process of regional policy-making.

Combining the analytical framework in section 2 and the case study in section 3, we conclude with certain propositions on the link between, and policy implications, of globalisation and regional integration. First, in terms of policy innovation and tackling the externalities generated by increased centrifugal societal tendencies, institutionalised convergence in the context of regional integration is superior to un-mediated convergence in the context of globalisation. Second, deep regional integration and globalisation are compatible in terms of encouraging increased factor mobility and trade. Third, deep regional integration is superior to shallow integration because of the former's 'institutional thickness' that allows for intra-bloc conflict resolution and cost/benefit distribution. Fourth, RIAs poses a threat to global management of the world economy not because of their discriminatory nature, but because shallow RIAs are weak in dealing with the externalities generated by centrifugal societal tendencies. In other words, the negative impact of RIAs on factor mobility will be felt as their failure to deal with externalities becomes apparent. Finally, even though globalisation carries the seeds of a backlash against the disruptive effect of increased trade and factor mobility, shallow regional integration may increase the probability of such a backlash occurring because it combines the *weakness* in tackling these disruptive effects with *increased scope* for bloc-wide unilateral reactions.

1. Globalisation and Regionalisation: What Does the Debate (Not) Tell Us that We Ought to Know?

Globalisation has become the buzz word in the study of the world economy. This trend is observable not only in international relations, but also in economics, sociology, politics and geography. In fact, one can argue that globalisation is set to become an independent area of study, drawing attention from all major disciplines of the social sciences. This paper does not intend to order and analyse the extensive debate - an exercise undertaken successfully by Higgot and Reich (1998) and Held et al (1999: 2-20). Here, we use the classification proposed by these reviews as a starting point to highlight the findings on the link between, and policy implications, of globalisation and regional integration.

The key issue in the globalisation debate is the extent to which policy autonomy may be undermined by cross-border movements of people, goods and factors of production. The preoccupation with policy autonomy is understandable because increased centrifugal societal tendencies may impinge on public policy-making in various ways. First, public policy-makers may engage in competitive bidding either to attract the mobile factors of production into their jurisdictions or to secure their loyalty thereto. This tendency generates 'a drive to the bottom' in terms of social protection, regulation or re-distributive policies. Secondly, increased centrifugal societal tendencies may undermine the efficacy of macroeconomic policies as divergent policy choices are penalised by massive capital flows and speculation. Thirdly, public policy intervention may become less feasible as technology makes the mobility of people, goods and capital highly difficult to control. Finally, the public policy-maker may loose ground vis-à-vis influential corporate actors with global strategies.

These likely impacts of globalisation on policy autonomy reflect the perennial conflict between the state (or the public policy-maker as a proxy) as a territorially competent actor and the societal actors whose competence is sectoral. Put it in other words, we are faced with the old question of centripetal vs. centrifugal forces that shape the process of governance and public policy-making. Yet one striking aspect of the globalisation debate is the absence of any theorisation about how the centripetal and centrifugal forces interact in the process of public policy-making. Another aspect is the absence of any theorisation about how high levels of centrifugal tendencies generate policy convergence among jurisdictions. In fact, policy convergence is taken as a given fact rather than an outcome to be explained. Under these conditions, the discussion on whether globalisation reduces the scope for policy autonomy/innovation remains without a foundation as the determinants of policy autonomy (i.e., the way in which the state interacts with societal forces and the extent of policy convergence) are not specified within a coherent analytical framework. Consequently, the debate tends to remain non-cumulative, parochial and speculative. It must be added that this shortcoming is amplified by the tendency of each discipline to use its own analytical tools, concepts and methodology in the study of globalisation and its policy implications.

Therefore, the lack of agreement even on the classification of the existing literature should come as no surprise. For example, Higgot and Reich (1998) list four approaches: the social democratic/re-distributive thesis that utilises a (neo)-Marxist state concept; the comparative regionalism thesis that focuses on the relationship between globalisation and regional integration; the modernisationist thesis drawing on the sociology and politics of development; and the 'Internet thesis' that emphasises the universalisation of the market structure. Held et al (1999), on the other hand, identify three approaches: the sceptics, the transformationalists, and the hyperglobalisers. One can also add the 'embedded globalisation' thesis that emphasises the particular contexts in which globalisation is produced and reproduced (Sassen, 1996; Dicken, 1998). These differences run across not only the major disciplines of the social sciences, but also the great traditions of social inquiry - i.e., liberalism, conservatism and Marxism.

In this paper, we propose to classify the existing approaches into two categories - depending on the unit of analysis adopted. On the one hand, we observe a *state-centric* tendency which focuses on the state as an actor and its response to centrifugal societal tendencies. According to the 'strong state' version of this approach, the state initiates, shapes or capitalises on the process of globalisation (Boyer and Drache, 1996; Ramesh, 1995; and Burbach et al, 1997). The 'weak state' perspective, on the other hand, draws attention to the fact that while globalisation tends to breakdown territorial boundaries interstate interaction reconfirms these boundaries and the structures contained by them (Armstrong, 1998; Held et al, 1999). In this ongoing struggle, Cox (1997) sees the state as a transmission belt through which liberal policy prescriptions pass from the global to the national domain. In a similar vein, Grant (1998) argues that the state might use globalisation as an alibi for implementing unpleasant policies which it would wish to implement anyway. (See also, Armingean, 1997). The comparative regionalism thesis can be included in this version as its central argument is based on the added capacity that regionalism provides the state with in the attempt to shield itself against globalisation (Sideri 1993 & 1997). In either the 'strong' or 'weak' versions of the state-centric approach, a scope for policy autonomy exists because policy convergence between jurisdictions is either shaped by state preferences or it is minimal as states are capable of erecting barriers against centrifugal societal tendencies.

On the other hand, one can identify a *society-centric* tendency that focuses on the extent to which centrifugal societal tendencies impose a constraint on public policy. Here again we are faced with two versions. The 'strong constraint' version which emphasises the universalisation of the market structures envisages no or very little scope for autonomous policy choices because of the high level of centrifugal societal tendencies generating policy convergence between jurisdictions (Ohmae, 1990 and 1995; Albrow, 1996; Greider, 1997). The 'weak constraint' version, on the other hand, envisages some scope for public policy either because of the low level of centrifugal societal tendencies or because of the externalities associated with such tendencies.

Of those focusing on the level of centrifugal societal tendencies, Hirst and Thompson (1996) envisage a significant scope for policy autonomy because such tendencies are not as intense as suggested by the universalisation of the market structures thesis. In fact, the world economy is comparatively less global now than it was in the nineteenth century. Those focusing on the externalities, however, envisage some scope for public policy intervention even though (or particularly because) the level of centrifugal societal tendencies are high. According to Dunning (1997), the significance of the state's systemic functions (minimising the extra-market co-ordination and transaction costs of the economic activity) will increase whereas the significance of the operational functions (the way in which the state participates in economic activity) may have to be revised. In other words, state involvement must shift away from correcting market failures to reducing their incidence. Similar arguments are put forward in a conference on globalisation and trade, where the participants tended to agree that globalisation makes a case for an increased government role in providing a safety net and internalising externalities (Arndt, 1997; see also, Commission on Global Governance, 1995: 147-57 for similar arguments at the global governance level).

Given the lack of theorisation about the centripetal-centrifugal interaction and the way in which centrifugal societal tendencies may lead to policy convergence, the emerging literature on globalisation-regionalisation linkages is also problematic. One weakness of the globalisation-regionalisation debate is its 'state-centric' focus, which overlooks the state-society interaction. As a result of this shortcoming, regionalisation is examined as a state reaction to globalisation. According to Sideri (1997: 53), regionalisation may be seen as an attempt to reduce the pace of globalisation and/or minimise its costs. In the case of less developed countries, regionalisation may lessen the effect of marginalisation implied by globalisation (Sideri, 1993). A similar view is put forward by Hirst and Thompson (1995), who indicate that trade blocs may allow member countries to withstand the global pressure on specific policy issues and to pursue policy objectives that they could not attempt independently. Still another interpretation focuses on regionalisation as a strategic reaction of the state to its main rivals in the world economy. As Streeck and Schmitter (1991: 149) have argued, the aim of the European Union's Single Market was '… to recapture collective autonomy in relation to the US and to begin to organise a competitive response to the Japanese challenge.'

The second shortcoming of the globalisation-regionalisation debate is the confusion about the link between regionalisation and convergence. There are two problems here. On the one hand, and in line with the tendency of the globalisation debate in general, the link between centrifugal societal tendencies and policy convergence is assumed but not specified. On the other hand, convergence is assumed to follow regional integration rather than the other way round. This confusion reduces the ability of various contributors to explain the differences in the degree of convergence within existing RIAs. For example Higgot (1998) and Stubbs (1998) highlight the differences in the level of intra-bloc convergence in the EU, the Asia-Pacific and North America, but neither they nor Coleman and Underhill (1998) provide any explanation as to why these differences exist and what they might imply for the future development of these RIAs. The third, yet the most significant, weakness of the globalisation-regionalisation literature is its lack of definite criteria for ascertaining the compatibility and/or incompatibility of regional integration with globalisation. For example, Milner (1998: 21) indicates that divided government is recipe for failure in the international co-ordination game, but again neither she nor other contributors to the volume examine the implications of loose RIAs for policy co-ordination in a global context.

Given these observations, we would argue that the literature on globalisation and regionalisation has been successful in drawing our attention to significant developments that have emerged in the 1990s and will continue to unfold in the future. It has also increased our awareness of the possible linkages between these developments and their implications for autonomy/innovation in public policy. Finally, it has gradually linked the processes of globalisation and regional integration and pushed the debate a step further from the compatibility of RIAs with multilateral management of the international trade to the RIAs' role in the global context. However, we are still far from having either a unified methodology to study the two processes or a common analytical framework from which testable hypotheses can be derived. As indicated above, this state of affairs is firstly due to a largely reductionist tendency to focus either on the state (the centripetal force) or society (the centrifugal forces) rather than state-society interaction in the process of national, regional or global public policy-making. Secondly, it is due to the lack of theorisation about the link between (i) centrifugal societal tendencies and policy convergence, and (ii) the types of convergence implied by globalisation and deep regional integration. Finally, this state of affairs is still depriving the debate from developing certain criteria that can be used to determine the compatibility of regionalisation with globalisation.

2. From Centrifugal Societal Tendencies to Policy Convergence: Explanation and Implications for the Globalisation-Regionalisation Debate

The debate on convergence is rich and long-standing. It has its roots in the political economy of Adam Smith and Ricardo, whose theory of international trade can be extended to predict inter-country convergence not only in welfare but also in factor incomes and prices. However, the strongest exposition of the convergence thesis can be credited to Solow (1956) who argued that the diffusion of technology, under the assumption of free markets and decreasing returns to capital accumulation per worker, the backward countries will eventually catch up with developed ones. This theory has been tested frequently, but empirical support has been either weak or lacking as technology is largely embedded in firms, cluster of firms, or regions (Dosi, 1988).

More relevant to the purpose of this article, however, is the debate on policy convergence rather the convergence of certain economic indicators. In this context, it is interesting to note that the post-1945 period witnessed the emergence of predictions concerning convergence towards interventionist policies. Then, high levels of investment and technological change was then considered to require long term private and public planning by 'technostructures' (Tinbergen, 1959; Aron, 1962; Galbraith, 1971). Nothing can demonstrate the limited predictive power of grand theories than the current swing in the convergence debate that predicts just the opposite: liberalisation and rolling back the state as a result of capital mobility, foreign direct investment and technological diffusion (Ohmae, 1990 and 1995; Albrow, 1996; Greider). This is not the point, however. After all, no theory is better that its assumptions. Therefore, we begin our exposition with making our assumptions explicit. First, we assume that the world economy will continue to be segmented as long as societal forces are unable to solve the extra-market co-ordination problem that the state, with its territorial competence, can tackle. In other words, exit from and entry into jurisdiction is costly although the cost may vary over time and across jurisdictions. Secondly, we assume that both the state and societal forces are rational in the narrow sense that they will respond to the cost/incentive structure they are faced with in a manner that will maximise their utilities. Finally, we assume that the public policy output is determined endogenously on the basis of interaction between state and society.

2.1. Convergence and Policy Implications: An Analytical Framework

Given these assumptions, we argue that the state's response to increased centrifugal societal tendencies may or may not reflect the preferences of the societal forces who try to maximise their utilities by moving between jurisdictions. To elaborate on this argument, we will refer to Hotelling (1929), who demonstrated that firms will adopt convergent pricing or location strategies in order to maintain the loyalty of their customers. Hotelling, like Curnot, Edgeworth and Bertrand, was one of the pioneers in the area of strategic interaction between firms - which was later developed further by game theory. His argument was twofold: (i) strategic interaction between firms with a certain degree of monopoly power leads to excessive convergence in terms of quality, price or location; and (ii) the resulting equilibrium price, quality or location may maximise firm profits but is not necessarily optimal for the customers (or the public at large), whose quest for maximised utility triggers the competition between firms in the first instance.

The first argument is worked out very well and it is still a standard entry in textbooks on industrial economics. It is also revisited and developed by various contributors, of whom d'Aspremont et al (1979) is a good example. It runs as follows: in a world where shifting loyalty from one supplier to the other is possible but costly (and the cost can be measured in terms of transportation cost, forgone established familiarity and trust, slight changes in the attributes of the goods/services obtained, etc.), the firms' best reaction is to approximate their products/services in terms of the attribute(s) that influence(s) the customer's choice of supplier. Hotelling demonstrated that the convergent price, quality or location would be sustainable in the long-run *unless* the demand is perfectly elastic with respect to any of these attributes or the cost of shifting loyalty from one supplier to the other is zero. Under these assumptions, the extent of convergence declines as the number of suppliers increases. However, even with a very large number of firms, the tendency towards convergence will prevail as long as the customers' quest for utility maximisation continues.

Shaked and Sutton (1981) have challenged Hotelling's findings by adopting a game theoretical approach involving a three-stage non-cooperative game. In the first stage, the firms choose whether to enter the industry or not. In the second stage, they choose the quality of their products. Finally, having observed the quality of their rivals' products, they choose their prices. In this anti-Hotelling framework, the resulting price is low enough to dissuade consumers from purchasing low quality products (hence the level of quality is high) and the degree of product differentiation is high. Given that the resulting price and quality levels are compatible with profit maximisation, Shaked and Sutton demonstrates that strategic interaction between monopolistically-competitive firms is conducive to a mutually beneficial steady state where firm profits and consumer utility are maximised.

The problem with this analysis, however, is twofold. First, the game is solved in reverse order and by reiteration. The authors first of all determine the price to be chosen by the strategically interacting firms, then they find the level of quality and product differentiation, followed by the number of firms deciding to enter the market. This is not satisfactory because the result of the last stage determine the results of the preceding two stages. Once the price is determined, then it is almost tautological to demonstrate that only firms producing high-quality products will survive and each of them will specialise in differentiated product ranges to maintain customer loyalty. However, if each of these variables (i.e., prices, quality and product differentiation) is determined simultaneously Hotelling's analysis remains valid. Secondly, Shaked and Sutton overlook the strategic interaction between the firms and their customers - an issue which is part of Hotelling's analysis even though it is not worked out fully. In Hotelling, the customers' quest for the lowest-cost supply (i.e., maximum utility) induces the firms to adopt price or quality levels that maximise firm profits yet produce sub-optimal outcomes for customers. The reason for this unpleasant outcome from the customers' point of view is the cost of shifting loyalty from one firm to the other. Aware of this cost, the firms respond to customer pressure in a way that increases the cost of loyalty shifts. If this is not possible by segmenting the market or by entering into collusion, the firms can obtain the same result by reducing the incentive for loyalty shifts. It was this dynamic that led Hotelling (1929: 58) to observe that the firms would engage in outright competition for the marginal customer but without discrimination in his or her favour.

How can firms reduce the incentive for loyalty shifts? One possible way is collusion on a set of prices, locations or quality levels that stabilises the movement of customers between firms. This is possible, but not practicable given the incentive for cheating. It is also not feasible in the long run because of the public authorities' declared stance against collusion and their sensitivity to reactions from the customers (i.e., voters). Another possibility involves erection of artificial barriers that would segment the market, such as excessive transportation costs. This, however, is also not feasible because it hits the firms themselves by increasing the cost of inputs and reducing the demand at a given level of disposable income. The most feasible and frictionless solution is to approximate the rates of utility that customers obtain as a result of their loyalty to any of the firms. This solution, which involves price, quality or location convergence, stabilises market shares and ensures maximum profits for the firms, but it generates sub-optimal outcomes for the customers as choice is reduced. Also, this solution is easy to defend against regulators because the resulting price, product or quality convergence can be defended as outcomes of production technologies, input costs, or tough competition.

The relevance of this analysis for states competing for constituent loyalty is obvious. Nevertheless, we need to avoid hasty generalisations. Unlike monopolistically competitive markets where the firm's monopoly power does not result from artificial barriers to loyalty shifts, the state system is littered with such barriers. Physical border controls, different legal systems, different levels of law enforcement, the ideological link between statehood and nationhood, etc. all work towards limiting the extent of loyalty shifts (i.e., the level of centrifugal societal tendencies). Also, in the state system, the costs/benefits of loyalty shifts are difficult to quantify due to lack of transparency or the impact of ideology. Finally, the implications of policy decisions in a given jurisdiction for different sections of the society are also difficult to ascertain. That may be the case either because the state or a section of the society (an interest group) can equate the decision with an overarching national interest that the policy-maker must defend. Therefore, in the state system (which we assume to exist as a result of the societal forces' failure to resolve the extra-market co-ordination problem) the extent of policy convergence as a means of stabilising constituent loyalty is likely to be less than may be observed in monopolistically competitive markets. In addition, the extent of policy convergence chosen by states will differ depending on the ability of each state to limit loyalty shifts through control-reliant measures. In Hirschman's (1970) terminology, the higher the ability of a state to block 'exit' tendencies the lower the level of policy convergence it would prefer. Finally, policy convergence may differ between policy areas depending on the extent to which the implications of public policy decisions for societal groups are transparent/divisible. The higher the level of transparency/divisibility is, the easier it is to identify the costs and benefits of the loyalty shifts and, *ceteris paribus*, the higher is the level of policy convergence required to dampen such loyalty shifts between jurisdictions.

One implication of the analysis above is that the extent of policy convergence is a result of strategic interaction not only between states at the international level but also between the latter and societal forces at the national level. This is similar to Putnam's (1988) 'two-level game', but it is also different as Putnam treats societal preferences merely as a constraint on policy choices. What is required is not only to acknowledge the existence of a two-level game in international policy co-ordination but also the endogenous nature of the convergent policy choices that result from the two-level game and may be codified in international agreements. In other words, strategic interaction between the state and societal forces at the national level and between states at the international level produce results that may be triggered by societal preferences. These results, however, may not necessarily reflect the preferences of those societal forces as the act of policy co-ordination itself may alter the cost/incentive structure with which societal groups are faced. To the extent this is the case, societal groups may become less able to constrain the public policy choices as the extent of policy convergence increases and the convergent policy choices are codified in binding agreements.

The second implication of the analysis above is that the extent of policy convergence can be anticipated by referring to two variables bearing upon the strategic interaction between the state and society and between different states: the extent of centrifugal societal tendencies and the transparency/divisibility of policy issues. While centrifugal societal tendencies reflect the extent of shifts in the loyalty of non-state actors to policy jurisdictions, issue transparency/divisibility reflects the extent to which the state and/or societal groups can equate a certain policy decision with an overarching national interest that the state must defend against states and constituents of other jurisdictions. The higher the level of transparency/divisibility is, the less able is the state or the societal groups act as veto groups by equating their interests with the national interest. Therefore, the more likely it is that the state will engage in package deals trading off gains in some areas with losses in others. As a result, policy co-ordination may be facilitated, the extent of convergence may be increased and the convergent policy choices may be less of a reflection of societal preferences. (Ugur, 1997). Therefore, the existing literature's assumption that reduced policy autonomy follows from high levels of centrifugal societal tendencies (i.e., globalisation as defined in that literature) must be qualified.

Finally, the analysis above enables us to use the level of policy convergence as a more reliable indicator of globalisation. The reliability of convergence as the measure of globalisation is due to certain properties. First of all, convergence enables us to capture the extent of loyalty shifts that the current globalisation debate tends to focus on as the measure of globalisation. In that sense, it does not involve any loss of information. Secondly, it enables us to capture the different implications for policy autonomy under different levels of centrifugal societal tendencies and issue transparency/divisibility. As will be explained below, high level of policy convergence (i.e., high level of globalisation as defined in this paper) may lead to reduced policy autonomy when issue transparency/divisibility is low, but policy autonomy is not necessarily reduced when issue transparency/divisibility is high. Thirdly, convergence as indicator of globalisation enables us to demonstrates the similarities and differences between globalisation and regional integration. As explained in Ugur (1997), regional integration can be analysed as the codifying of a primordial process of policy convergence that the member-states embark upon as a means of loyalty maintenance. In that sense, it shares a common ground with globalisation. However, it also differs from globalisation because the latter is essentially an un-institutionalised policy convergence whereas (deep) regional integration is essentially institutionalised policy convergence.

2.2. Convergence at Global and Regional Level: A Diagrammatical Exposition and Some Evidence

Having examined the relationship between centrifugal societal tendencies and policy convergence, and having justified policy convergence as a more meaningful measure of globalisation and integration, we can now examine the similarities and differences between globalisation and regional integration. As indicated in the introduction, these two processes share a common feature in that they are positively correlated with centrifugal societal tendencies. However, centrifugal societal tendencies generate different levels of convergence (i.e., globalisation and integration) and have different implications for policy autonomy depending on the transparency/divisibility of policy issues. These results are summarised for the global and regional levels in Figure 1 below.

A quick glance at Figure 1 would reveal a number of differences between the proposed approach and those adopted in the current debate on globalisation/regional integration. First of all, what is taken as the dependent variable in the current debate (centrifugal societal tendencies) is an independent variable here. Secondly, the dependent variable is the level of policy convergence, which is related not only to centrifugal societal tendencies but also to another variable overlooked by the current debate: transparency/divisibility of policy issues. Therefore, the current focus on centrifugal societal tendencies (capital flows, movement of goods or people, etc.) is problematic not only because it misrepresents the dependent/independent variables, but it also assumes that the correlation between centrifugal societal tendencies and policy convergence is uniform. That this is not the case can be seen clearly in Figure 1. The correlation is positive when both independent variables (centrifugal societal tendencies and issue transparency/divisibility) tend to have similar values (i.e., when they are both high or low). When the independent variables diverge, however, the correlation between centrifugal societal tendencies and policy convergence breaks down. Therefore, a given level of centrifugal societal tendencies may be associated with different levels of policy convergence, depending on the level of issue transparency/divisibility. For example, the level of convergence in cell B1 is relatively lower because low levels of issue transparency/divisibility enable the state to deploy exit-blocking strategies as a means of loyalty maintenance. In cell B2, the level of convergence is relatively higher because high issue transparency/divisibility facilitates issue linkage and package deals as a basis for policy co-ordination. The upshot here is that different levels of globalisation and regional integration may be expected, depending not only on the level of factor mobility or international trade (what we describe here as centrifugal societal tendencies) but also on the extent of issue transparency/divisibility.

Another conclusion that can be derived from Figure 1 is that the levels of policy convergence is consistently higher at the regional level compared to the global level. This, however, is not the main point to make. A more significant point raised by Figure 1 is that the higher levels of policy convergence at the regional level are associated with a greater scope for policy autonomy. There are various factors that account for this difference. Some of these are not tackled in the analytical framework of this paper, but they can be referred to without the danger of making *ad hoc* statements. One of these factors is the lower transaction costs involved at the regional level given the smaller number of players. The other is the higher level of similarities between the objective functions of the players at the regional level compared to the global level. Both of these factors facilitates the establishment of regional institutions because they inject a certain degree of transparency/divisibility into the policy issues under negotiations.

Figure 1: Levels of Convergence and Implications for Policy Autonomy under Different Levels of Centrifugal Societal Tendencies and Issue Transparency/Divisibility

Centrifugal societal tendencies

B. High	B1 **Globalisation: Selective** 1. Selective convergence (Mainly un-institutionalised) 2. Reduced policy autonomy (Due to competitive bidding) ________ **Regional integration: Shallow** 1. Selective convergence (Partly institutionalised) 2. Variable scope for policy autonomy	B2 **Globalisation: High** 1. High convergence (Partly institutionalised) 2. Limited scope for policy autonomy ________ **Regional integration: Deep** 1. High convergence (Institutionalised) 2. Enhanced scope for policy autonomy
A. Low	A1 **Globalisation: Lowest** 1. Lowest convergence (Un-institutionalised) 2. Fictive policy autonomy, sub-optimal policy outcomes ________ **Regional integration: Shallow** 1. Lowest convergence (Un-institutionalised) 2. Fictive policy autonomy, sub-optimal policy outcomes	A2 **Globalisation: Selective** 1. Selective convergence (Mainly un-institutionalised) 2. Limited scope for policy autonomy ________ **Regional integration: Shallow** 1. Selective convergence (Partly institutionalised) 2. Variable scope for policy autonomy
	1. Low	2. High

Transparency/divisibility of policy issues

Other factors can be derived from the proposed analytical framework itself. First, RIAs facilitate the distribution of the costs and benefits associated with policy convergence by providing a permanent forum for negotiations, increasing the transparency/divisibility of policy issues through technical/econometric studies, linking policy issues in package deals, and acting as impartial brokers. In the case of the EU, these likely effects have been studied by a large number of studies on the EU Commission (e.g., Nugent, 1995: Pollack, 1997; Ludlow, 1991&1992; and Wessels, 1997). Second, RIAs can increase the cost of defection and free-riding (through suspending the preferential treatment) and reduce the cost of compliance with agreed policies (through side payments). Third, RIAs can have an 'expectations effect' whereby societal groups are forced to revise their expectations about the future path of the national policy and the extent to which they can capture the policy-making process. This factor has been examined in the context of trade policy by de Melo et al (1993) and Panagariya and Findlay (1994). Finally, RIAs approximate the rates of return to jurisdictional loyalty and, thereby, can reduce the incidence of one-way centrifugal societal tendencies that may constrain the policy-maker's choices. For example, Gros and Thygesen (1992: 118-20) draw attention to the fact EU member states experienced a drop in the level of one-way capital flows after the liberalisation of capital movements in 1987.

Having indicated the general conclusions, we can now turn to particular, yet equally significant, conclusions that can be derived from Figure 1. Starting with cell B1, we can see that the low level of issue transparency/divisibility enables either the state or societal groups to equate a sectoral policy issue with the national interest - leading to a reduced scope for package deals as a basis for common accords and binding rules. Under this condition, state-society interaction generates a process of convergence based on competitive bidding as the main method of maintaining and/or attracting loyalty. At the global level, the result is a typical prisoners' dilemma that reduces policy autonomy and produces sub-optimal policy outcomes. The severity of the prisoner's dilemma and loss of policy autonomy may be attenuated in the context of regional integration as the latter (even though shallow) may be conducive to a limited level of codification and institution building.

In cell B2, the difference between globalisation and regional integration is at its highest. Despite the high level of policy convergence at the global and regional levels, policy autonomy may be enhanced substantially in the latter whereas the scope for such improvement is limited in the former. This contrast is due to the four factors indicated above. Also, even if cell B2 implies a limited increase in policy autonomy in the context of globalisation, this gain will be distributed unequally between states. As Rodrik (1998) has demonstrated, the higher the pressure of globalisation is, the more likely it is that states equipped with well-established institutions of social conflict resolution would gain at the expense of others with deeper social divisions, weaker institutions of conflict management and less transparent modes of governance.

In addition, cell B2 also reflects a state of affairs where the level of convergence is higher and more uniform within RIAs compared to the global level. It is higher because integration itself reduces the artificial barriers to movements between jurisdictions and thereby induces further convergence. It is also more uniform because deep regional integration implies binding rules that apply to all member states in the medium-to-long run, even if some of them may be granted a period of non-compliance in the short run. Therefore, it is not surprising to observe that the spread of interest rate in the European Monetary System (EMS) dropped from 7.38 to 2.26 percentage points whereas it increased from 3.78 to 4.87 percentage points in non-EMS OECD countries over the periods of 1973-78 and 1979-90. (Fratianni and von Hagen, 1992: 33). It may be added that this spread has dropped to zero in the Euro-zone following the establishment of the monetary union.

Finally, cell B2 implies that high levels of convergence do not necessarily lead to reduced policy autonomy and the scope for such autonomy increases as the level of convergence increases in the context of regional integration. We will examine the relevance of this conclusion in the EU context. However, it may be relevant to provide some comparative evidence here. As can be seen from Table 1 below, high income countries have higher levels of convergence with respect to various indicators. Obviously, this convergence is induced by centrifugal societal tendencies. Whether it necessarily implies loss of policy autonomy, however, is a debatable question. It may not necessarily imply a loss policy autonomy because convergence itself reduces the incentives for one-way movements from one jurisdiction to the other(s). Secondly, the cost of macroeconomic performance is lower for high-convergence countries as can be seen from the levels of inflation, black market premium on the exchange rate, and budget balances. Finally, low macroeconomic instability may reduce the scope for sectoral pressure aimed at forcing the state to under-write the losses emanating from private contracts on the grounds that these losses have been due to a volatile macroeconomic environment.

Table 1: Indicators of Convergence and Macroeconomic Performance

		Developing Countries			
Indicator	High Income Countries	Fast integrators	Moderate integrators	Weak Integrators	Slow Integrators
Inflation(a)	3.63	13.40	16.86	23.86	19.89
Inflation volatility (b)	1.65	7.24	7.63	14.21	13.27
Real exchange rate volatility(b)	0.06	0.13	0.20	0.27	0.40
Black market Premium	0.00	0.12	0.56	0.41	0.48
Budget balance / GDP	-2.46	-2.37	-6.66	-3.70	-5.92
Budget balance volatility(b)	2.27	2.31	2.82	2.79	4.53

Notes: a = Based on consumer price index; b = standard deviation.
Source: World Bank (1996), p. 28.

That policy convergence may be an optimal response for policy-makers is confirmed by the evidence in Table 2 as well. Whereas high-convergence countries can borrow at rates that are near to the United States interest rates, low-convergence countries have to pay premiums that could be 5% or higher. In addition to the higher cost of borrowing, developing (i.e., low-convergence) countries bear an additional cost in terms of lower foreign direct investment (FDI) flows. In the first half of the 1990s, the FDI/GDP ratio in these countries has been consistently lower than 1% compared to 1.6% for developed (i.e., high-convergence) countries. Given that lower levels of FDI in low-convergence countries are closely related to the volatility of macroeconomic indicators (World Bank, 1996: 22, 27), the unsustainability of divergent policy choices becomes clearer. Therefore, it is possible to argue that the policy autonomy associated with divergent policy choices may well be a misnomer.

Table 2: Country Credit Ratings, March 1995

Credit Rating* / Country	A	B	C	D
High-income countries (27)	70%	26%	4%	0%
Developing countries				
East Asia (10)	0%	50%	20%	30%
South Asia (5)	0%	0%	60%	40%
Latin America and the Caribbean (24)	0%	4%	42%	54%
Middle East and N. Africa (14)	0%	29%	29%	42%
Sub-Saharan Africa (25)	0%	0%	24%	76%
Europe and Central Asia (21)	0%	14%%	33%	53%

Notes: * Credit ratings A – D reflects the interest rate premium on borrowed loans.
E.g.: A = 50 or less basis points above benchmark US rates;
C = 500 or more basis points above benchmark US rates.

Source: World Bank (1996), p. 23.

Turning to cell A1, we can see that the level of policy convergence is the lowest at the global and regional levels. This is due to the low levels of centrifugal societal tendencies combined with low levels of transparency/divisibility. While low levels of centrifugal societal tendencies reduce the incentive for engaging in policy convergence as a means of loyalty maintenance, low levels of transparency/divisibility increases the cost of convergence. Unlike what the current debate would suggest, however, this state of affairs may not be conducive to policy autonomy. Because the level of transparency/divisibility is low in cell A1, either the state or societal groups can elevate their preferences to the level of a non-negotiable national interest. To the extent this is the case, state-society and/or state-state interaction would generate competitive bidding, free-riding and retaliation - leading to sub-optimal policy outcomes. The most striking example of such an outcome is the 1913-45 period when many countries embarked on go-it-alone attitudes justified by nationalism as a device for reducing the transparency/divisibility of policy issues. Therefore, that this period reflected the lowest level of policy convergence (hence globalisation) is not surprising.[1] It is also not surprising that the policy autonomy deployed during that period was un-sustainable - as demonstrated by the proliferation of convergence-facilitating international or regional institutions after 1945.

In cell A2 the level of globalisation/regional integration is relatively higher that observable in cell A1. That is mainly because higher levels of issue transparency/divisibility reduce the cost of policy convergence by limiting the ability of either the state or the societal groups to equate a partial interest with the national interest. Again, however, the level of policy convergence under regional integration is higher and the scope for policy autonomy is less limited compared to the global level as regional institutions contribute to the transparency/divisibility of the policy issues as indicated above.

A final point to be made here is that Figure 1 highlights not only the similarities/distinctions between globalisation and regionalisation, but also the differences in the compatibility of RIAs with increased policy convergence taken here as the measure of globalisation. From the analysis above, it is obvious that deep regional arrangements with some degree of supranational competence and legally binding rules interpreted by supranational courts would be more compatible with globalisation with respect to a number of criteria. First, deep RIAs are compatible with globalisation because they reduce the artificial barriers to loyalty shifts more than shallow RIAs. These barriers are reduced in various ways, including elimination, harmonisation and mutual recognition of relevant policies and/or policy instruments. Secondly, in deep RIAs national and regional policy-makers are relatively less constrained by societal preferences and, therefore, they are better able to tackle the

[1] According to various studies, indicators of policy convergence hit the lowest levels during the 1913-45 period. On interest rate convergence, see Obstfeld and Taylor (1997). On wage convergence, see Taylor and Williamson (1994). For a general discussion on convergence, see Williamson (1996).

implications of the interdependence at the global level. Thirdly, shallow integration is associated either with low issue transparency/divisibility or low levels of centrifugal societal tendencies. Therefore, it is more likely to be used by the member-states more as a means of shielding themselves against the rest of the word as either low issue transparency/divisibility or low centrifugal societal tendencies encourage them to do so. Finally, the reactive use of the RIAs is made more probable as the size of the bloc increases. This tendency encourages excessive regionalisation but it eventually increases the probability of retaliation by others, hence exacerbating the sub-optimality of the policy choices made in a non-cooperative environment.

3. Tax Policy Co-ordination in the EU: Does Deep Integration Enhance the Scope for Policy Autonomy in the Age of Globalisation?

The stylised facts about European taxation policy are fairly straightforward. Increased capital mobility has induced the European governments to engage in tax competition with a view to maintain the loyalty of the mobile tax base to their jurisdictions. For example, the statutory overall (national and local) corporate tax rates in the EU member-states have declined from 46% in 1980 to 40.5% in 1992. This is very similar to the trend in the OECD area, where rates have declined from 46.3% to 40.3% over the same period. Also, over the same period, the top schedule tax rate on capital income (bank deposits) has fallen from 48% to 36.4% in the EU and from 49.6% to 37% in the OECD (Owens, 1993: 37, 32). As a result of this competitive bidding, the average European tax rate on the relatively mobile factors of production (capital, energy, natural resources, etc.) has fallen from 45% in 1980 to 35% in 1996. In contrast, the implicit tax rate on the less mobile factors (mainly employed labour) has increased from 35% to 42% over the same period (de Silguy, 1998). This trend is expected to intensify after the establishment of the monetary union as the elimination of currency risk would encourage further capital mobility between jurisdictions.

These trends lend support to the main argument of the existing literature on globalisation and regional integration - namely that increased capital mobility would shift the tax burden away from the mobile tax base and that the taxing capacity of the member-states would diminish. In fact, this is confirmed by OECD (1998), which concludes that harmful tax competition has re-shaped the desired level and mix of taxes and public expenditures, and undermined the fairness of the national tax structures. Although such diagnosis and predictions are relevant, they tend to overlook the factors that could instigate a counter-tendency towards tax policy co-ordination. Given that this counter-tendency is now observable at the EU level, we need a more robust yet flexible approach that would enable us to predict the incidence of both competitive bidding and policy co-ordination when policy-makers are faced with increased centrifugal societal tendencies.

In what follows, we will demonstrate that the emerging tendency towards tax policy co-ordination in the EU is a significant development that can be predicted and explained by the model of globalisation and regional integration developed in the previous section. Unlike the existing literature, our model specifies the conditions under which competitive bidding would dominate managed convergence or *vice versa*. It predicts that, under high levels of centrifugal societal tendencies (i.e., capital mobility in the context of this paper), the scope for policy co-ordination and innovation in the EU would increase as the transparency/divisibility of the taxation policy increases. In the 1990s, the transparency/divisibility of the European taxation policy increased for two reasons' On the one hand, the debate on taxation - even though it is still coloured with a sovereignty discourse - has acquired a technical dimension following the indirect tax co-ordination induced by the single market and the fiscal convergence criteria imposed by the monetary union. On the other hand, the elimination of non-tax barriers to movement of goods and services has increased the sensitivity of the companies' location decisions to tax differentials. This tendency has eroded the tax base of the member-states and made their tax revenue more volatile. As a result, the elevation of taxation issues to the level of a non-negotiable national interest has become less feasible. Under these conditions, tax policy co-ordination has become less of a taboo for the member-states and the European Commission has found it relatively less difficult to construct package deals that would facilitate inter-state agreements.

Although this increased transparency/divisibility is the primary factor that has facilitated the move from competitive bidding to policy co-ordination, its effect has been augmented by the increased convergence and institutional thickness that followed the single market and the monetary union. Increased convergence, as the Commissioner for economic, monetary and financial affairs has observed, has left fewer reasons for markets to distinguish between the member-states (de Silguy, 1998). In other words, increased convergence has approximated the returns on loyalty to a given jurisdiction and, thereby, reduced the incentive for one-way loyalty shifts. On the other hand, increased institutional thickness has increased the ability of the EU and its member-states to manage the externalities generated by high levels of centrifugal societal tendencies (i.e., capital mobility). Consequently, the co-ordination of tax policy has become not only more desirable but also more feasible.

It must be stated at the outset that the achievement by June 1999 is far from being impressive for various reasons. First, and this is something with which students of European integration are familiar, the process of EU policy making is not efficient in terms of speed. Secondly, the EU policy-making process is technocratic and representation is highly skewed in favour of strong interest groups. Thirdly, despite extensive negotiations and significant progress leading to package deal, there is no guarantee that EU member states would agree to binding rules open to scrutiny by EU institutions - especially the Commission, the European Parliament and the European Court of Justice. Finally, although there appears to be a consensus that the EU should lead in practice, there is still the danger that decisions may be delayed because of the concern that non-EU countries may gain a competitive edge if they do not embark on a similar process counteracting harmful tax competition.

Despite these drawbacks, however, it must also be indicated that what has been achieved in the EU since 1996 is much more comprehensive than any other group of countries, including the OECD. Ongoing negotiations and technical work in the EU covers three major areas: a code of conduct for business taxation aimed at combating harmful tax competition, minimum taxation of capital income (i.e., bank deposits), and harmonisation of tax rates applicable to interest and royalty payments between companies. This compares very favourably with the second most advanced attempt, which is taken by the OECD and is limited only to tax policy co-ordination in the area of financial transactions. [2] In addition, the work carried out by the Taxation Policy Group and the Code of Conduct Group (both composed of member-state representatives and the Commissioner for internal market) has shed so much light on the aggressive poaching techniques utilised by all member states that the 'national interest' argument is now less likely to hold water than it was three years ago. This 'injected' transparency/divisibility will reduce the veto power of the member-states because not only the sub-optimality but also the unfairness of the current practices are now more apparent than they have ever been. Finally, the lengthy process of negotiations and consultations has helped to create a certain degree of trust and

[2] The OECD itself acknowledges the limited nature of their work and indicates that the EU code is part of a wider package and is more likely to address the issues raised by changing patterns of investment and trade and the interface between them. See, OECD (1998: 11-13).

collegiality between members of the said groups. Given that societal groups in favour of the old regime are now forced to argue their case in public and against others in the EU, this new culture is likely to be conducive to further co-operation.

That is why, what has happened in the EU in the area of tax policy co-ordination over the last three years should be taken seriously. It must be taken seriously also because of the timing involved. Until the meeting of the Economics and Finance Ministers (ECOFIN) of April 1996 in Verona, discussions on tax policy co-ordination were almost non-existent. Therefore, it is not surprising to find out that, until then, 18 Commission proposals on tax policy co-ordination had been blocked and 30 had been withdrawn due to lack of sufficient support in the Council. As European integration deepened and the globalisation debate intensified, however, there was a sudden change of mood among the member-states. In the Commission's view, this change was due to various factors. First, the deepening of European integration has made taxation a significant factor that influences the companies' location decisions. This trend was reinforced by globalisation at the international level. Secondly, the European tax system has become increasingly biased against labour, especially the less qualified sections thereof. Finally, the incidence of fraud and tax avoidance has increased. (European Commission, 1997a). In sum, the EU's attempt at tax policy co-ordination has been clearly inspired by the level of integration and globalisation on the hand and the extent of externalities associated with centrifugal societal tendencies on the other. Recalling that the EU is ahead of the pack in this area, this state of affairs can be taken as a significant indicator that globalisation and integration do not necessarily lead to reduced policy autonomy or convergence towards the bottom.

Instead of converging towards the bottom, the EU member-states appear to be engaged in a process of convergence that would reduce the incidence of one-way loyalty shifts, arrest the process of deterioration in their tax base, and tackle the externalities associated with increased capital mobility. These aspects of the policy innovation and the way in which deep regional integration has facilitated the construction of package deals will become clearer as the details of the developments in the last three years are examined below.

Following the Verona meeting of the ECOFIN, the Commission was instructed to prepare a report on harmful tax competition between the member-states. This report was published in November 1996 and formed the basis for the Dublin Summit decision on the establishment of the Taxation Policy Group. Other EU institutions have also had an input into this debate. For example, the Monetary Committee of the European Monetary Institute drew the attention of the Council and the Commission to the issues of harmful tax competition, tax evasion and the potential for further erosion of the tax base as the single currency is introduced (European Commission, 1997a). Also, in early January 1997, tax policy co-ordination was a central theme in the debate of the European Parliament. While Germany acknowledged the need to stop unfair practices, France and Belgium drew attention to the de-stabilising effects of unfair competition. Austria, on the other hand, declared its desire to replace the unanimity required in article 227 with qualified majority. (Agence Europe, 27/28.1.1997: 6-7).

By March 1997, the Taxation Policy Group was established and held its first meeting on 11 March. It agreed to define harmful tax competition as all practices (legal or administrative) implemented by a member-state with detrimental effects on others. In other words, harmful tax competition is identified by the negative externalities it generates. It also decided that the two representatives of each member-state should submit a list of such measures to the Commission, which would analyse and discuss these lists with a view to secure agreement. (Agence Europe, 10/11.3.1997: 8 and 12.3.1997: 10). Until June 1997, the Taxation Policy Group held three meetings and the basis for a draft code of conduct was laid down. In the mean time, the Commission linked the work on harmful tax competition with the issues of capital income taxation, company taxation and indirect taxation; and submitted its first post-Verona proposal to the ECOFIN in September 1997.

In this proposal, the Commission's package consisted of four elements to be negotiated simultaneously: the code of conduct on business taxation (to lock the member-states into a process of information exchange, identifying harmful practices, and ensuring effective taxation); minimum taxation of interest payments on bank deposits (capital income taxation); removal of double taxation on interest and royalty payments between companies; and reducing the divergence between rates and bases of indirect taxation. This strategy has the drawback of blocking progress on a particular measure on the grounds that progress in other areas is impossible. However, it has also the advantage of securing agreement given the fact that taxation matters are subject to unanimity. In fact, the latter aspect turned out to be the dominant one because there was always at least one member-state that was opposed to any single element.

The ECOFIN found the Commission's wording too vague and was not prepared to include indirect taxation in the package. Therefore, the Commission's proposal had to be revised twice - leading to the exclusion of indirect taxation but a clearer definition of what the code of conduct should include and how capital income should be taxed. The code of conduct should include all business tax measures 'which affects or may affect the location of business activity in a significant way'. Business activity refers to *all* activities carried out within a group of companies and not only financial transactions. It also includes special tax regimes for employees which may affect the location decisions. The aim is to identify and eventually roll back all measures designed to poach the tax base of other member-states. (European Commission, 1997b: Annex). Aware of the sensitivity of the taxation issues, the Commissioner for the Internal Market, Mr Monti, declared just before the submission of the second proposal that the Commission was trying not to appropriate the sovereignty of the member-states but to help them by pooling certain elements of the taxation policy. In other words, he was signalling that the Commission's aim is to act as an impartial broker who could facilitate package deals which may eventually lead to binding rules. For that purpose, he also suggested that a Code of Conduct Group consisting of member-state representatives and functioning under similar principles to those of the Taxation Policy Group should be established (Agence Europe, 23.8.1997: 2).

The package approach of the Commission was accepted in ECOFIN meeting of 13 September 1997 in Mondorf-les-Bains, leading *Agence Europe* to comment that the Mondorf meeting 'set out premises that had hitherto been largely taboo.' (Agence Europe, 15/16.9.1997: 10). It must be indicated here that the UK has been consistently silent on these issues - despite their sensitivity which the tabloid press tends to exploit. The ECOFIN meeting of 13 September accepted the Code of Conduct in general but asked the commission to resolve the issue of what system should be applied for capital taxation: a withholding tax or declaration of information?. The third proposal of the Commission (submitted in November 1997), adopted the principle of co-existence. In this system, countries with banking secrecy laws should apply a minimum withholding tax on the capital income of non-residents; others where banking secrecy is not the norm should provide information to the country where the beneficiary of interest payments is residing. In either method, the incentive for granting tax-exempt treatment to non-resident investors will be reduced if not totally eliminated.

The ECOFIN discussed the final proposal on 1 December 1997 and accepted the final version, which included a code of conduct for business taxation and the basic elements of the taxation of capital income. (See, Official Journal C2, 6.1.1998: 1-7). Nevertheless, the ECOFIN meeting also signalled the difficulties in moving forward to identify the measures that constitutes harmful tax competition and determine the details of the capital income taxation directive. For example, the UK raised the issue of distinguishing between ordinary bank deposits and Eurobonds, with the aim of excluding the latter from the future directive. France indicated that the rate of withholding tax on capital income should be at least 25%, which was unacceptable for Luxembourg. Belgium, Italy and Portugal stated that they would not agree to the directive on royalty and interest payments between companies unless the directive on taxation of capital income is adopted. In other words, the ECOFIN decision was a good sign of the conflicting trends in EU taxation policy co-ordination. On the one hand, the EU was able to move on issues that had been deadlocked in the past, but it also demonstrated that further progress would be subject to prolonged bargaining and trade-offs.

Under these circumstances, Mr Monti's description of the ECOFIN decision as a historic breakthrough (Agence Europe, 3.12.1997: 4-5) may be exaggerated but not totally out of place. The decision signalled the limited scope for a breakthrough but it also reflected the fact that the EU was capable of laying the basis for policy co-ordination and binding rules on an issue that has been: (i) associated with aggressive competitive bidding and (ii) treated as the ultimate indicator of sovereignty. Further developments in 1998 and the first half of 1999 indicates that the Commission's evaluation of the ECOFIN decision should not be overlooked altogether.

During 1998, four developments are worth mentioning. The first one concerned the Presidency of the Code of Conduct Group, that has been functioning on an ad hoc basis. On 9 March 1998, the ECOFIN agreed by majority that the president should be elected by the members of the group for two years and, if necessary, by majority (Agence Europe, 9/10/3/1998: 7). This was in line with the preferences of the large member-states, but it also reflected an agreement on the need to ensure continuity and break bargaining deadlocks involving the selection of the president. More significantly, this majority decision was taken during the UK presidency - the country for whom tax policy co-ordination has been an anathema. Although the UK was rewarded with the first presidency of the Code of Conduct Group, this was not a bad trade off for other member-states who were keener on tax policy co-ordination. After all, the new President, Mrs Dawn Primarolo, could be representing a member-state not committed to tax policy co-ordination, but she had to undertake to 'put her heart into the work' of the Group (Agence Europe, 8.5.1998).

In fact this proved the be case. Under her leadership, the Code of Conduct Group performed remarkably well. It secured agreement from the ECOFIN that allowed it to establish sub-groups specialising in different areas and whose remits would be determined by the Group itself rather than the ECOFIN. It developed a work programme until December 1998 and collated the information provided by the member-states on all fiscal schemes that may have a significant effect on location decisions. Although it was phrased in general terms, the Group's first report was completed before deadline. Also, the information collated by the Group has enabled the Commission to classify the practices of harmful tax competition into 5 categories involving 85 harmful tax measures - a classification adopted by the Group in its future work. These categories consist of the following : intra-group services (i.e., transactions between affiliates of the same company); finance&insurance services and off-shore companies; sector-specific arrangements such as maritime transport, aviation, etc.; regional incentives; and other tax advantages granted to small or newly created companies (Agence Europe, 16.7.1998: 6).

The group also began to examine each category with a view to ascertain the following: (i) are tax advantages granted only to non-residents (i.e., is the tax base of other member-states targeted)? (ii) are the advantages to non-residents ring-fenced (i.e., is the poaching country limiting its loss of tax revenue at the expense of others)? (iii) are the advantages granted in the absence of real economic activity (i.e., are they encouraging tax evasion in the country of residence?) (iv) are the rules determining company profits substantially different from internationally agreed ones (i.e., is the poaching country attracting foreign companies by inducing them to avoid tax)? (v) Do fiscal measures lack transparency (i.e., do they involve arbitrary discretion)?

The significance of these methods lie in the extent to which they were functional in cracking the black box of the tax policy and dispelling the taboos with which it has been surrounded. Because this information has also increased the transparency of the national fiscal measures and their implications for other member-states, it helped to delineate the possible trade-offs in the policy co-ordination game. Finally, it also reduced the ability of those benefiting from these beggar-thy-neighbour policies to argue against policy co-ordination.

The second development concerned the specification of the minimum withholding tax to be applied to capital income of non-residents. Despite strong objections from Luxembourg who argued for a withholding tax rate of 10%, the Commission, in its proposal of May 1998, settled on 20% - which was closer to the maximum rate of 25% requested by France. That this tendency to converge towards the top rather than the bottom is not only a function of Luxembourg's small size can be seen in other aspects of the proposal for directive. For example, the Commission included a paragraph requiring the member-states to ensure the implementation of the directive in territories where they have tax prerogatives. Also, it ensured that Eurobonds remained included in the directive despite persistent objections form the UK (European Commission, 1998b. See also, Agence Europe, 21.5.1998: 6).

The third development concerned negotiations with neighbouring countries and international organisations on harmful tax competition. The ECOFIN met with the Director of the IMF in the early days of the UK presidency to discuss a code of conduct for banking surveillance. Later on the ECOFIN authorised the Commission to begin dialogue with neighbouring countries such as Switzerland, Monaco, Liechtenstein, Andorra and San Marino with the aim of securing their agreement to a code of conduct similar to the one under negotiation within the EU. The most significant aspect of these negotiations is that the ECOFIN did not make progress within the EU conditional on the attitudes of the interlocutors. This is an indication that competitive bidding by the neighbouring countries would be a factor to be taken into account, but not necessarily a stumbling block for intra-EU policy co-ordination.

The fourth development was related to the method in which transactions between companies of different member-states should be taxed. The Commission proposed that interest and royalty payments between associated companies with at least 25% holding in each other should be taxed in the member-state where the companies are registered. The aim here is to avoid double taxation and facilitate technology transfer between companies of different member-states (European Commission, 1998a). The importance of this proposal is twofold. On the one hand, it demonstrates the extent to which the Commission can resist pressure from member-states by arguing against them on the basis of transparent criteria. Of the net capital/technology importing member-states, the Commission granted exemption only to Greece and Portugal on the grounds that these member-states were less developed. It rejected similar demands by Italy and Belgium on the basis of the same criteria. On the other hand, the proposal is a good indication of how deep integration can enable the EU and its member-states to co-ordinate tax policy without necessarily erecting barriers against capital mobility. In fact, the aim of the proposal is to encourage capital mobility in the form of joint ventures, mergers, partnerships and technology transfer.

If the developments in 1998 indicated the scope for policy co-ordination, those in 1999 highlighted the difficulties involved in securing binding rules and the need for further transparency. The Code of Conduct Group examined the 85 measures mentioned above and decided that all of them constituted harmful tax competition. It also identified the member-states where any particular measure was implemented. This prompted the German representative in the ECOFIN meeting of 25 May 1999 to state the following: 'We now have total transparency on what is done in each member-state. … This transparency allows us to move forward to the 2nd phase of work - i.e., identification of the illegal practices that actually enter the Code's field.' (Agence Europe, 25/26.5.1999: 10). Although, the ECOFIN has until the end of 1999 to decide on these measures, the existing signals indicate that agreement on the final coverage of the Code of Conduct will be more difficult than that involving the stock-taking of the harmful tax competition practices.

Also, although the Parliament has approved the Commission's proposal for the taxation of capital income without amendment, the UK's objection concerning Eurobonds was still preventing agreement in the ECOFIN. In an attempt to allay British concerns, Mr Monti visited London on 12 May 1999 and held talks with Lord Grenfell - the Labour Peer chairing the House of Lords Committee on European Taxation. Lord Grenfell did not say anything that would weaken the UK's bargaining position, but he stated that a compromise would be found as neither nor his colleagues wanted to 'see the taxation package as a whole just fraying away.' (Agence Europe, 15.5.1999: 9). Given that the UK government has still not come forward with the promised alternative plan for Eurobond deposits, one is led to think that the UK's objection may be more of a bargaining tactic than an outright veto. In fact, some signals from the City of London suggests that this is the case. The secretary-general of the London-based Primary Market Association told the press that the UK is not trying to 'talk this thing [the directive on taxation of capital income] to death.' (European Voice, 2-8.9.1999: 1).

Despite these difficulties, tax policy co-ordination has now become part of the EU's policy agenda. The member-states' commitment to progress in this area is reflected in the declarations of the Cologne European Council, which confirmed the following: the need to combat harmful tax competition and make the European tax system more employment friendly; the desire to conclude the directive on the taxation of capital income before the end of the Finnish Presidency; the desire to conclude the discussions on the Code of Conduct by that time; the call to the Commission to present a report on progress to the Helsinki Summit. (Agence Europe, 6.6.1999: 11). This result is a far cry away from the refusal of the member-states to even discuss the Commission's proposals on tax policy co-ordination submitted before 1996.

Conclusions

The analysis above has been based on the observation that the current debate on globalisation and regional integration tends to overlook significant linkages and differences between the two processes for two reasons. On the one hand, it measures globalisation and integration in terms of what is described here as centrifugal societal tendencies and assumes that these tendencies would generate policy convergence that would undermine policy autonomy. On the hand, it tends to focus on either the state or society as the unit of analysis at the expense of state-society interaction. Because of these tendencies, we have argued, the current debate tends to produce either reactive or backward-looking conclusions about the implications of globalisation and regional integration for policy autonomy.

Focusing on state-society interaction, this paper attempted to demonstrate that globalisation and regional integration share a common feature: they both reflect the extent of policy convergence induced by the tendency of societal forces to move between jurisdictions with the aim of maximising the returns on jurisdictional loyalty. The paper also demonstrated that globalisation and regional integration are also different processes in that policy convergence is un-institutionalised in the former whereas it is institutionalised in the latter. Therefore, policy convergence does not necessarily imply loss of policy autonomy as long as it is shaped by high levels of centrifugal societal tendencies and issue transparency/divisibility. This is even more the case when the policy convergence is managed and codified through the institutions of regional integration.

Therefore, in terms of policy innovation and tackling the externalities generated by increased centrifugal societal tendencies, institutionalised convergence in the context of regional integration is superior to un-mediated convergence in the context of globalisation. Secondly, deep regional integration and globalisation are compatible in terms of encouraging increased factor mobility. Thirdly, deep regional integration is superior to shallow integration because of the former's 'institutional thickness' that allows for intra-bloc conflict resolution and cost/benefit distribution. The relevance of these propositions is examined in the light of the EU's recent attempts at tax policy co-ordination. The evidence presented above suggests that the proposed model can predict and explain the inclusion of taxation matters into the EU's policy agenda despite the fact that taxation has been a jealously guarded national prerogative and a high level of aggressive poaching of each other's tax base has been the norm since early 1980s. The model also enables us to explain why such a move towards policy co-ordination is undertaken by the EU and not other RIAs or international organisations.

Finally, the analysis above enables us to speculate on three issues. First, deep RIAs can contribute to the global management of the externalities associated with increased capital mobility and international trade. The Commission on Global Governance (1995: 151) has already made a similar observation when it stated that RIAs can make such a contribution by pioneering new methods for integration in advance of progress at the global level. This prediction, however, is too optimistic. The analysis in this paper suggests that it must be qualified by indicating that such a contribution is possible only if the RIAs are deeply institutionalised. That is because only deep regional integration can reduce the probability of lowest-common-denominator outcomes through conflict resolution and weakening of the societal constraint on policy-makers.

Secondly, shallow RIAs could pose a threat to the global management of the world economy not because of their discriminatory nature, but because they are weak in dealing with the externalities generated by centrifugal societal tendencies. In other words, they combine the *weakness* in tackling these disruptive effects with *increased scope* for bloc-wide unilateral reactions. Therefore, the proliferation of the shallow RIAs should be interpreted as a reflection of a reactive and backward-looking approach to policy autonomy. Therefore, the policy autonomy that they may secure for their members is not necessarily conducive to optimal outcomes either for their members or for the world economy - irrespective of what the declared intentions may be.

Finally, although deep integration may be conducive to enhanced policy autonomy because of the high levels of issue transparency/divisibility, the nation-states are well-equipped with the experience and instruments of blurring that transparency/divisibility. In that sense, the compatibility between deep integration and policy innovation cannot be taken for granted. Currently, the EU and its member-states appear to be committed to increasing the transparency/divisibility of the policy issues. In other words, they are less prepared to grant special treatment to sectional interests or to equate those interests with a non-negotiable national interest. However, this commitment can be reversed if the EU economies are hit by adverse shocks leading to prolonged period of low performance.

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