(Re)theorising European Integration under Globalisation: A Political Economy Approach

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Abstract

In the last two decades, the European Union has become wider and deeper. In addition, the number of regional integration arrangements has increased dramatically since early 1990s. Against these developments, the focus of regional and European integration studies has shifted away from the motives for and drivers of the integration process towards policy analysis or the comparative politics or regional blocs. This article attempts to bring the regional integration theory back in by proposing a political economy model that explains the dynamics of European integration, the reasons as to why governments agree to delegate authority to regional (EU) institutions, and the relationship between globalisation and integration.

Keywords: *Convergence, Globalisation, Integration, Interjurisdictional Competition.*

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1. Introduction

Writing at a time when the European Union (EU) was about to complete the single market, Cohan (1991: 200) observed that the 'European Community literature' has become 'descriptive' and tended to 'avoid theoretical questions'. This trend has become more evident as approaches from policy analysis or comparative politics had overtaken the functionalist/neo-functionalist or intergovernmentalist theories of the earlier decades. Two major exceptions to this trend have been the liberal intergovernmentalist work of Moravcsik (1993, 1998); and the work inspired by Sandholtz and Stone Sweet, who attempt to combine neo-functionalism with historical/sociological institutionalism (see the collection of articles in Sandholtz and Stone Sweet, 1998; and Stone Sweet et al, 2001).

Another characteristic of the 1990s was the attempt from economists to understand the motives for regional integration. This was in contrast to earlier attempts that had been interested in welfare consequences of regional integration rather than its causes. This new interest was closely related to the proliferation regional integration arrangements (RIAs).[1]

These trends point out to a degree of disciplinary re-alignment in the study of regional integration. In this re-alignment, the discipline that tended to focus on the causes and drivers of regional integration in general and European integration in particular (i.e., political science) began to focus on EU policy processes and consequences of the EU system for national politics and policy-making. In contrast, the discipline that had focussed on the consequences of regional integration (i.e., economics) began to ask questions about the motives that induce governments to engage in regional integration.

In this article, we aim to contribute to the recent economics and political science literature that focuses on the causes and drivers of regional integration in general and European integration in particular. Due to space constraints, we limit our empirical references only to

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[1]   Outside Europe, 50 RIAs were concluded within five years from 1990-94. As of 2000, almost all members of the World Trade Organisation were either members of, or negotiating participation in, at least one RIA.

European integration, frequently referred to as 'deep' integration because of the relatively high degree of institutionalisation and supra-nationalism it embodies. We propose a political economy model that would enable us to derive some hypotheses about: (i) the dynamics of European integration; (ii) the policy-making process of the European Union; and (iii) the impact of globalisation on European integration. Although these hypotheses may be relevant to other RIAs, we do not elaborate on the extent of their relevance simply because of space limitations.

To derive these hypotheses, we build on Hotelling's (1929) spatial competition model. In the proposed model, the government is an actor whose objective is to maximise *constituents' loyalty* to the national jurisdiction. To maximise loyalty, the government uses different combinations of exit barriers and policy convergence. Whilst exit barriers enable the government to *prevent* loyalty shifts, policy convergence enables it to *reduce the incentives for* loyalty shifts. On the other hand, we model constituents as actors whose objective is to maximise the returns on their loyalty to a given jurisdiction. To maximise these returns, constituents resort to different combinations of 'exit' and 'voice'. While exit enables them to *shift loyalty to the jurisdiction with higher returns*; voice enables them to *increase the returns on loyalty to the current jurisdiction*. (For the original exit-voice-loyalty framework, see Hirschman, 1970).

The article is organised follows. Section 1 identifies the strengths and weaknesses of the recent economics and political science literature that analyses the causes and drivers of European integration. In section 2, we build on Hotelling's spatial competition model to demonstrate why governments engage in policy convergence and why the latter occurs before formal integration that locks it in. In section 3, we demonstrate why policy convergence requires EU-level institutions as commitment devices. Finally, section 4 explores the link between globalisation and European integration and demonstrates that globalisation acts as an exogenous shock that deepens the integration process. The conclusions will summarise the main findings and suggest new research directions in the study of European integration.

2. Recent Work on the Causes of and Motives for Regional Integration: A Review

A theory or model of integration must address two essential questions. First, why do governments agree to binding rules and common policies that tie their hands and reduce the choice for their constituents? Secondly, why do sovereign governments delegate authority to regional institutions that monitor government compliance with common policies and rules?

The first-generation economic theories of integration could not address these questions because their focus was on the welfare implications of regional integration rather than its causes. This was evident in Viner (1950), whose main concern was whether regional integration would improve welfare.[2]

Recently, a new strand of economics literature began to address the question as to why countries participate in RIAs. For example, Baldwin (1995) proposes a domino theory of integration, which suggests that a country joins an RIA to avoid the cost of discrimination that outsiders are likely to face. The domino theory, however, cannot explain why: (i) an RIA such as the EU is established in the first place; and (ii) some RIAs have an open-membership policy (e.g. APEC) or expand despite the fact that the benefits of being an 'insider' *decreases* as membership size *increases* (e.g., the EU).

These shortcomings instigated a search for a 'public good' rationale. One public good that a RIA could provide is reduced transaction costs. This view is first put forward by Krugman (1993) and is supported by Baldwin (1997). Another public good is effective diplomacy (Schiff and Winters, 1997). An RIA leads to increased import from the partner and, thereby, reduces the latter's security concerns. Therefore, the RIA succeeds where conventional diplomacy may fail. A third type of public good is policy credibility. Joining an

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[2] Viner's work led to a large number of studies that tried to identify the conditions under which regional integration could improve welfare – i.e., trade creation could outweigh trade diversion. For a review, see Robson (1998: 1-62).

IRA increases policy credibility because the subscription to an '*acquis*' reduces the probability of policy reversals.[3]

One problem with the 'public good' approach is that its specification of the government-constituent interaction is too simplistic. Generally, the median-voter theorem is assumed to hold. Under this assumption, the government will maximise its objective function subject to the constraint of median voter preferences. This specification implies that a country's EU membership is essentially a reflection of the median-voter preferences. Such a hypothesis, however, cannot be upheld in the face of frequent difficulties that EU governments experience in securing support for their involvement in the EU. This hypothesis is also incompatible with the tendency of many EU governments to avoid referendums on crucial integrative steps.

Some economists are aware of the need to specify the government-constituent interaction more satisfactorily. For example, Krugman (1993: 58-59) states that regional integration may be intended to protect governments not only from each other, but also from their own interest groups. Applied to the EU context, Krugman's proposition implies that regional integration constitutes a new institutional context for government-constituent interaction, which reduces (for example) the risk of trade policy capture by interest groups.

De Melo et al (1993: 177, 180-81) concur with this suggestion and demonstrate that regional integration may have a 'preference dilution effect'. According to De Melo et al, regional integration reduces the marginal utility of lobbying as the regional authority, compared to the national authority, has to contend with a much larger number of groups clamouring for attention. Therefore, it will be less likely to accommodate a particular group demands for special treatment. This constraint on the regional authority will induce interest groups to reduce the intensity of their lobbying activities be-

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[3]   There is a burgeoning literature on this type of public good. See, Fernandez (1997: 7-27) for a review of the non-traditional benefits of regional integration. For the 'anchoring' benefits of RIAs in the Mediterranean context, see Francois (1997) and Lawrence (1997).

cause of the reduced chance of securing favourable outcomes from lobbying.[4]

This is a step in the right direction, but remains open to a valid criticism. It is true that as the jurisdiction size increases, the number of interest groups also increases, leading to lower probability of demand accommodation by a regional authority such as the EU. However, the increase in jurisdiction size does not prevent the formation of sector-specific, EU-wide coalitions. In fact, this has proved to be the case: European integration has led to a marked increase in the number of EU-wide interest groups lobbying the EU directly. Therefore, and as we will demonstrate in part 2, the preference dilution effect, if any, must come through different channels.

The political science literature on European integration is both older and more extensive. In fact, a review of the literature on European integration only has to be either limited to a particular approach/period or can fit only into a fully-fledged monograph.[5] Yet, the political science literature suffers from two shortcomings.

First, the literature has been characterised by a shift of focus from the causes and drivers of the integration process to the study of either EU institutions/policies or consequences of integration, sometimes referred to as Europeanization.[6] In a way, this is a natural outcome because of the deepening and enlargement of the EU, and the cumulative effects of EU legislation on national legislation. However, it can sometimes lead to or reflect a presumption that the theory of integration (i.e., a theory that explains the motives for and the drivers of integration) is now less relevant or urgent.[7]

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[4] This reasoning is similar to that of the 18th-century American Federalists, who argued that federation would reduce the risk of policy capture that was observed at the local state level.

[5] For recent reviews, see Rosamond (2000), Pollack (2001), and Jachtenfuchs (2001).

[6] For a representative list of recent work on Europeanization, see European Research Papers Archive at the Queen University of Belfast website. Address: www.qub.ac.uk/ies-old/onlinepapers/poe.html. See also, U. Sedelmeier and F. Schimmelfennig (200s).

[7] We do not discuss the implications of this tendency for the reciprocal communication between what we call integration theory and theories of EU policy-making or Europeanization due to space limitation.

As indicated above, Moravcsik (1993, 1998), Sandholtz and Stone Sweet, (1998) and Stone Sweet et al. (2001) are notable exceptions to this tendency. However, these contributions can be criticised for the second shortcoming associated with the political science literature – namely reductionism.[8] These contributions reduce European integration to the preferences of either transnational actors (as argued in functionalist/neo-functionalist theories or the earlier period) or governments (as it is the case in intergovernmantalist theories). Yet, the question remains as to why integration remains acceptable to one of these actors even though it essentially reflects the preferences of the opposite party. After all, governments have the option to withdraw from a regional integration arrangement if the latter essentially serves the interests of the trans-national actors at its own expense. Similarly, non-governmental, trans-national actors are also capable to vote out a pro-integration government if integration is essentially collusion between like-minded governments.

The contributors to Sandholtz and Stone Sweet (1998) take the debate on European integration a significant step beyond the society-centric reductionism of the functionalist/neo-functionalist theory. In the introduction, Stone Sweet and Sandholtz (1998) hypothesise that three inter-related variables determine the move towards deeper integration (or supranationalism) in the EU: (i) EU rules that constrain behaviour of the political actors operating at the EU level; (ii) EU organisations that execute the EU rules; and (iii) supranational society that engages in cross-border exchange. Their theory suggests that any increase in one of these independent variables leads to an increase in the remaining two, and more importantly, to a deepening of the integration process.

The hypothesis is tested with two data sets. First, Fligstein and McNichol (1998: 78-79) examine the relationship between the secondary legislative output (regulations and directives) and the number of major EU-wide pressure groups. Their findings suggest that there is a positive correlation of 0.41 between the number of pressure groups formed and legislative output in dis-aggregated policy domains.

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8   On this, see Ugur (1997).

This is a significant step in the direction of developing testable hypotheses and testing their relevance. Yet, there are two problems with Fligstein and McNichol's analysis. First, the sequence of the interest group formation and EU legislation is important. If group formation follows legislation, the role of supranational society in deepening the integration process should be rejected. All we can say in such cases is that interest groups had to shift their attentions towards the regional authority as the integration process deepened. Second, at the aggregate level, the correlation between legislative output and organisational activity breaks down totally. This can be seen in Table 1 below. If anything, Table 1 suggests that there is an *inverse* relationship between legislative output and organisational activity. This is the case whether we take contemporaneous or lagged, total or annual figures.

*Table 1: **Secondary EU Legislation and EU-wide Pressure Groups***

A. Total Figures

	pre 1958	1958-69	1970-79	1980-86	1987-91	1992-94
Secondary Legislation	n.a.	499	2606	3408	3957	5173
Pressure Groups Established	92	351	140	71	40	n.a.

B. Average Annual Figures

	pre 1958	1958-69	1970-79	1980-86	1987-91	1992-94
Secondary Legislation	n.a	42	261	487	791	1724
Pressure Groups Established	n.a.	29	14	10	8	n.a.

(Source: Fligstein and McNichol, 1998: 80-83).

Stone Sweet and Caporaso (1998) come to the rescue of the hypothesis by examining the relationship between intra-EU trade (indicator of transnational transactions) and Article 177 references to the European Court of Justice.[9] They demonstrate successfully that intra-EU trade is a good predictor of Article 177 references. However, even if this finding can be generalised, the 'new' society-centric research agenda cannot answer a simple question: why do EU governments agree to have an Article 177 in the first place? The task of answering this question is left to 'new' intergovernmentalism, which argues that treaty provisions are determined in intergovernmental bargains.

Moravcsik (1991 and 1993) focuses on the formation of 'state preferences' and how these preferences generate 'demand for integration.' Yet, Moravcsik's early work does not go beyond treating the demand for integration as a function of government preferences. He essentially theorises the government's demand for integration given the constraint imposed by societal preferences. (See, for example, Moravcsik, 1993: 482-495, 496-507). Later on, Moravcsik (1998: 8-9) has adopted a rational-choice perspective. He derives the demand for integration endogenously from the strategic interaction between governments – specifically from the need for a credible commitment device that would reduce the probability of defection.

This move has not enabled Moravcsik to resolve the preference formation problem for two reasons. First, Moravcsik is now faced with an obvious inconsistency: why does he *not* endogenise the outcomes of government-constituent interaction whilst he *does* endogenise the outcomes of government-government interaction? Secondly, if outcomes of government-government interaction are endogenous, the impact of exogenously given constituent preferences on governments' demand for integration is blurred even if it does not disappear altogether. That is why Moravcsik (1998) is still an account of how EU governments bargain with each other, and

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[9]   Article 177 provides for European Court of Justice rulings when European
       Community law is material to the resolution of the legal dispute heard by na-
       tional courts. In that sense, it indicates a move towards supranationalism or
       deeper integration – i.e., the dependent variable of the hypothesis tested by
       Stone Sweet and Caporaso.

not an account of how government-constituent interaction induces governments to adopt convergent policies which, in turn, makes his 'celebrated bargains' necessary and feasible.

The brief review above demonstrates that existing work on regional integration in general and European integration in particular does not provide unambiguous answers as to why governments (i) delegate authority to EU institutions; and (ii) agree to binding rules and common policies at the regional level. In section 2 below, we propose a political economy model that may be useful in establishing the basis for tackling these questions.

### 3. Policy Convergence as a Means of Stabilising Constituent Loyalty

There are two obvious stylised facts about the EU: (i) the adoption of common policies in some policy areas; and (ii) the establishment of regional institutions that propose new policies and supervise compliance with agreed ones. Therefore, any theory of integration must explain how government policies converge towards the common policy stance and why governments voluntarily delegate authority to regional institutions. The model proposed here addresses these two elementary questions.

The model involves two governments and their constituents. The government is appointed by constituents to supply a composite public good – i.e., 'public policy'. Its objective is to maximise the constituents' loyalty to the jurisdiction over which the public good is supplied. To do this, it can use two instruments: (i) changing the attributes of the public good; and/or (ii) changing the cost/benefits associated with the constituents' decisions to 'exit' the jurisdiction. Constituents are private actors who consume the public good against contributions towards the cost of its supply. To maximise the returns on loyalty to a jurisdiction, the constituents can choose either to raise their 'voice' by lobbying, protesting, voting in an alternative government, etc; and/or they can 'exit' the jurisdiction in the sense that they consume the public supplied by another government. (For the original exit-voice-loyalty analysis, see Hirschman, 1970).

This setting is similar to the spatial competition model of Hotelling (1929), who demonstrated that two firms would locate next to each other in order to maximise the number of loyal customers. The model can be (and has been) extended to explain convergence in prices or product qualities (see for example, D'Aspermont et al, 1979) or convergence of political party programmes (see, for example, Downs, 1957).

Hotelling and the models that followed share a number of common assumptions. For example, customers (or voters) are rational actors trying to maximise utility; there is perfect information about the costs/benefits of switching between suppliers/parties; there are no artificial barriers to switching between suppliers/parties; and suppliers/parties can 'leap frog' each other (i.e., change positions) to maximise loyalty. Under these assumptions, location, quality or price convergence tends to be perfect. This is known as the principle of minimum differentiation – as depicted in Figure 1.

*Figure 1: **Inter-Firm Convergence***
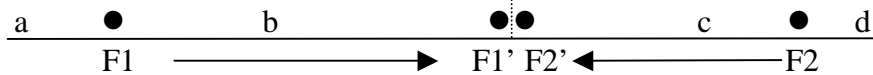
Suppose the customers are distributed along the line a+b+c+d. Customers in (a) are loyal to Firm 1 (F1) and those in (d) are loyal to F2. However, customer loyalty in segments (b) and (c) is contestable, because each firm can adjust its location (or price or product quality, etc.) so as to increase the number of loyal customers. For example F1 can move to the right in order to increase the size of (a) and lure some marginal customers in (c). On the other hand, F2 can move to the left to increase the size of (d) and lure some of the marginal customers in (b). This strategic interaction between firms and between the latter and their customers will continue until both firms locate next to each other at F1' and F2'. The equilibrium at F1' and F2' is stable because for each marginal customer gained by one firm due

to further movement there is a marginal customer lost to the other firm.

We must indicate here that this outcome is sub-optimal for both firms and customers. For customers, who instigate competition by switching loyalty between suppliers, convergence is a sub-optimal outcome because it reduces choice. The outcome is sub-optimal for the firms too. Although it enables each firm to stabilise its market share, it deprives it of the ability to increase that market share at the expense of its rival.

Hotelling's original model has been criticised for over-emphasis on perfect convergence. For example, D'Aspermont et al (1979) demonstrated that perfect convergence is sustainable only if equilibrium prices are zero. Given that this condition implies zero profits, the firms would not choose to locate next to each other. In fact, D'Aspermont et al demonstrated that equilibrium prices in Hotelling's model would imply a location at or near mid-points of each firm's market segment. However, at this location, the marginal profits are positive and increasing in the value of (a) and (d). In other words, each firm has incentive to increase the size of (a) and (d) by moving closer to the centre. Therefore, Hotelling was right in predicting convergence, but this convergence is not necessarily perfect and the process is messier than he envisaged.[10]

The application of Hotelling's model to political processes has also been criticised. For example, Adams and Merrill (1999) argue that the model overlooks the voters' non-policy motivations shaped by socio-demographic characteristics, partisanship, or retrospective policy evaluations. If such motivations are allowed for (i.e., if costs/benefits of loyalty shifts are not as transparent as Hotelling assumed), convergence between parties may remain limited. Drawing on a similar theme, Adams (2001) demonstrates that convergence

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[10] Imperfect convergence is also derived by Wang and Yang (1999), who demonstrates that convergence will approximate Hotelling's principle of minimum differentiation when the customers' reservation price (i.e., their willingness to pay for quality) decreases. Irmen and Thisse (1998) too demonstrates that convergence is imperfect when firms compete on the basis of multiple product characteristics. Under this scenario, firms will diverge with respect to the dominant characteristic but will converge with respect to the remaining n-1 characteristics.

will also be limited if the voters are biased - i.e., if their loyalty to a party is high due to the impact of party leader's image, or the impact of social-psychological attachments rooted in class, religion, or ethnicity.

Perfect convergence does not obtain either when the units of analysis are governments and their constituents. Governments, as agents with territorial competence, can erect artificial barriers against constituent loyalty shifts by using border controls and imposing sanctions. In other words, territorially competent governments divide the 'constituent market' and add to the normal cost of 'exit'. In addition, costs/benefits of loyalty to (or exit from) the jurisdiction are not fully transparent because of the constituents' social, cultural or ideological attachments to a given jurisdiction. Therefore, the extent of policy convergence as a means of stabilising constituent loyalty is less than perfect. This outcome can be followed in Figure 2.

Figure 2: *Inter-Government Convergence*
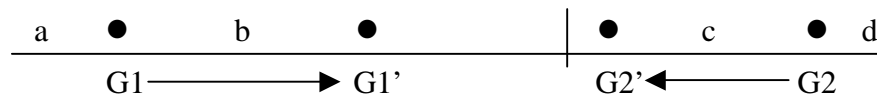
The first government (G1) is assumed to have erected more stringent barriers against loyalty shifts – hence the bolder line demarcating its jurisdiction. Because barriers increase the cost of exit, G1's constituents will have to rely more heavily on voice and will cross the jurisdiction only when the benefits of 'exit' are sufficiently high. In G2, the cost of exit is lower. Therefore, G2's constituents will rely more heavily on exit compared to those of G1. This asymmetry implies that G1 will be less and G2 more willing to engage in convergence as a means of stabilising constituent loyalty. As a result, G1 will move only to G1' whereas G2 moves further to G2'. This imperfect convergence, however, is unstable.

One reason is that G1 can increase the number of loyal constituents by moving marginally to the right. In response, G2 must either

move to the left of G2' or increase the barriers. The other reason is that G2 can also increase the number of loyal constituents by moving to the left of G2'. Then, G1 will have to respond either by increasing the barriers or by converging towards G2. This strategic interaction can continue indefinitely as long as perfect convergence is impossible due to the existence of barriers to constituent loyalty shifts.

The preceding analysis suggests that policy convergence is an endogenous outcome of strategic interaction at two levels: government-constituent interaction at the national level and government-government interaction at the international level.[11] Given this finding we can now propose two hypotheses that would highlight the difference between our approach and the state- or society-centric approaches to European integration.

The analysis above suggests that governments adopt convergent policies *before* any 'major bargain' on international agreements. Convergence results from government attempts to stabilise constituent loyalty, and not from intergovernmental negotiations that may lead to agreements codifying the *primordial* policy convergence. Negotiations between governments may be functional for fine tuning purposes, but it is not the cause of convergent policy choices. Therefore, the *first hypothesis (H1)* on European integration can be stated as follows: *the convergence of national policies precedes the inter-governmental negotiations aimed at establishing or deepening the EU.*

H1 implies that intergovernmentalists are fighting the windmills when they focus on intergovernmental bargains as the engine of the integration process. If regional integration is the adoption of common policies (i.e., if integration implies codification of convergent policies) and establishment of regional institutions for ensuring compliance with those policies, it is obvious that its probability should increase if bargaining on common policies and regional in-

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[11] Putnam (1988) was a sophisticated attempt at modelling the two-level game. However, Putnam's constrained (as opposed to strategic) optimisation remains the major source of the vulnerability that haunts Moravcsik's (1998) approach too.

stitutions is *preceded* by convergent policy choices. It is also clear that any such convergence is an endogenous outcome that governments have to live with in order to stabilise constituent loyalty. Therefore, the drive towards regional integration begins *within* the national jurisdiction before the negotiations at the regional level. Unless this condition is satisfied, intergovernmental bargaining would remain a highly erratic process, the outcome of which cannot be predicted.

In addition, policy convergence is not necessarily compatible with *ex ante* government or constituent preferences. In other words, policy convergence may well be a sub-optimal outcome that governments and constituents have to satisfice with. Sub-optimality is due to collective action problems faced by constituents as well as governments. As rational agents, constituents do try to maximise the returns on loyalty to a given jurisdiction. However, they are not motivated to contribute to the cost of the public policy, the quality of which determines the returns on jurisdictional loyalty. Similarly, the governments' collective action problem is manifested in their tendency to maximise constituent loyalty at the expense of their competitors. Therefore, the *second hypothesis (H2)* on regional integration can be stated as follows: *neither primordial policy convergence nor the integration arrangement that embodies it can be reduced to either government of societal preferences in favour of integration.*

H2 implies that state- or society-centric theories of integration are essentially reductionist exercises with teleological connotations. By relating integration to *ex ante* government or constituent demands for integration, state- or society-centric analyses boil down to demonstration of how pre-existing preferences are realised despite the odds. What is involved, however, is a more complicated process: policy convergence and the EU institutions that codify it are not pre-mediated outcomes. Rather, they emerge historically as solutions to collective action problems encountered in government-constituent and government-government interaction.

Now let us consider these hypotheses in the light of some evidence on European integration.

Of course, as Moravcsik (1991, 1993 and 1998) and Cameron (1992: 59-64) among others have demonstrated, intergovernmental bargains *did* precede major integrative steps. The significance of this finding, however, is less than what is read into it. That is because, in all major stages of European integration, intergovernmental bargaining has been preceded by a marked convergence in policy choices.

This was evident before the conclusion of the Treaty of Rome. After the war, constituents became more assertive and posed a serious challenge to the legitimacy of post-war governments.[12] Faced with a decrease in constituent loyalty, European governments reacted by approximating their policies with a view to reduce the incentives for 'exit'. This policy convergence took the form of commitment to intra-European trade liberalisation as a basis for economic growth.[13] It was this primordial convergence towards a managed and territorially limited trade liberalisation that underpinned and facilitated the intergovernmental bargaining that led to the establishment of the EC as a customs union.[14]

Similar convergence processes were also at work before two major steps in the deepening of European integration: the single market and the establishment of the monetary union.

The single market was preceded by a process of policy convergence that is often neglected in the literature – namely, the gradual move away from Keynesian demand management towards supply-side economic policies. This process was reflected first in the change of government in the United Kingdom and was spread to the rest of Europe from 1979-83. It engulfed not only the centre-right govern-

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[12] Pizzorno (1964) describe this development as the 'individualistic mobilisation of Europe'.

[13] This policy convergence was the basis for the establishment of the European Payments Union (EPU) in 1950. On this, see Eichengreen (1993). On the history of the EPU, see Kaplan and Schleiminger (1989); Milward (1992: 119-223).

[14] The benefits of managed liberalisation within Europe influenced even the traditionally sceptic UK and Dutch governments, who began to embrace the 'European solution' to the government-constituent interaction problems from mid-1950s onwards. See Milward (1992, 127, 134).

ments, but also those of the centre-left, culminating in the conversion of the socialist French government from 'Keynesianism in one country' to embracing the market discipline in 1983.[15]

This convergence was instigated by government concerns about constituent loyalty in the face of poor economic performance. In that sense, it preceded 'intergovernmental bargains' on, or business pressure for, deepening the integration process. In fact, intergovernmental bargaining began after the convergence was evident. The call for strengthening the internal market was made in the Luxembourg Summit of 1981, and was repeated in following summits until 1985. Business involvement came even later, when Commission's preparations were well under way. Therefore, the origin of the single market lies not in intergovernmental bargains or 'big business' pressure per se, but in the crisis that the pre-existing convergence/barrier combination was faced with.

Similarly, convergence preceded the establishment of the monetary union too. As is well known, attempts at monetary union date back to the Werner Report of October 1970. Member states did not endorse the report in full, but picked up some of its recommendations that were considered as functional for shielding European economies against external (mainly US) monetary shocks. The fixed exchange rate arrangement (known as the 'snake in the tunnel') proved unsuccessful, mainly because of the divergence between national macroeconomic policies. In that sense, the Snake experience demonstrated clearly that intergovernmental bargaining or agreements based on such bargaining cannot lead to integration unless they are underpinned by a primordial process of policy convergence.[16]

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[15] On the convergence of economic policies towards the supply-side, see OECD (1988). On the link between this convergence and the establishment of the single market, see Cameron (1992: 56-58) and Sandholtz and Zysman (1989).

[16] Gros and Thygesen (1998: 26) state the reason for the Snake's failure as follows: ' … differences in policy preferences … overrode any formal undertaking. Even for the participants in the Snake, the exchange-rate commitment was insufficient to sustain parallel inflation and compatible budgetary policies.'

The success of the Exchange Rate Mechanism (ERM) in the second half of the 1980s and the transition to monetary union in the 1990s provide further support for H1 and H2. As indicated above, national macroeconomic policies began to converge towards a new consensus in the 1980s. The factors conducive to this convergence were increased loyalty volatility reflected in increased capital mobility and financial innovation, both of which reduced the scope for erecting barriers against constituent loyalty volatility.[17]

It was due to macroeconomic policy convergence that the Exchange Rate Mechanism (ERM) was relatively successful in reducing nominal and real exchange rate volatility and dampening inflationary expectations. Also, it was this policy convergence that induced Germany to relax its 'economist' approach to monetary integration, which required macroeconomic policy convergence prior to any agreement that involved institutionalised monetary integration. Once convergent policy choices were evident enough, the frequency of re-alignments decreased and speculative capital flows were checked. This happy scenario continued until early 1990s, when German unification constituted an exogenous shock.

4.   Regional Integration as Commitment Mechanism

The analysis in section 2 also enables us to explain why European governments may be induced to set up regional institutions for 'locking in' the primordial policy convergence. Let us recall that the governments' territorial competence enables them to erect barriers against constituent loyalty shifts. However, territorial competence also reduces governments' ability to maintain a stable convergence/barrier combination that would stabilise constituent loyalty. That is because territorial competence generates a collective action problem that is characterised by competition for constituent loyalty. This problem can be resolved only through policy co-ordination. Policy co-ordination, however, enables governments to overcome the collective action problem only if they can agree on and imple-

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[17]   On the high levels of capital outflows observed in late 1970s and 1980s despite capital controls in France and Italy, see Gros and Thygesen (1998: 128-136).

ment rules that would tie their hands. This condition is derived in Figure 3, which is nothing but a 'blown up' account of the interaction in Figure 2.

Figure 3 consists of three schedules drawn against two variables. The variables are the instruments of convergence (C) and exit barriers (B). The feasible policy frontier (FPF) depicts the feasible combinations of C and B that both governments can deploy to achieve a given level of constituent loyalty. For simplicity, we assume that government 1 (G_1) and G_2 face the same FPF. The indifference curve of G_1 (I_1) is steeper and reflects the scenario in Figure 2, where G_1 relies on barriers rather than convergence as a means of loyalty stabilisation.

Figure 3: ***Loyalty Stabilisation Requires Binding Agreements***
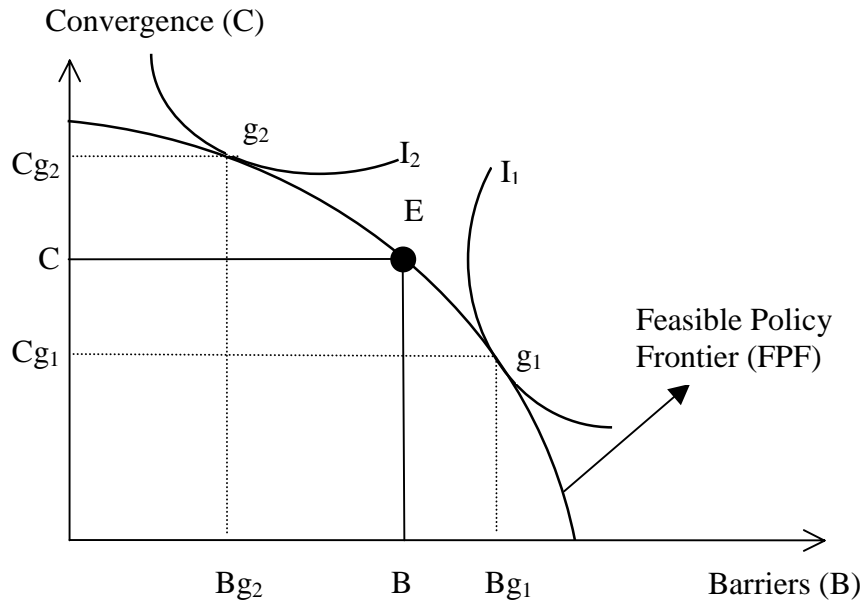
Given the preferences reflected in I_1 and I_2 and the FPF, the optimal combinations of convergence and barriers for each government are given by points of tangency (g_1 and g_2). It can be seen that G_1 has a barrier bias ($Bg_1 > Bg_2$), whereas G_2 has a convergence bias ($Cg_2 > Cg_1$). Given that both governments are sovereign, they will stick to

their preferred positions at points g_1 and g_2. However, sovereignty (or territorial competence) is a source of collective action problem that renders these positions (hence, the implied constituent loyalty) unstable in the long run. This possibility can be derived from Figure 2, where we demonstrated that the governments' ability to change the convergence/barrier mix is conducive to strategic actions aiming to increase their segments of loyal constituents at the expense of each other. Then, the only option for stabilising constituent loyalty in the long run is to conclude an agreement that would fix the convergence/barrier combination.

If such an agreement is concluded, the equilibrium may be at any point between g_1 and g_2, for example E. However point E may not be stable either. That is because at point E, the agreed levels of convergence and barriers are C and B, respectively. These levels however, satisfy neither G1 nor G2 because $Cg_2 > C > Cg_1$ and $Bg_2 < B < Bg_1$. In other words, the agreement resulting in C and B is not incentive-compatible. Hence, it is not credible. This problem can be resolved only if both governments delegate authority to a third party that would ensure that the agreement is implemented. Given the territorial competence of the governments, the third party must have a 'supranational' competence.

We can see that the government's territorial competence is a source of strength and weakness. On the one hand, it enables governments to change the barrier/convergence mix and, thereby, increase constituent loyalty. On the other hand, however, territorial competence creates at least one of the following two problems. First, it makes the stability of constituent loyalty an elusive quest because of strategic interaction. Secondly, territorial competence (or sovereignty) allows for stable constituent loyalty only if governments agree to delegate authority to a 'supranational' body that would tie their hands. Then, we can state the *third hypothesis (H3)* about European integration as follows: *the demand for integration is a function of the collective action problem, which results from government-constituent interaction and induces governments to renege on their contractual commitments.*

There is evidence that supports H3 too. As Currie et al (1989) have indicated, policy convergence is a 'relative policy co-ordination'

problem, which involves the approximation of one government's policy towards other governments. The literature on policy co-ordination also suggests that non-coopoerative interaction between governments tends to generate Nash outcomes, which tend to be more inefficient the higher is the initial divergence between policies. (On this, see Currie and Vines, 1988).

Given these findings, it can be seen that policy convergence prior to formal integration increases the probability of establishing a commitment mechanism that would force governments to comply with formal agreements. We can also see that such commitment mechanisms are necessary to reap the benefits of convergence as a special case of policy co-ordination. The commitment mechanism must involve a superior authority that would punish non-cooperative behaviour.[18] In addition, that authority must be granted competence to distribute the costs/benefits of the cooperative solution. Unless such a distribution mechanism exists, policy co-ordination tends to be less feasible. (See, Currie et al, 1989: 27).

H3 is also supported by findings of intergovernmentalist research on European integration. For example, Moravcsik (1998: 9) states clearly that the delegation of authority to supranational institutions (or the pooling of sovereignty) occurred in policy areas where the member states felt the need for credible commitment. In addition, H3 is also supported by the findings of rational-choice institutionalism. For example, Garrett (1992) indicates that EU member states (as 'principals') have established the European Court of Justice (ECJ) as an 'agent' to resolve the problems that might arise out of incomplete contracting. Yet, the difference between H3 and intergovernmental or institutional hypotheses is that, H3 is derived from a general theory of integration whereas the others are not.

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[18] In other words, the superior authority must be capable of resolving the 'sovereign' government's punishment dilemma, which was first pointed out by Buchanan (1975).

5. Globalisation-Integration Linkages

The proposed model also enables us to account for the impact of globalisation on regional integration. The key issue in the globalisation debate is the extent to which cross-border movements of people, goods and factors of production lead to policy convergence.[19] The extent of policy convergence depends on who is driving the globalisation process. If societal actors are the driving force, convergence is inevitable and complete. Otherwise, it is limited and erratic. In a way, these results are similar to the society- and state-centric conclusions about the extent of regional integration.

The emerging literature on globalisation-regionalisation linkages is also problematic. Because of its state-centric focus, this literature explains regionalisation a reactive state response to globalisation. According to Sideri (1997: 53), regionalisation is an attempt to reduce the pace of globalisation. A similar view is put forward by Hirst and Thompson (1995), who argue that trade blocs allows member countries to withstand the global pressures and to pursue inward-looking policy objectives that they could not pursue otherwise.

We think that the model developed above should be the starting point for assessing the relationship between globalisation and regional integration. In line with the consensus in the globalisation debate, we assume that globalisation increases cross-border mobility, which makes constituent loyalty to a national jurisdiction more volatile. Then, the impact of globalisation on regional integration can be captured in Figure 4 below.
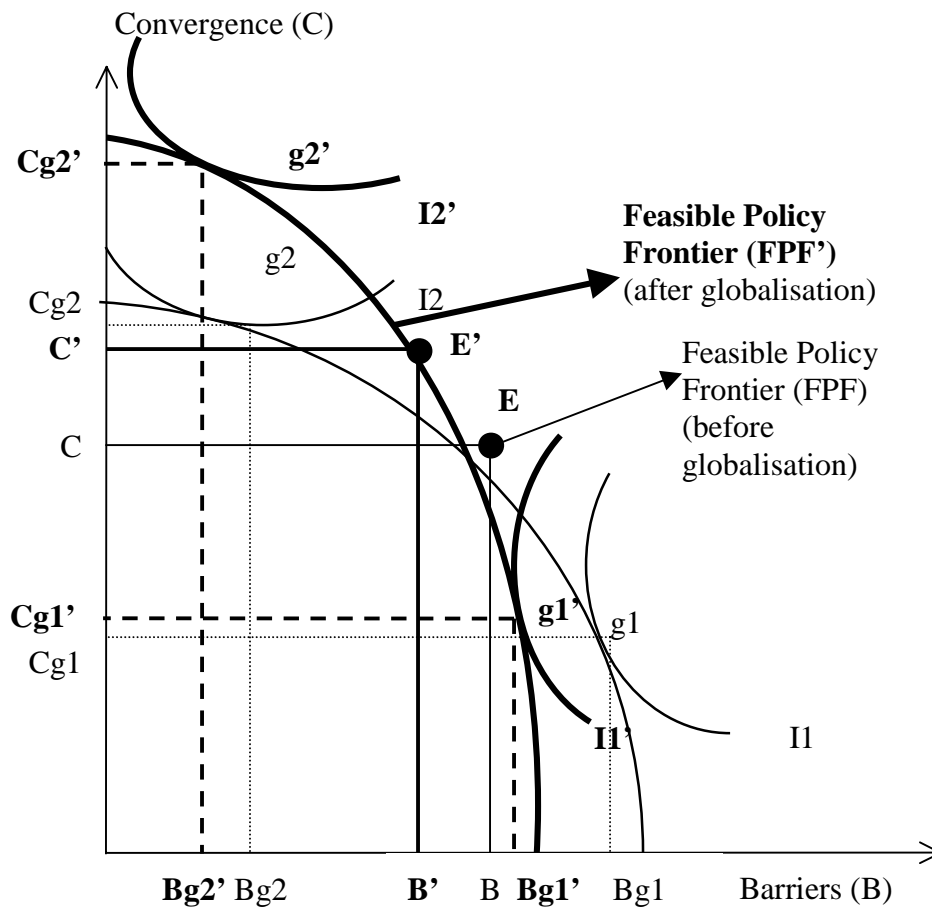
Figure 4 is nothing but a replica of Figure 3, with a new feasible policy frontier (**FPF'**) imposed to reflect the reduced level of barriers after globalisation. Assuming that both governments' preferences (i.e., the slopes of their indifference curves) remain the same,

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[19] In the globalisation literature, policy convergence and loss of policy autonomy are used interchangeably. The literature can be classified on the basis of convergence (policy autonomy loss) implied or on the basis of pressure for policy arbitrage. For a review, see Higgot and Reich (1998) and Held et al (1999). For a critical view, see Hirst and Thompson (1995).

the optimal combinations of convergence and exit barriers are given by points **g1'** and **g2'**. Comparing the convergence/barrier combinations before and after globalisation, we see that **Bg1'**<Bg1; **Bg2'**<Bg2; **Cg1'**>Cg1; and **Cg2'**>Cg2. Stated differently, after globalisation, the levels of barriers deployed by each government are lower whereas the levels of policy convergence are higher.

*Figure 4: **Globalisation Requires Further Policy Convergence***

Convergence (C)

g2'

I2'

Feasible Policy Frontier (FPF') (after globalisation)

Cg2'

g2

I2

C'

E'

Cg2

Feasible Policy Frontier (FPF) (before globalisation)

C

E

Cg1'

g1'

g1

Cg1

I1'

I1

Bg2' Bg2   B'   B **Bg1'** Bg1   Barriers (B)

The governments are now faced with two problems. First, and as demonstrated in Figure 3, the post-globalisation equilibrium (points

g1' and **g2'**) are not stable. That is because, in the absence of perfect convergence, governments always have incentive to change the convergence/barrier combination in order to increase the size of their loyal constituency. Secondly, the post-globalisation convergence and barrier combinations **Cg1'/Bg1'** and **Cg2'/Bg2'** are different that those codified in the already existing regional agreement (i.e., Cg1/Bg1 and Cg2/Bg2). Therefore, both governments must now negotiate a new agreement that would reflect a new compromise (such as point **E'** on **FPF'**). The new agreement would codify the mutually-agreed, post-globalisation levels of convergence and barriers implied by **E'** (i.e., **C'** and **B'**).

The question now is whether the new agreement will codify a lower or higher level of convergence compared to what has been codified in the previous one. We argue that the new agreement will codify a higher level of convergence for two reasons. First, post-globalisation, barriers are less effective in securing constituent loyalty. Second, a reversal to higher barriers and lower convergence will be resisted by existing regional institutions that have a vested interest in maintaining their existing competencies. As a result, the new agreement will settle on a point such as **E'**, with lower barriers (**B'** < B) and higher convergence (**C'** > C).

Then, the *fourth hypothesis (H4)* can be stated as follows: *globalisation will lead to deepening of the integration process, which entails increased policy convergence, less exit barriers, and extra competence to regional institutions*. H4 differs from the hyper-globalisation hypothesis because it captures the possibility of a negotiated agreement at E' as opposed to the complete convergence at g2'. H4 also differs from hypotheses that portray regional integration as a reactive state response to globalisation. Whereas the latter predict that the EU would try to use its bargaining power to restrict trade and capital mobility under globalisation, our model predicts that globalisation will induce the EU to reduce barriers and increase policy convergence. Ugur (2003) provides evidence that globalisation has been accompanied by increased tax policy co-ordination in the EU, further competence to EU institutions, and no reversals in the liberalisation of capital movements. In addition, the European Monetary Union can also be seen as a pro-active response to globalisation in the sense that it combines the highest degree of conver-

gence in monetary policy with no reversals in the extent of capital mobility.

6.   Conclusions

One conclusion that can be derived from the analysis above is that regional integration in general and European integration in particular cannot be reduced to government or constituent preferences. Instead, integration should be analysed as an endogenous outcome, which generates costs and benefits for both governments and their constituents. Under integration, governments benefit from reduced constituent loyalty volatility (due to policy convergence) whereas constituents benefit from reduced exit barriers. On the other hand, however, regional integration causes governments to incur losses due to reduced policy autonomy. It also imposes losses on constituents because the convergence of national policies reduces the incentive for switching loyalty from one jurisdiction to the other. To our knowledge, the model proposed in this article is the only one that enables us to predict such outcomes. What is more significant however is that this model is unique in its ability to predict and explain the support for as well as the opposition to European integration voiced by both governments and societal actors - over time and across policy issues.

The second conclusion is that treaties, secondary legislation and EU institutions are based on a certain degree of prior policy convergence among governments. This convergence, however, is underpinned by the governments' need to reduce the incentives for constituent loyalty shifts and not by approximation of the views concerning the desirability of regional integration per se. Integration emerges as a necessary mechanism that would enable the member states to lock in the prior policy convergence. This is a fine but highly significant detail because it means that the process of integration is less orderly than what functionalist/neo-functionalist theories would predict and more orderly than what intergovernmentalism would predict. Put differently, the findings in this essay challenges both the 'spill-over' thesis and the ambiguity thesis associated with intergovernmentalism.

The third conclusion concerns the relationship between globalisation and European integration. The analysis above suggests that European integration is likely to deepen as cross-border mobility of goods, capital, people and information increases as a result of globalisation. The deepening of the integration process, in turn, implies that the EU would be contributing to globalisation - understood as increased cross-border mobility.

The final conclusion is a statement of humility: we acknowledge that the evidence cited in support of the hypotheses derived from the model is limited. Therefore, we would like to emphasise the avenues for further research that the model may open rather than empirical robustness of the model itself. The research avenues encouraged by the model requires construction of a number of indices. One such index should measure the extent of constituent loyalty volatility, as reflected in cross-border movements of goods, people, information and capital. This index can be constructed for different policy areas where the extent of European integration would be analysed. The other index will measure the level of barriers among EU countries in relevant policy areas. A third index should capture the extent of convergence in policy areas under examination. Finally, we need to construct an index measuring the extent of integration in a given policy area. This index should include data on EU legislative output, decision-making rules and the involvement of the European Court of Justice. Then, the hypotheses derived above can be tested on the basis of rich data sets capturing the dynamics of the integration process and the nature of EU policy making.

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