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The Political Economy of Globalisation and Regional Integration:
The Case of Tax Policy Co-ordination in the European Union

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Abstract

Globalisation and regional integration increase the scope for movement between jurisdictions. As a result, tax policy arbitrage and policy convergence can be expected to constrain public policy choices. Nevertheless, regional integration can also enable the policy-makers to reclaim policy autonomy as the rates of return on constituent loyalty are equalised by convergent policy choices. This paper reviews the debate and develops an analytical framework that enables us to explain the linkages between and policy implications of globalisation and regional integration in an open-ended manner. We propose a political economy framework that differentiates between market-driven and institutionalised policy convergence under increased inter-jurisdictional mobility. The proposed analytical framework is applied to the EU's experience in tax policy co-ordination. We observe that globalisation and the deepening of European integration have in fact enabled EU and national policy-makers to reclaim policy autonomy and make attempts to halt/reverse the market-driven process of tax competition. Although the pro-active co-ordination effort is still in its infancy, it constitutes a significant development that stands in contrast to the prisoners' dilemma outcomes of the 1980s and early 1990s.

Key Words: Globalisation, regional integration, tax policy co-ordination, policy convergence.
Introduction

A central theme in the debate on globalisation and regional integration is the loss of public policy autonomy, caused by increased inter-jurisdictional mobility of non-state actors. This loss is either permanent as the society-centric view of globalisation would argue; or it is fictive as the state-centric anti-globalisation thesis would predict. To our knowledge, there has been no systematic effort to analyse the impact of globalisation and regional integration on policy autonomy as an endogenous outcome determined by the interaction between public and private actors. This paper aims to contribute to the ongoing debate by developing a political economy approach that explains the impacts of globalisation and regional integration for public policy as endogenous outcomes of the interaction between governments and internationally mobile non-state actors.

In the proposed approach, globalisation and regional integration share a common feature: they reflect the extent of policy convergence induced by the inter-jurisdictional mobility of non-state actors and the government’s optimal reaction given the level of institutionalisation. The main distinction between the two processes, however, is that policy convergence is generally market-based under globalisation whereas it may be a co-ordinated outcome under regional integration. In game-theoretic terminology, policy convergence under globalisation tends to be a prisoners’ dilemma outcome whereas regional integration may enable the national policy-makers to improve on the prisoners’ dilemma outcome through co-operation.

To apply this analytical framework to tax policy co-ordination in the European Union (EU), the paper is organised in three sections. Section 1 reviews the debate on globalisation and regional integration. The aim here is to develop the case for treating globalisation and regional integration as endogenous outcomes of public-private interaction rather than as outcomes determined by structural exigencies or exogenously given actor preferences. In section 2, we draw on Hotelling’s (1929) theory of locational competition to derive two propositions. The first proposition is that policy convergence generated by the mobility of non-state actors may or may not reflect the preferences of the actors who instigate the convergence process by moving between policy jurisdictions in an attempt to maximise the returns on jurisdictional loyalty. The second proposition is that deep (i.e., highly institutionalised)
regional integration may be compatible with enhanced public policy autonomy despite the high level of policy convergence implied by integration.

Based on this analytical framework, section 3 examines the issue of policy co-ordination with respect to capital income and corporate taxation in the European Union (EU). Given the increased mobility of capital, the existing literature on globalisation and regional integration would predict either curtailed policy autonomy or a 'reactive' policy response involving restrictions on capital mobility. The evidence examined in section 3 demonstrates that these predictions are incompatible with the developments in EU tax policy co-ordination and may be misleading in terms of their policy implications. Section 3 will demonstrate that institutionalised policy convergence induced by high levels of capital mobility can go hand in hand with tax policy autonomy/innovation for two reasons. First, the convergence of policies approximates the rates of return on jurisdictional loyalty and reduces the incentives for punitive capital flows. Secondly, EU institutions may reduce the cost of policy convergence by designing package deals and providing commitment devices or the deepening of the integration process may increase the cost of non-cooperation.

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 paper does not intend to order and analyse the extensive debate - an exercise already undertaken by a number of students of globalisation (See, inter alia, Higgit and Reich, 1998; Held et al., 1999: 2-20). Here, we build on the classification proposed by these reviews to identify 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 mobility of people, goods and factors of production. This preoccupation is understandable because increased mobility may impinge on public policy autonomy 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 may generate 'a drive to the bottom' in terms of taxation, public good provision, regulation or re-distribution. Secondly, increased mobility may undermine the efficacy of macroeconomic policies
as divergent policy choices are penalised by massive capital flows and speculation. Thirdly, interventionist policies may become less feasible as technology makes the mobility of people, goods and capital highly difficult to control. Finally, the public policy-maker may lose ground vis-à-vis influential corporate actors with global strategies.

These likely impacts 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/functional. 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 inter-jurisdictional mobility generate policy convergence among jurisdictions. In fact, policy convergence is taken as a given fact rather than an outcome to be explained. Consequently, the debate tends to remain non-cumulative, parochial and speculative.

Therefore, 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 to globalisation: the social democratic/re-distributive thesis; the comparative regionalism thesis that focuses on the relationship between globalisation and regional integration; the modernisationist thesis; 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.

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 that focuses on the state as an actor and its response to inter-jurisdictional mobility. 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 that it would wish to implement anyway. (See also, Armingean, 1997). The comparative regionalism literature can be viewed in the same light for its main concern is the added capacity that regional blocks provides the state with in the struggle to shield itself against globalisation (Sideri 1993 & 1997).

On the other hand, one can identify a society-centric tendency that focuses on the extent to which inter-jurisdictional mobility imposes a constraint on public policy. Here again we are faced with two versions. The 'strong constraint' version emphasises the universalisation of the market structures and envisages no or very little scope for autonomous policy choices (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 mobility or because of the externalities associated with such tendencies.

Of those focusing on the level of mobility, Hirst and Thompson (1996) envisage a significant scope for policy autonomy because current inter-jurisdictional mobility is not as intense as suggested by the universalisation of the market structures thesis. In fact, the world economy may be comparatively less global now than it was in the nineteenth century. Those focusing on the externalities, however, envisage some scope for public policy intervention particularly because the level of mobility is high. According to Dunning (1997), the significance of the state's systemic functions will increase even though the significance of the interventionist functions may have to be revised. Similar arguments are put forward in a conference on globalisation and trade. The participants tended to agree that globalisation strengthens the 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).

The emerging literature on the link between globalisation and regional integration is also problematic. One weakness of this literature is its 'state-centric' focus, which overlooks the state-society interaction. Regional integration is examined as a reactive
state response 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 developing countries, it lessens 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.'

Another shortcoming of the globalisation-regionalisation literature is the lack of theorisation about policy convergence. As a result, differences in the degree of convergence within existing regional blocks are not explained. 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. However, neither they nor Coleman and Underhill (1998) provide an explanation as to why these differences exist and what they might tell us about policy autonomy under different levels of convergence. The third weakness of the globalisation-regionalisation literature is its lack of definite criteria for ascertaining the compatibility-incompatibility of regional integration with globalisation. For example, Milner (1998: 21) indicates that divided government is a recipe for failure in the international co-ordination game. However, neither she nor other contributors to Coleman and Underhill (1998) examine the implications of shallow integration for policy co-ordination within the block itself or for the block's response to globalisation.

Given these observations, we would argue that the literature on globalisation and regionalisation has been successful in drawing our attention to significant developments that emerged in the 1990s and will continue to unfold in the future. However, we are still far from having either a unified methodology for studying the two processes or a common analytical framework from which testable hypotheses can be derived. As an attempt to contribute to the debate in that direction, we develop below an analytical framework that would enable us to examine globalisation and regional integration as functions of two variables: inter-jurisdictional mobility of non-state actors and transparency/divisibility of policy issues. This framework implies
that policy autonomy is determined endogenously by the interaction between public and private actors under different levels of inter-jurisdictional mobility and issue transparency/divisibility.

2. Inter-Jurisdictional Mobility and Policy Convergence: Implications for Policy-Making under Globalisation and Regional Integration

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 in terms of welfare and factor incomes/prices. However, the strongest exposition of the convergence thesis can be credited to Solow (1956) who argued that the diffusion of technology would enable the developing countries to 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 paper, however, is the debate on policy convergence rather than convergence of economic indicators. In this context, it is interesting to note the post-1945 predictions concerning convergence towards interventionist policies. High levels of investment and technological change, it was argued, would require long term private and public planning by 'technostructures' (Tinbergen, 1959; Aron, 1962; Galbraith, 1971). The current swing in the convergence debate that predicts just the opposite is good indicator of the limited predictive power of such structural theories. The same structural conditions are now considered to require liberalisation and rolling back the state as a precondition for wealth creation (Ohmae, 1990 and 1995; Albrow, 1996; Greider, 1997). 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 non-state actors are rational in the narrow sense that they will respond to the cost/incentive structures 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 inter-jurisdictional mobility may or may not reflect the preferences of the societal forces who try to maximise the returns on their jurisdictional loyalties. To substantiate 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 Cournot, 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, whose quest for maximised utility triggers the price, quality or location convergence 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: when loyalty shifts from one supplier to the other is possible but costly, 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 (i.e., unless the cost of shifting loyalty is zero). Under this assumption, the extent of convergence declines as the number of suppliers increases. However, even with a very large number of suppliers, 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. Shaked and Sutton demonstrate that strategic interaction between
monopolistically-competitive firms is conducive to a mutually beneficial steady state where firm profits, consumer utility and product differentiation 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 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 these variables are 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.

The relevance of this analysis for states competing for the loyalty of mobile production factors (such as capital) is obvious. Nevertheless, we need to avoid hasty generalisations. Unlike monopolistically competitive markets where physical/legal barriers to loyalty shifts cannot be erected, 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. Also, the cost of public policy decisions for different sections of the society is also difficult to ascertain. That may be the case either because the state or an interest group can equate the decision with an overarching national interest that must be defended irrespective of the cost for some other groups. Therefore, in the state system, the extent of policy convergence as a means of loyalty stabilisation is likely to be lower compared to markets. In addition, the extent of policy convergence will differ depending on the ability of the state to limit loyalty shifts through control-reliant measures. In Hirschman’s (1970) terminology, the higher the state’s ability to block the ‘exit’ avenue 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 higher is the level of policy convergence required to dampen loyalty shifts (Ugur, 1997).

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 non-state actors 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, however, is to treat policy options not exogenously (i.e., determined outside the model), but endogenously (i.e., determined by public-private interaction). The result of the interaction, however, may not necessarily reflect the preferences of non-state actors because the latter may become less able to constrain the public policy choices as the public actors engage in policy convergence.
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 state-state and public-private interaction: the extent of inter-jurisdictional mobility and the transparency/divisibility of policy issues. While inter-jurisdictional mobility reflects the extent of loyalty shifts, 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 other states and/or constituents of other jurisdictions. The higher the level of transparency/divisibility is, the less able is the state or the societal groups to act as veto groups, 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 coordination 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 inter-jurisdictional mobility (i.e., globalisation) must be qualified.

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

Having examined the relationship between inter-jurisdictional mobility and policy convergence, 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 inter-jurisdictional mobility. However, inter-jurisdictional mobility generates different levels of globalisation and integration and has 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.
Figure 1: Levels of Convergence and Implications for Policy Autonomy under Different Levels of Inter-Jurisdictional Mobility and Issue Transparency/Divisibility

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A quick glance at Figure 1 reveals that a given level of inter-jurisdictional mobility does not necessarily produce a uniform level of policy convergence. For example, the level of convergence in cell A1 is lower than cell A2 despite the fact that the level of inter-jurisdictional mobility is the same (high). That is because low levels of issue transparency/divisibility in cell A1 enable the state to deploy exit-blocking strategies as a means of loyalty maintenance. In cell A2, exit-blocking is not viable due to higher issue transparency/divisibility that, in turn, facilitates issue linkage and package deals as a basis loyalty maintenance. 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 inter-jurisdictional mobility) but also on the extent of issue transparency/divisibility.

Another conclusion that can be derived from Figure 1 is that the level of policy convergence is generally higher at the regional level compared to the global level. In addition, higher levels of policy convergence at the regional level are associated with a greater scope for policy autonomy. There are various reasons for this discrepancy. The first is the lower transaction costs involved at the regional level given the smaller number of players. The second is the higher level of similarities between the objective functions of the players at the regional level.

Another reason is that regional institutions facilitate the distribution of the costs/benefits associated with policy convergence by: (i) providing a permanent forum for negotiations; (ii) linking policy issues in package deals, (iii) acting as impartial enforcers that increase the cost of non-cooperation; and (iv) reducing the cost of compliance through side payments. Regional integration also has 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 secure special treatment in the national 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).

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 A1, we can see that the combination of high mobility and low issue transparency/divisibility leads to selective convergence for loyalty maintenance under both globalisation and regional integration. At the global level, the policy autonomy is undermined by the
market-driven convergence. At the regional level, there is variable scope for policy autonomy, which is determined by the limited supply of institutions. Therefore, the incidence of the prisoner’s dilemma is reduced under regional integration as the latter (even though shallow) may be conducive to a limited level of negotiated policy coordination.

In cell A2, the contrast between globalisation and regional integration is at its highest. The high level of policy convergence at the global is conducive to loss of policy autonomy as it is determined by market forces. Under this condition, the prisoners' dilemma outcome is even more pronounced than cell A1. In contrast, the high level of convergence under integration is compatible with policy autonomy because of the high supply of regional institutions. Unlike the global level, the high supply of regional institutions facilitates co-ordinated choices. Also, the loss of policy autonomy under globalisation in cell A2 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.

Turning to cell B1, we can see that the level of policy convergence is the lowest at the global and regional levels. While low inter-jurisdictional mobility reduces the incentive for policy convergence as a means of loyalty maintenance, low transparency/divisibility increases the cost of convergence. In other words, the constraints on policy autonomy are quite weak. However, the policy autonomy implied by this state of affairs may be counter-productive. Because issue transparency/divisibility is low, 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.\(^1\) It is also not surprising that the policy autonomy deployed during that period was not conducive to optimal policy choices - as demonstrated by

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\(^1\) 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).
protectionism, unilaterality, and heavy interventionism that contributed to the outbreak of two world wars.

In cell B2 the level of globalisation/regional integration is relatively higher than cell B1. 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 enables us to distinguish between regional blocks in terms of policy autonomy. Deep regional blocks with some degree of supranationalism and legally binding rules would be characterised by higher degree of policy convergence and policy autonomy compared to shallow regional blocks. The higher level of convergence within deep regional blocks is due to the removal of protectionist barriers to inter-jurisdictional mobility. These barriers are reduced in various ways, including elimination, harmonisation and mutual recognition. The higher degree of policy autonomy within deep regional blocks is due to the negotiated policy convergence that reduces the incentives for punitive inter-jurisdictional mobility of the non-state actors. Finally, 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 member-states as a protectionist weapon against the rest of the word. That is because either low issue transparency/divisibility or low inter-jurisdictional mobility encourages them to engage in exit- or entry-blocking strategies for loyalty maintenance.

3. Institutions and Norms in Deep Integration Schemes: The Case of Tax Policy Co-ordination in the EU

The stylised facts about European taxation policy are fairly straightforward. As capital movements were liberalised in the 1980s, capital mobility increased and so did the competition for attracting the mobile tax base. Consequently, the effective tax rate on capital in the EU decreased from 44.1% in 1980 to 35% in 1995. Because labour is less mobile, the tax rate on labour income increased from 34.7% to 42% over the same period. (European Commission, 1996b. See also Owens, 1993). This trend is
underpinned by the proliferation of preferential tax regimes for capital in the form of direct investment as well as bank deposits by non-residents. It is expected to intensify after the establishment of the monetary union as the elimination of currency risk encourages further capital mobility. Given that tariff and non-tariff barriers to trade have been eliminated, the impact of tax differentials on intra-EU movements of goods will also be felt strongly. The combination of these factors is highly likely to generate tax-related externalities and cause distortions, leading to sub-optimal results for all EU member-states.

Of course, the positive impacts of tax competition should not be overlooked. Tax competition is conducive to lower tax rates and wider tax bases — both of which reduce the extent of tax-induced distortions in the EU economy. Therefore, any attempt at addressing tax competition must be based not only on revenue considerations but also on a careful assessment of the costs and benefits of tax policy co-ordination. According to Sorensen (2000), tax policy co-ordination within the EU is likely to have a positive welfare effect, but this effect will remain less than 1% of the EU GDP. In terms of equity, however, implications are more significant: the poorest 20% of the EU population will gain by 2.2% of their disposable income against a loss of 0.85% of the disposable income of the richest 20%.

This finding is compatible with the arguments in OECD (1998), which states 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. It is also compatible with the EU Commission's repeated arguments that intra-EU tax competition has eroded the tax base, placed excessive burden on immobile factors of production, and threatened the smooth functioning of the single market. (European Commission, 1996a; 1996b; 1997a and 1997b).

In what follows; we will demonstrate that the recent move towards tax policy co-ordination in the EU is a significant development that can be predicted and explained by the analytical framework developed in section 2. Our framework predicts that high levels of capital mobility would lead to market-driven convergence and tax policy arbitrage under globalisation, but institutionalised convergence and policy co-ordination under regional integration. It also predicts that the scope for avoiding market-driven arbitrage would increase under integration as the transparency/divisibility of the taxation policy increases. These predictions imply that the EU, as a highly-institutionalised regional block, should be able to engage in tax
policy co-ordination without erecting barriers to capital mobility. This ability will increase as tax policy issues become more transparent/divisible.

In the 1990s, the transparency/divisibility of the European taxation policy increased for two reasons. First, the linkage between integration and taxation has become more obvious following the indirect tax co-ordination induced by the single market and the fiscal convergence criteria imposed by the monetary union. Secondly, 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 highlighted the negative externalities associated with un-coordinated tax policies. Under these conditions, taxation issues have become less of a taboo – enabling the European Commission to construct a tax package that would facilitate EU-level agreement.

This increased transparency/divisibility, combined with high levels of capital mobility that followed the liberalisation of capital movements in the 1980s, meant that the EU should respond to the erosion of tax base and the change in the tax structure in accordance with the predictions outlined in cell A2 of Figure 1 above. Indeed, recent developments indicate that this has been the case. In response to increased capital mobility, the EU has embarked on tax policy co-ordination in 1996 and progressed more than any other regional block or international organisation, including the OECD. Ongoing negotiations and technical work in the EU covers three major areas: a Code of Conduct aimed at combating harmful tax competition in the area of corporate taxation; withholding tax or information exchange with respect to the taxation of capital income from deposits; and harmonisation of tax rates applicable to interest and royalty payments between companies. This compares very favourably with the second most advanced initiative, 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 and Commission representatives) has exposed the aggressive poaching techniques that had been utilised by member states to such an extent that the 'fiscal sovereignty' argument is now less likely to hold water compared to three years ago. This 'injected' transparency/divisibility will

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).
reduce the veto power of the member-states not only because of the sub-optimality of the exposed tactics but also because of their equity implications. Finally, the lengthy process of negotiations and consultations has helped to create a certain degree of trust and 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, tax policy co-ordination was a non-starter. Therefore, it is not surprising 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. 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 inter-jurisdictional mobility on the other. Given that the EU's attempt at tax policy co-ordination has developed against a background of deepening integration and intensifying globalisation, it can be seen as a good indicator that these processes 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 taxation on immobile factors of production (especially labour), arrest the gradual erosion of their mobile 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.

The Verona ECOFIN meeting of April 1996 instructed the Commission to prepare a report on intra-EU harmful tax competition. This report was prepared after long discussions within a High Level Group composed of national representatives and oral evidence was taken from the representatives of employers, employee organisations and the Chair of the Ruding Committee that had prepared a report on taxation in 1992. The Commission’s report (European Commission, 1996b) was published in October 1996 and formed the basis for the Dublin Summit decision to establish a Taxation Policy Group. Other EU institutions were also involved in the tax policy 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, 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 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 for corporate taxation was laid down. In the mean time, the Commission combined the issues of taxation of capital income from saving deposits, corporate taxation and taxation of interest and royalty payments between companies into a package and submitted it to the ECOFIN meeting of September 1997.

Following the ECOFIN meeting, the Commission carried out further work on the tax policy package, which consisted of a proposal for a Council resolution and two proposals for directives to be negotiated simultaneously. This strategy had the
drawback of blocking progress on a particular measure on the grounds that progress in other areas was impossible. However, it had also the advantage of securing agreement through issue linkage and package deals. In fact, the latter aspect turned out to be the dominant one. The package escaped the fate of the previous 48 proposals that had been either blocked in the Council or withdrawn by the Commission.

The most developed element of the package was the proposal for a Code of Conduct concerning corporate taxation. The Code defined harmful competition in this area as all business tax measures 'which affects or may affect the location of business activity in a significant way'. It also provided for three principles. First, member states must inform each other of existing and future tax measures that may fall within the scope of the Code. A follow-up group will also be established, where member states discuss and comment upon tax measures adopted by other member states. Secondly, the Code includes a standstill principle whereby member states undertake not to introduce new measures constituting harmful tax competition. Finally, there was the principle of rollback, which required phasing out the harmful measures within two years after the adoption of the Code (European Commission, 1997c).

Aware of the sensitivity of the taxation issues, the Commissioner for the Internal Market stated that the Commission was not trying to appropriate the sovereignty of the member-states but to help them by pooling certain elements of the taxation policy (Agence Europe, 23.8.1997: 2). In other words, he was signalling that the Commission's aim is to devise package deals that enable the member states to escape the negative consequences of unrestrained competition for the mobile tax base. This view was repeated at various occasions and culminated in a statement by the Director-General for taxation as follows:

'There is a danger that, without tax co-ordination ... member states may be forced ... towards a less than ideal type of tax harmonisation, and loss of national tax sovereignty, in favour of the markets. Member states themselves have become increasingly aware of this through the process of discussion over the last few years ...' (Vande Abele, 2000: 6).

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 the sensitivity of domestic politics to EU-level initiatives in general and in the area of taxation in particular. 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 Commission's proposal on 1 December 1997 and agreed to a resolution concerning the Code of Conduct for corporate taxation. (See, Official Journal C2, 6.1.1998: 1-7). There was no agreement on the taxation of capital income from savings for two reasons. First, Luxembourg (a member state with a preferential regime for non-resident deposits) was opposed to the withholding tax rate of 20-25%. It was in favour of a much lower rate of 10%. The second, and more significant reason, is the risk of deposit leakage to tax havens and preferential regimes in small European states such as Monaco, Andorra, and Switzerland as well as dependent/associated territories of the member states (such as the Channel Islands, Isle of Man, and the territories in the Caribbean). In addition, the UK raised the issue of distinguishing between ordinary bank deposits and Eurobonds, with the aim of excluding the latter from the future directive. In other words, the ECOFIN decision was a good sign of the conflicting trends in EU tax policy co-ordination. 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.

Three developments during 1998 are worth mentioning. The first one concerned the Presidency of the Code of Conduct Group. 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 to break deadlocks involving the selection of the president. More significantly, this 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 to be the case. Under her leadership, the Code of Conduct Group performed remarkably well. It secured agreement from the ECOFIN 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 measures that may affect corporate location decisions. The Group's first report was phrased in general terms, but it was completed before the deadline. Also, the information collated by the Group had enabled the Commission to classify the harmful tax measures into 5 categories - 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 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 associated/dependent territories. 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 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 explicitly conditional on the attitudes of the interlocutors. This was 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.

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 300 measures considered to constitute potentially harmful tax competition. 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 second 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 had until the end of 1999 to decide on these measures, the existing signals indicated 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, the Commissioner responsible for taxation, 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 assured him that a compromise would be found as 'neither he 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 the ups and downs examined above, tax policy co-ordination has become part of the EU's policy agenda. Undoubtedly, progress has been very slow and the taxation package has not been finalised by the end of the Finnish Presidency – as promised by the Cologne European Council (Agence Europe, 6.6.1999: 11). In addition, the Code of Conduct Group has undertaken a comprehensive review of the potentially harmful taxation measures in 3 three reports, but its reports remain confidential. Therefore, the transparency of the corporate taxation regimes in the member-states is far from being ensured. Finally, intra-EU co-ordination has not been made explicitly conditional on progress in other countries, but this conditionality appears to be holding in practice. According to the ECOFIN report submitted to the European Council summit of June 2000 in Santa Maria Da Feira, the Commission and the Troika should continue to negotiate with tax havens, preferential regime countries such as Switzerland, and the US before the adoption of the directive on capital income taxation. The only positive aspect of that report is that the Council is required to decide on the directive by the end of 2002. (European Voice, 29.6 – 5.7 2000: 13).

Conclusions

The review in section 1 suggests that the current debate on globalisation and regional integration tends to overlook significant linkages and differences between the two processes. On the one hand, it equates globalisation with what is described here as inter-jurisdictional mobility and assumes this mobility would necessarily
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 derive either reductionist or backward-looking implications for policy autonomy.

Focusing on state-society interaction, section 2 demonstrated that globalisation and regional integration share a common feature: they both reflect the extent of policy convergence induced by inter-jurisdictional mobility aimed at maximising the returns on their jurisdictional loyalties. The paper also demonstrated that globalisation and regional integration are also different processes in that policy convergence is co-ordinated in the former whereas it is market-driven in the latter. Therefore, policy convergence does not necessarily imply loss of policy autonomy as long as it is co-ordinated through the institutions of regional integration.

The evidence presented in section 3 suggests that norm setting and policy co-ordination under deep integration can be a pro-active and innovative process despite increased inter-jurisdictional mobility. The inclusion of taxation matters into the EU's policy agenda is one example of such innovation, predicted by analytical model of section 2. The inclusion of tax policy co-ordination into the EU’s policy-making agenda is a major development after a long period of aggressive tax base poaching by the member states.
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