Part VII

The political economy of Europe
Integration among unequals
How the heterogeneity of European varieties of capitalism shapes the social and democratic potential of the EU

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Introduction: a political-economy perspective on European integration

One and a half decades have passed since Lisbet Hooghe and Gary Marks wrote their seminal article ‘The Making of a Polity: The Struggle over European Integration’ (Hooghe and Marks 1999). Hooghe and Marks argued that with the Single European Act and the Maastricht Treaty the European Union had entered a phase of struggle between two competing projects: regulated and neoliberal capitalism, two ideals championed by different coalitions of member states, national and international interest groups, and European institutions and organizations. They also observed that the politics of European integration had changed. The struggle over Europe’s future had become politicized and could no longer be fought by technocrats behind the scenes. In short, Hooghe and Marks described an integration phase in which both European social and economic governance and the legitimacy of European decisions appeared in a new light.

Much has happened in the 15 years since the publication of this analysis. European integration has witnessed an unforeseen dynamic. The treaties of Amsterdam (in effect since 1999), Nice (since 2003) and Lisbon (since 2009) have introduced important institutional reforms; in addition, following the Eastern enlargements of 2004, 2007 and 2013, the EU now consists of 28 members, with more candidates awaiting accession. These changes have also affected the social and democratic potential of the EU. At first glance, the democratic quality of the EU seems to have improved with these reforms. For example, the Lisbon reforms strengthened the European Parliament (EP), the only directly elected EU institution. Another democratic innovation is the European Citizens’ Initiative (ECI), whereby citizen petitions receiving enough popular support (at least one million signatures from at least one-quarter of the EU member states) can call on the European Commission to initiate legislation (on the growing involvement of citizens in the EU, see Chapter 10).
The social objectives of European integration have been strengthened as well. With the Lisbon reforms, the European Charter of Fundamental Rights has become legally binding. The Charter includes social rights, such as employees’ consultation rights and the right to strike. In addition, Article 3 of the Treaty on European Union (TEU) states that the EU shall work to ensure ‘a highly competitive social market economy, aiming at full employment and social progress’. In a similar vein, according to Article 152 of the Treaty on the Functioning of the European Union (TFEU), the EU ‘recognizes and promotes the role of the social partners at its level, taking into account the diversity of national systems. It shall facilitate dialog between the social partners, respecting their autonomy’. At first glance, it would thus seem that the project of regulated capitalism has made considerable progress over the last 15 years.

We will argue that this impression is misleading. In fact, the asymmetry between market-enforcing and market-correcting integration has increased rather than decreased, and although the rights of the EP have been strengthened, EU democracy is still unlikely to emerge. We contend that the heterogeneity of European varieties of capitalism limits the social and democratic potential of the EU. In so doing, we bring together two strands of literature that rarely meet: integration theory and comparative political economy. In the course of our analysis, we follow Weiler and Scharpf in analytically distinguishing between two different forms of integration: political integration, brought about by intergovernmental bargains, and judicial integration, which stems from the interpretations of European law made by the Commission and the European Court of Justice (ECJ). Political integration can serve either the regulated or the neoliberal project. If political unanimity existed, political integration could in principle harmonize social policies and transfer competencies to the European level by, for example, establishing European-wide codetermination rights or building a European social security system. In contrast, integration through law primarily serves to enlarge the scope of individual – mostly economic – rights and to abolish national regulations that might potentially restrict the free movement of capital, goods, services or persons. In the case of anti-discrimination rulings, judicial integration also widens the scope of individual social rights.

In this chapter, we show that the heterogeneity of European varieties of capitalism affects political integration and judicial integration differently. Heterogeneous member states generally find it difficult to harmonize regulatory standards or agree on redistribution. National welfare levels and institutions have grown more diverse with each round of enlargement. In core areas of national production and welfare regimes – such as codetermination, capital taxation and labour standards – political integration has often resulted in deadlock; prolonged negotiation has not led to harmonization, but rather to the protection of national autonomy. At the same time, the political-economic heterogeneity of member states has increased the opportunities for integration through law, since the ability of governments to correct ECJ decisions depends on political agreement. In many cases, this would have to be based on unanimous decision. Super-majoritarian political decision rules, in combination with highly diverse production and welfare regimes, provide ECJ judges with exceptionally extensive room for manoeuvre in comparison to national constitutional courts. The ECJ has used this leeway to enlarge its own competencies and the scope of EU law. If the heterogeneity of European varieties of capitalism were less significant or even absent – i.e. if European integration were taking place among equals – both the opportunity for political integration and the ability to politically control judicial integration would improve.

We elaborate the argument by proceeding as follows. In the next section, we briefly revisit ‘intergovernmentalist’ and ‘supranational’ integration theory and develop our theoretical argument in greater detail. The third section documents the heterogeneity of European production and welfare regimes. The section ‘Political and judicial integration under condi-
tions of heterogeneity’ discusses three cases in which political integration has either proved inconclusive or safeguarded national autonomy: the European Company Statute, corporate tax harmonization and the Posted Workers Directive. In each of these cases, subsequent ECJ decisions unsettled political compromises and advocated a degree of liberalization that had not been achievable through political agreements. The different dynamics of judicial and political integration worked to the detriment of regulated capitalism and in favour of its neoliberal counterpart. We conclude in the last section by discussing how member state heterogeneity affects not only the social but also the democratic potential of the European Union.

Integration theory and member state heterogeneity

Different varieties of capitalism coexist within the European Union, and thus national interests with regard to the speed and scope of European integration are likely to differ. In order to situate our argument in the literature, we review how integration theory has incorporated this insight. We revisit three of the most influential strands of integration theory – neofunctionalism, classical and liberal intergovernmentalism and supranationalism – revealing a paradox. We argue that the growing heterogeneity of European member states has steadily increased the relative autonomy of supranational agencies. However, neofunctionalists and supranationalists, who usually stress this autonomy, have largely neglected the heterogeneous political-economic base of Europe. Intergovernmentalists, by contrast, emphasize the diversity of the member states’ production and welfare regimes, but question the autonomy of the Commission and the ECJ in propelling European integration.

Since the 1990s, integration research has devoted increasing attention to the small, politically unintended but cumulatively transformative steps by which integration proceeds – much as early neofunctionalism, with its emphasis on spillovers, did. In particular, Haas (1958/1968) expected actors to redirect their expectations, interests, activities and loyalties towards the European level over time. In his view, an expansive logic is systematically built into regional integration processes. Every redirection of actions toward the transnational level necessarily produces side-effects that press for further transnationalization and for the transfer of competencies – ‘from coal to steel, to tariffs on refrigerators, to chickens, and to cheese, and from there to company law, turnover taxes, and the control of the business cycle’ (Haas 1971: 13). Most notably, he expected nonpolitical, mainly economic transnationalization to spill over to political integration; as a consequence, a ‘new central authority may emerge as an unintended consequence of incremental earlier steps’ (ibid.: 23). Haas considered the fact that the political-economic regulations among the (from a current perspective, relatively homogeneous) ‘Europe of the six’ differed in many respects. However, he expected functional spillovers to override this diversity; in fact, in the presence of diversity, supranational regulations might become even more likely. For example, governments may push supranational agencies to legislate in order to overcome a competitive disadvantage, as the Belgian government did in 1954 to offset its stricter regulations on working hours. In such situations, diversity may serve as an engine of spillover rather than a barrier to it.

In his alternative interpretation, Hoffmann (1966) by no means denied that functional spillovers might trigger incremental, politically unintended integration steps ‘from below’. However, he insisted on a logical hierarchy of integration forms, consisting of an intergovernmental logic at the top of the hierarchy and a neofunctional logic at the bottom. The neofunctional logic, Hoffmann argued, reaches its limits where – in the language of modern game theory – zero-sum games between member states are concerned: ‘Functional integration’s gamble could be won only if the method had sufficient potency to promise a permanent excess of gains over losses, and of hopes over frustrations’ (ibid.: 882). However, where potential integration touches
on ‘issues that can hardly be compromised’, political integration becomes unlikely. Therefore, integration dynamics are mainly determined by the goals, interests and strategies of national governments and the power constellations between them.7

For Hoffmann, the degree of diversity of national interests was crucial for understanding regional integration. Interestingly, however, he drew a clear line between economic and political integration, viewing economic matters as ‘low politics’. ‘[E]conomic integration’, he asserted, ‘obviously proceeds and the procedures set up by the governments hard to extend harmonization in all directions. With a common market and a joint external tariff the states cannot afford widely different wage, budgetary and monetary policies’ (Hoffmann 1964: 1289). In this respect, Hoffmann’s interpretation differs little from that of Haas. However, the ‘diversity of national situations’ was presumed to translate into blockades where ‘high politics’ (such as security and defence policies, foreign policies and political unity) were concerned (Hoffmann 1966: 876).

In the 1990s, Moravcsik revitalized Hoffmann’s intergovernmentalism by theorizing on the emergence of national integration preferences and by providing intergovernmentalism with an explicit political-economic foundation. He argued that national governments’ integration decisions should be analysed by ‘assuming that each first formulates national preferences, then engages in interstate bargaining, and finally decides whether to delegate or pool sovereignty in international institutions’ (Moravcsik 1998: 473). Government preferences reflect the objectives of the respective state’s most influential interest groups and are primarily economic in nature (ibid.: 24). Economic preferences need not necessarily relate to overall efficiency; they can also be rooted in distributional concerns (ibid.: 36). Accordingly, member states’ preferences will differ along the lines of sectoral competitive advantage, wealth and regulatory standards (ibid.: 28). Moravcsik claimed that the distribution of such preferences among member states and the power relations between them determine the outcomes of intergovernmental integration negotiations, affecting not only market liberalization but also issues such as product regulation, social policy and monetary policy (Moravcsik 1993: 485f.; 1998: 474).

However, ‘grand bargains’ and political integration are only one part of the story – and perhaps no longer the most important part. Accordingly, supranationalists focus their attention on the small but cumulative steps by which integration gradually proceeds and supranational agencies, without any government involvement, enlarge their scope of influence. In particular, supranationalists have discovered the ECJ to be ‘a strategic actor in its own right’ (Mattli and Slaughter 1998: 177). These scholars argue that integration through law has shaped the speed and scope of integration at least as much as political integration has. According to this view, judicial integration must be understood as a self-perpetuating process featuring three types of actors that activate one another:8 first, national and transnational litigants who make use of the opportunities that the European legal system offers; second, national courts that are willing to bring the respective cases before the ECJ;9 and, third, the ECJ itself, which is characterized by a strong preference to ‘promote its own prestige and power by raising the visibility, effectiveness, and scope of EU law’10. In other words, the speed and direction of integration can be altered by shifting it to ‘a nominally nonpolitical sphere’ (Burley and Mattli 1993: 69). Thus, supranationalists argue that European agencies have both the power and opportunity to override the integration preferences of governments, and that progress in European integration has often resulted from the skilful exploitation of this opportunity.

Intergovernmentalists have, in turn, produced sophisticated arguments questioning the idea that the ECJ and the Commission use their politically uncontrolled room for manoeuvre to speed up integration. In principle, member states possess the means to emasculate agency drift, since European agencies cannot directly enforce European law. Governments may collectively
refuse to comply with European law or may formally override ECJ decisions by changing EU Directives or primary law.\textsuperscript{11} The ECJ’s autonomy is therefore at risk.

Empirically, however, coordinated resistance to ECJ decisions is rare or even nonexistent. Rather than raising doubts about the ability of member states to control supranational actors, Garrett concludes that agency drift has not actually occurred: ‘A more powerful explanation for the maintenance of the EC legal system is that it is actually – and seemingly paradoxically, given its consequences for national authority – consistent with the interests of member states’ (Garrett 1992: 556). Even if ECJ decisions lead to allegedly unintended losses of sovereignty, member states may view these as less significant than the gains obtained from the ECJ’s effective solutions to monitoring problems, from the assurance of the credibility of European commitments and from the mitigation of incomplete contracting (Garrett and Weingast 1993; Garrett 1995: 172). In this perspective, therefore, there are no ‘unintended’ losses of sovereignty.\textsuperscript{12}

However, the assertion that the Court’s ability to ignore government preferences is not unlimited does not in any way prove that its room for manoeuvre is negligible or even nonexistent (Pollack 1997). In practice, coordinated resistance to the ECJ is far more difficult than intergovernmentalists are prepared to admit. First, the law serves not only as a ‘mask’ but also as a ‘shield’ of politics. Judicial independence and the rule of law are viewed as incontrovertible features of modern democracies. Therefore, strategic and coordinated noncompliance is generally not perceived as a legitimate option.\textsuperscript{13} Second, due to the numerous veto points operating in the European political system, formal ex-post correction of ECJ decisions is difficult to achieve. Achieving political agreements in the EU is difficult and time-consuming, and when unanimity is required the resistance of a single member state can be sufficient to prevent action. As a consequence, the Commission and the ECJ can exploit disagreement among member states (Pollack 1997: 129). Third, ECJ judges and national governments differ with respect to their time horizons. Since the full impact of ECJ decisions is often felt not in the short term, but in the medium to long term, politicians may avoid the costs of noncompliance or ex-post corrections (Pierson 1996: 135–6; Alter 2009: 118–21). And, fourth, direct influence over judges’ behaviour is an equally difficult undertaking: ECJ judges cannot be dismissed during their six-year terms and, even more importantly, decisions are taken secretly and no minority opinions are published. It is therefore impossible for national governments to single out the behaviour of individual judges (Pollack 1997: 117; Mattli and Slaughter 1998: 181). Even if we accept these arguments, a puzzle still remains. Attempts to formally override ECJ decisions and coordinated noncompliance are not simply unsuccessful; they are virtually nonexistent. If ECJ decisions violate member states’ integration preferences as systematically as the supranationalists maintain, why have the member states not made any attempt to control the Court?

We suggest that the answer to this question lies in the political-economic heterogeneity of the EU. In order to evaluate member states’ preferences vis-à-vis judicial integration, we need to assume a two-dimensional rather than a one-dimensional conflict model. The first dimension is the well-known conflict between integration and sovereignty, the dimension along which the member states’ integration preferences (as well as those of the supranational agencies) are located.\textsuperscript{14} Integration through law often has systematic consequences for the division of labour between the market and collective regulation. We expect member states to evaluate their likely gains and losses in this dimension as well, and to weigh losses of sovereignty against potential political-economic gains. The resulting preferences necessarily differ with respect to anticipated welfare transfers and asymmetrical needs for institutional adjustment. Of course, this by no means suggests that preferences are internally homogeneous within the respective member states (a point on which both liberal intergovernmentalists and supranationalists agree). Given the strict consensus requirement for treaty amendments, the likelihood of the constitutional override of
ECJ decisions is very low in situations in which decisions asymmetrically target different European varieties of capitalism. As a consequence, the freedom of action of supranational agencies to widen the range of application of European primary law should grow as political-economic heterogeneity increases.

This implies that not only intergovernmental but also supranational integration theory requires a comparative political-economy foundation. The heterogeneity of European varieties of capitalism shapes both the likelihood of achieving intergovernmental agreements and the ability of member states to politically control integration through law. As a result, the dynamics of political and judicial integration differ, with consequences for the projects of regulated and neoliberal capitalism. While the former project must come to terms with diverging interests, the latter project benefits from interest diversity, as the empirical examples provided below will illustrate. Before we explore the integration dynamics in three policy fields in more detail, we will document the heterogeneity of varieties of capitalism within the European Union and discuss how it has evolved over time.

The heterogeneity of European production and welfare regimes

We have argued that the existing literature does not fully reflect the fact that European integration today takes place among unequals. Political integration must come to terms with differences not only in wealth and productivity but also in taxation and welfare spending. Perhaps even more importantly, the political–economy literature has identified important institutional differences that differentiate national production and welfare regimes, even among relatively wealthy industrial democracies. In the European Union, we find several ‘worlds of welfare capitalism’, as well as different production regimes (Esping-Andersen 1990; Hall and Soskice 2001; Amable 2003; see Box 39.1 for details).

To visualize the heterogeneity among current EU members, we have collected a number of the indicators frequently used to identify differences in welfare or production regimes, standardizing them such that the average of all countries equals zero and the standard deviation equals one. This allows us to compare three groups: the six founding member states, the EU-15 and all 27 member states (throughout the entire section: the EU-28 without Croatia). In general, not only do the founding members score higher on almost all indicators, but the differences are also smallest within this group. Belgium, Germany, France, Italy, Luxembourg and the Netherlands constitute a comparatively homogeneous group of countries. If they were the only member states in the EU, harmonization of tax and social policies would seem conceivable. However, this does not hold for either the EU-15 or the EU-27.

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**Box 39.1: The literature on the varieties of capitalism**

In 2001, Peter Hall and David Soskice published the edited volume *Varieties of Capitalism*, which has influenced much of the research on contemporary capitalism over recent years. In their introduction, Hall and Soskice differentiate between ‘liberal’ and ‘coordinated market’ economies; the United States exemplifies the former type, while Germany corresponds to the latter. These economies differ in the degree to which firms coordinate their actions within the company (with employees) and among themselves. Institutional differences among liberal market economies and coordinated market economies (e.g. in finance, vocational training, industrial relations and labour law), propel firms to follow different production strategies and to target different market segments.
Figure 39.1 shows how diverse each group is in terms of wealth and labour costs. Clearly, the founding members are the least diverse and the wealthiest group (although Luxembourg is an outlier even in this group of relatively rich countries). Labour costs in the six founding countries by far surpass average labour costs, and the differences within this group are relatively small. In contrast, even the EU-15 countries are far more heterogeneous, in terms of both wealth and labour costs. However, these differences are minor in comparison to those that exist among the 27 current member states. Leaving Luxembourg aside, GDP per capita is nine times higher in Denmark than in Bulgaria, and almost three times higher in the EU-15 than in the ten post-Communist countries. If we turn to labour costs, even greater differences exist. Hourly labour costs are 4.5 times higher in the EU-15 than in the new member states (excluding Cyprus and Malta). These differences constitute a strong incentive for the citizens of new member states to enter the labour markets of the old member states, making the territoriality of labour standards a highly contested issue (Afonso 2012).

For welfare spending and taxation, a similar picture emerges (see Figure 39.2). Visual inspection again shows that the EU-6 countries are the most coherent group in terms of spending and taxation. The welfare state is more generous and taxation is higher in these countries than in the other groups. However, it is not only the amount of spending and taxation that differs, but also, more importantly, its structure: for example, all EU-6 countries belong to the group of Bismarckian welfare states, which are heavily reliant on social security contributions to finance
social protection. This does not hold for either the Anglo-Saxon or the Scandinavian countries, which are more dependent on income taxes. New member states form a heterogeneous group in themselves: some of them fall into the Bismarckian camp, but others do not. Similarly, the various member states follow different strategies in corporate taxation. Whereas smaller states generally use low nominal tax rates to attract foreign direct investment (FDI), larger member states are less inclined to do so. Accordingly, notable differences in the statutory tax rates for corporate income exist. Given these differences, any attempt to harmonize taxation or the financing of the welfare state seems a daunting task, even among the EU-15 countries.

One of the core insights of the comparative capitalism literature is that national production regimes differ in the degree to which economic action is coordinated, both between and within companies. Institutional differences – in labour markets, vocational training, corporate governance or financial regulation – facilitate different strategies on the part of firms. Strong trade unions and employer organizations have been identified as core elements of coordinated market economies. Figure 39.3 displays four indicators that differentiate between coordinated and liberal market economies. Somewhat surprisingly, all three country groups are internally highly diverse in terms of union density. In contrast, employers are much more highly organized in the EU-6 than in the two other groups. The most significant differences are found, however, in the scope and coverage of collective bargaining. The average number of employees covered by collective wage agreements is higher in the EU-6 countries, and differences among these
countries are smaller. Although some new member states (for example, Slovenia) have extremely high coverage rates, this does not hold for others (like Lithuania). As a result, European Union countries are highly heterogeneous in terms of collective bargaining coverage. A final aspect that defines coordinated market economies is the requirement for management to consult with employee representatives. Within the European Union, there is no uniform model of board-level codetermination, even within the founding member states. Overall, the diversity of national production regimes exceeds that of welfare regimes. Institutional differences cut across old and new member states alike. Given these differences, it is hard to imagine uniform regulations or policies that could be applied in all member states.

However, a focus on cross-sectional data might conceal underlying processes of convergence. To address this possibility, Figure 39.4 displays trends over time for four variables. The left side of the figure reports the mean for all 27 countries, whereas the right shows coefficients of variation. Specifically, this latter measure indicates whether countries have grown more or less diverse over time. While the average levels of total taxation and social expenditure scarcely change during the period in question, the same does not hold for bargaining coverage and corporate tax rates, which have been declining over the last 10 to 15 years. However, even though these rates have declined almost across the board, the rate of decline has varied significantly, rendering countries more diverse at the end of the period than at the beginning. Rather than convergence, we observe stable or even growing differences in the production and welfare regimes of the 27 member states.
This brief discussion shows that EU member states have become more heterogeneous with each round of enlargement; if the Balkan states and possibly Turkey or Ukraine entered the EU, these disparities would further increase. At the same time, spending patterns and the institutional set-up of national welfare states have not converged, and the diversity of collective bargaining institutions and taxation systems has even increased. According to these data, European integration will remain a process of integration among unequals for a long time to come, which will make it difficult to achieve consensus on interventionist policies that apply to all member states. Indeed, negotiations on the defining elements of national political economies have frequently ended in an impasse, as the next section shows.

**Political and judicial integration under conditions of heterogeneity**

Political integration decisions become unlikely when the respective integration projects target production and welfare regimes so asymmetrically that the outcome will create a gap between winners and losers (Scharpf 1999: Ch. 2). It is therefore unsurprising that certain areas (such as social security, wage bargaining and codetermination) have turned out to be resistant to political integration. The same can be said about capital and income taxes and other sensitive political-economic areas. In such constellations, once the initially ambitious harmonization projects have
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failed, member states have often chosen to preserve their regulatory autonomy, as described in
the first subsection below; however, these political agreements have proven to be unsustainable.
In the following subsection, we will see that the European Court of Justice has effectively nullified
these compromises by enlarging the reach and scope of the principles of the common market.

Political integration and national autonomy

The first example involves employees’ board-level codetermination. The regulation of the internal
organizational structures of firms (corporate governance) belongs to the competencies of the
member states. Forms of corporate governance differ widely among European varieties of
capitalism. This is particularly true for board-level codetermination: actual practices vary from
half of the board seats being allocated to the employee side (which is the case in Germany) to
no board-level codetermination at all (as in the UK and Italy). Given this heterogeneity, it comes
as no surprise that member states have never managed to agree on a common European
codetermination model. Nevertheless, the issue of board-level codetermination has appeared
on the European agenda: the European Company Statute (Societas Europaea, SE) offers
transnational companies the possibility to choose a European rather than a national legal status.
This statute does not entail any obligatory minimum standards or harmonization, but rather
provides a legal option that no company is forced to adopt against its will.

Numerous proposals and models have been discussed and ultimately rejected over the decades
since the Commission, on the initiative of the French government, began drafting a statute for
the European company in 1966 (Fioretos 2009: 1177–82). The first draft proposed one-third
participation of employees, based on the then-existing German practice. The discussions over
different versions of this proposal extended through the 1970s, but to no avail. The SE was
finally removed from the agenda in the early 1980s. In 1989, the Commission put forward a
completely redrafted Directive that offered a choice between four different SE codetermination
models, largely corresponding to German, Dutch, French and Scandinavian practices. Although
the SE remained an entirely optional legal form and the proposal offered substantial choices
between codetermination models, member states still could not agree. In particular, the UK
government strongly opposed any European Directive that might serve as a ‘Trojan horse’ for
company-level codetermination (Fioretos 2009: 1178). It took another 12 years before the
Council finally endorsed a model that would not endanger national industrial relations systems.
The SE statute, passed in 2001, does not regulate worker participation at all, but only obliges
managers and employees to enter into a bargaining process with certain fallback provisions in
the case of non-agreement between the negotiating parties. If an SE is founded by merging
firms from codetermination-free countries, no board-level codetermination applies. In short,
decades of debate have led to a political compromise that has enabled the member states to
protect their respective industrial relations systems (Callaghan 2011: 6).

The second example concerns capital taxation. In a common market, transnational firms can
minimize their tax burden by transferring earnings and losses across borders without having to
relocate production plants. In order to sustain their levels of corporate tax revenue, states must
offer competitive tax rates to firms, and they have an even stronger incentive to lower corporate
taxes if their neighbours do so or if they expect them to do so. In principle, the European
member states could put an end to this form of tax competition by harmonizing corporate tax
rates; indeed, such a move has been under discussion for decades. Genschel and colleagues identify
two phases in the long history of failed harmonization attempts in this area (Genschel 2002:
128–231; Ganghof and Genschel 2008; Genschel et al. 2008). The first phase started with the
so-called Neumark Report, written by a European expert group in 1962, which led to a
Commission Directive proposal in 1975. In this phase, the discussion revolved around the idea of full harmonization; however, the member states’ willingness to harmonize was limited because the pressure was still marginal.

The second phase started roughly with the Single European Act (1986), which pushed for the transnationalization of firms and consequently created new opportunities for tax arbitrage. Due to increased tax competition, a race to the bottom of nominal corporate tax rates set in (Ganghof and Genschel 2008: 59), but still no harmonization of corporate taxes could be achieved. Two factors made harmonization unlikely. First, the Commission changed its perception of tax competition and began to adopt a positive view of its impact on tax ratios and budget discipline (Genschel 2002: 207). Rather than aiming at full harmonization, the discussion shifted its focus to minimum standards and coordinated determination of the taxable base. Second, as tax competition grew, the heterogeneity of interests among member states grew as well. Not all member states were equal victims of tax competition. For example, Ireland consciously employed a low tax regime to attract FDI and, after the Eastern enlargement in 2005, several accession states followed suit. Among the various determinants of corporate tax strategies is country size. Small countries have a higher probability of profiting from tax competition because they have relatively few domestic tax bases to lose but comparatively much to gain if they undercut their neighbours’ corporate tax rates (Dehejia and Genschel 1998: 23–6). As a consequence, harmonization attempts have thus far failed.

Our third example is the Posted Workers Directive of 1996 (Council Directive 96/71/EC). The similarities to the first example of board-level codetermination are striking. Due to fundamentally diverging interests among member states, no harmonization of labour standards in the European Union has occurred thus far. Despite the political rhetoric found in countries with relatively high labour standards (such as Germany), most governments perceive the extension of their respective standards across the EU to be unrealistic. As a result, they focus on the protection of national autonomy in order to maintain their ability to legislate and impose their standards on market participants in their own territory. A potential threat to this autonomy is the transnational posting of employees. The greater the restrictions on member states’ abilities to impose national standards on posted workers, the more intense labour standard competition will become.

Eichhorst has provided a detailed analysis of the process that led to the 1996 Posted Workers Directive, a Directive that – similarly to the European Company Statute – abstains from full harmonization and enables the member states to protect their respective standards (Eichhorst 2000: 143–297). The compromise was difficult to achieve, not only due to the heterogeneity of standards but also because of the different interests involved in protecting the respective standards. As Eichhorst shows, member states that received more posted workers than they dispatched tended to support autonomy-protecting solutions, in particular Austria, Belgium, Denmark, Finland, France, Germany, Luxembourg, the Netherlands and Sweden. The UK and Portugal were most strongly opposed, while somewhat weaker opposition was prevalent in Greece, Ireland, Italy and Spain. In the end, however, those who fought for the strict protection of the territoriality of labour law prevailed.

Some aspects of the Posted Workers Directive that was finally passed deserve attention. The Directive imposes a double ban on discrimination: not only does it forbid member states to impose standards on posted employees with which domestic firms need not comply, but it also forbids member states to deprive foreign employees of standards to which domestic employees are entitled. In other words, member states have not just the right but also the obligation to impose their standards on posted workers (Streeck 2000). In Article 3 (1), the Directive lists a number of areas in which member states must ensure the application of the respective standards, among them...
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Working hours, health and safety, and pregnancy and maternity protection. Article 3 (7) makes it explicitly clear that this list is not a closed list of maximum standards, but an open list: ‘Paragraphs 1 to 6 shall not prevent application of terms and conditions of employment which are more favourable to workers.’ A further aspect that will be important for our discussion in the next subsection is the fact that the member states expressed their intention that the Posted Workers Directive should apply ‘without prejudice to the law of the Member States concerning action to defend the interests of trades and professions’, i.e. labour dispute law.19

In some respects, the same conflict reappeared on the European agenda some years later when the Directive on Services in the Internal Market was negotiated in the 2000s (Directive 2006/123/EC). Again, the debate primarily concerned the extent to which posted workers should be protected by domestic labour law. While the Commission favoured the strict adoption of the country of origin principle, the majority of the member states and the EP successfully fought for the superiority of the Posted Workers Directive over the Directive on Services in the Internal Market (see Article 1 (6) of the latter Directive). As Copeland shows, the conflict lines between the member states clearly resembled a production regime divide, consisting of Austria, Belgium, Denmark, France, Finland, Germany, Greece, Italy, Portugal and Sweden on the more ‘protective’ side and the UK and Ireland, all Eastern European ‘dependent market economies’, and Luxembourg and the Netherlands on the other (Copeland 2010).

Expanding markets: integration through law

In this subsection, we take up the three examples discussed above – codetermination, taxation and the Posted Workers Directive – and show how the European Court of Justice has partially reversed hard-fought political compromises. Initially, the ‘four freedoms’ (see Box 39.2) sought to guarantee discrimination-free transnational access to markets. Since the Dassonville and Cassis de Dijon decisions, however, the Court has replaced the principle of nondiscrimination with the principle of non-restriction.20 According to the latter, any national regulation that potentially restricts the transnational exercise of one of the four freedoms – that is, any regulation that makes the exercise of one of the fundamental freedoms less attractive – violates European law, even if the regulation does not discriminate against foreigners (i.e. even if it is imposed equally on nationals and non-nationals alike). Such restrictions are only lawful if they pass a four-stage test, uniformly applied to the four freedoms: they must not discriminate against foreigners, they must be justified by imperative requirements of the general interest, they must be suitable to secure the attainment of the objective and they must not go beyond what is necessary.21

Our first example of such judicial expansionism is the liberalization of corporate law. As we have seen, in the debate over the European Company Statute governments have adopted rules that seek to preserve national codetermination practices. With a number of decisions, the ECJ has effectively undermined the ability of member states to impose uniform rules on companies located in their territory. Until the end of the 1990s, there was a general consensus that European law was not an obstacle to application of the so-called ‘company seat theory’ or ‘real seat doctrine’. This doctrine stated that the legal status of a company was not based on its country of incorporation, but rather on the country where its actual headquarters was located. In other words, if the seat of a company was in Germany its internal matters were governed by German law. Given that headquarter relocation costs usually outweigh the advantages of a more attractive national corporate law, firms usually had no choice but to accept the respective body of regulation (Dammann 2003: 611).

The ECJ overturned the application of the company seat doctrine in its rulings in the Centros, Überseering and Inspire Art cases.22 In the view of the Court, the application of this theory violated...
the European freedom of establishment, and the judges saw no overriding reasons of general public interest to justify this violation. In particular, the Court ruled that European law allows the establishment of foreign letterbox firms, in which the company seat has no practical meaning for the economic activities of the business. In practice, this implies that entrepreneurs now have the freedom to choose whichever legal form among the entire EU-27 they deem appropriate when founding a company (Deakin 2009).

The freedom to circumvent national corporate law has consequences for employees’ codetermination: when a company’s seat is in Germany but it does not choose the German legal form, management board codetermination does not apply once the company has grown beyond the size of 500 or 2,000 employees. In Germany, the Court’s corporate law decisions have led to a boom in the number of firms with foreign legal forms. In most of the cases, the respective firms do not exceed 500 or even 2,000 employees. However, codetermination is affected in an increasing number of cases. Sick and Pütz find that from December 2006 to December 2010 the number of cases relevant to codetermination (i.e. firms of more than 500 employees) increased from 17 to 43 (Sick and Pütz 2011: 35–8). In effect, the ECJ has transformed German supervisory board codetermination, generally perceived as a key element of Germany’s model of capitalism, from an obligatory into a voluntary institution.

Our second example of the power of judicial integration concerns tax law, in particular the law on corporate income taxes. Politically, it has been impossible to harmonize corporate taxes, as we saw in the previous subsection. Nonetheless, some member states have sought to restrict companies’ tax-avoidance strategies – the transfer of profits and losses across national borders to minimize the tax burden – in order to tame tax competition. However, in a series of decisions such as Cadbury Schweppes and Marks & Spencer, the ECJ ruled that the common market logic legitimized tax-transfer practices and that efforts to curb these practices were not justified by overriding reasons of the public interest. By handing down these decisions, the ECJ has fuelled inner-European tax competition. The more heterogeneous the tax systems of the member states are, the more intense tax competition becomes, and the more unlikely it becomes that political harmonization efforts will succeed. As a consequence, nominal tax rates are declining faster in the European Union than in the wider OECD.

As Ganghof and Genschel have shown, competition to lower corporate taxes does not necessarily reduce tax revenue (Ganghof and Genschel 2008). Thus far, the broadening of corporate tax bases has prevented a dramatic decline in tax revenues. More important is the indirect effect of corporate tax competition on personal income taxes. Because firms can be used as tax shelters for personal income, the corporate tax rate has a shelter function for personal income tax (the so-called ‘backstop function’). As tax competition pushes nominal corporate tax rates down, the backstop function is undermined. In this situation, governments have two

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**Box 39.2: The four freedoms of the Single European Market**

The four freedoms guarantee the free movement of goods, services, capital and people within the European Union and are therefore the cornerstone of the European single market. Since they have been laid down in the 1957 Treaty of Rome, their actual meaning has been a matter of ongoing political and judicial contestation. Since the European Court of Justice’s Cassis de Dijon decision in 1979 and subsequent jurisprudence, the member states are obliged to justify any restriction of the four freedoms by reference to a mandatory requirement.
options: they can accept the widening tax rate gap between corporate tax rates and top personal tax rates, thereby opening up loopholes for top earners, or they can limit the progressivity of personal income tax. Corporate tax competition therefore constrains the progressivity of income tax and, as a result, member states’ redistributive capacity.

The ECJ’s *Viking*, *Laval* and *Rüffert* decisions – our third example – have recently received a great deal of attention because they have been interpreted as landmark decisions on the struggle between neoliberal and regulated capitalism in the EU. In the context of our discussion, two aspects are of particular importance. The first is the reinterpretation of the Posted Workers Directive of 1996. Recall that Article 3 (1) lists a number of mandatory rules for posted workers’ minimum protection on matters such as pay, rest and holidays, while Article 3 (7) explicitly states that this minimum protection in force in the host country shall not prevent the application of terms and conditions of employment that are more favourable to workers (see the previous subsection). In *Laval*, however, the Court referred to the list in Article 3 (1) as defining the ceiling on the maximum standards that member states are allowed to impose on posted employees from other EU member states. With this judicial reinterpretation, the Court effectively limited the host countries’ room for manoeuvre in preventing races to the bottom in the field of labour standards, a problem that will become increasingly prevalent as heterogeneity among member states increases.

A second aspect of this case is equally relevant to our discussion: the Court also expanded the so-called horizontal or ‘third-party’ effect of the European market freedoms to trade unions. In general, the third-party effect implies that European law obliges not only member states but also private bodies (such as firms or trade unions) to refrain from actions that might restrict market freedoms. In its decisions in the *Viking* and *Laval* cases, the Court ruled that trade unions are obliged not to hinder or block transnational economic activity by collective action (such as strikes) unless their demands are justified by overriding reasons of public interest and pass the proportionality test (Joerges and Rödl 2009). Until *Laval*, few observers would have argued that restricting disputes among the social partners was among the aims of the European fundamental freedoms (compare the barring clause in Art. 153 (5) TFEU).

These three lines of ECJ case law illustrate the dynamics involved in European judicial lawmaking. In the cases discussed above, the ECJ clearly overrode member states’ attempts to shelter sensitive areas of national sovereignty from being transformed by European law. This outcome is puzzling if we treat the conflict between sovereignty and integration as the only decisive conflict axis. However, the ECJ’s activism affects not only the conflict line between sovereignty and integration, but also the conflict line between market and state (and other forms of collective regulation). With its extensive interpretation of European law, the ECJ has weakened the redistributive capacity of the national tax systems, it has transformed employees’ supervisory board-level codetermination from an obligatory into a voluntary institution, and it has subordinated collective labour law under the European economic freedoms. Along this line of conflict, given the heterogeneity of European varieties of capitalism, the ECJ has targeted member states’ preferences much more asymmetrically than along the conflict line between integration and autonomy, in terms of both transnational welfare redistribution and asymmetrical needs for institutional adjustment. Once we assume that the member states evaluate their gains and losses along both lines of conflict and weigh their potential political-economic gains against potential losses of sovereignty, it becomes less surprising that we see no unanimous motivation to ‘curb’ the Court’s activities. Among the determinants of the Court’s freedom to engage in judicial lawmaking is the ability of potential ‘court curbers’ to make resistance a credible threat. However, in light of the diversity of the member states’ political-economic interests, the threat of constitutional override becomes so small that it can be virtually ignored by the Luxembourg
judges. Integration through law, in other words, profits from the two-dimensionality of the European conflict structure.

The logic of this claim becomes evident when we review the cases discussed above. Let us assume that, in all three cases, all the member states were ready to agree that the ECJ’s expansionist interpretation of the fundamental freedoms limited their political discretion by identifying ‘legal obligations or constraints not found in the treaty texts or supported by the intentions of their drafters’. But why should low-tax countries such as Ireland protest when judicial lawmaking constrains member states’ ability to slow down tax competition? Why should the UK engage in protest against Centros, since the respective line of ECJ decisions helps to spread the British limited company across the European continent? And why should Eastern European countries and the UK curb the Court for Viking, Laval and Rüffert, given that judicial lawmaking has brought about precisely the labour market and services liberalization that the respective countries had – unsuccessfully – fought for in the political arena?

Our claim rests on the premise that the ECJ has enough strategic capacity to evaluate the likelihood of resistance against its case law. Note that this assumption does not imply any ‘hyper-rationality’ on the part of the Court. In order to accept our interpretation, it is sufficient to assume that the judges understand that the ECJ is insulated from the threat of constitutional override when expansionist judicial lawmaking targets member states’ preferences asymmetrically. Increased heterogeneity has reduced the likelihood that, beyond individual noncompliance (which frequently occurs), member states will collectively fight back. This point is of particular importance for the dialogue between integration theory and political economy because it implies that the political-economic structure of the EU is one of the determinants of the potential of both the intergovernmental and the supranational integration mode – with consequences not just for the struggle between regulated and neoliberal capitalism, but also, as we conclude in the closing section, for the prospects of European democracy.

Conclusion: how heterogeneity shapes the democratic deficit

The struggle over European integration does not take place on a level playing field. Whereas the project of regulated capitalism must overcome the joint-decision trap, the neoliberal project proceeds even under conditions of heterogeneous political-economic interests. As a consequence, market-enforcing rulings dominate over market-correcting policies. These imbalances harm democracy as ‘a system of popular control over governmental policies and decisions’ (Dahl 1999: 20), since, in a democracy, citizens must be able to choose between representatives who differ in their ideological profiles. Although party platforms may not differ on each and every item, they nonetheless need to diverge enough to make choices between them meaningful. If a change in the composition of parliament does not translate into changes in at least some policies, and if governments fail to be responsive to citizens’ demands, electoral competition becomes superfluous and democracy becomes a charade. In the European Union, for reasons we have explored in this chapter, changing political majorities in the Council and the European Parliament often do not translate into policy change. Hence, we contend that the effects of member state heterogeneity impinge on the EU’s potential to overcome its democratic deficit.

Those who are concerned about the democratic deficit of the European Union often promote institutional reforms that would bring about a further politicization of EU politics (Follesdal and Hix 2006). The underlying assumption is that politicization will generate European parties, interest groups and social movements that organize across borders and that will, in turn, instigate public debates and help to build a European demos. However, in the cases that we have discussed, the lines of conflict do not predominantly run along ideological cleavages; instead, the quest
for liberalization often pits member states with high levels of regulation against those with lower levels. Even in the European Parliament, national and ideological cleavages cut across each other where core features of national production models are concerned. For example, the debates over both the Services Directive and the Takeover Directive showed that the two large party groups were internally divided along national lines (Callaghan and Höpner 2005; Crespy and Gajewska 2010). Under the present conditions of the political-economic conflict structure in the EU, intensified politicization might neither give rise to transnational alliances nor shape a European demos, but instead intensify struggles along national lines. The more intense and salient such conflicts become, the less likely the emergence of European parties that are coherent enough to offer distinguishable political programmes to voters will be. If this is the case, increasing the power of the EP will not necessarily increase the democratic quality of European decisions.

European integration has reached an impasse. Support for further integration is declining in many member states, and there are open conflicts among governments about how to deal with the financial and Euro crises, enlargement and border controls. ‘More of the same’ will not cure the disease. For many citizens, EU politics still seem opaque and inaccessible, despite efforts to make them more transparent. What is more, nation-states still attract most citizens’ loyalty, and the willingness to step up redistribution across member states is clearly limited. One way to reduce the imbalance between political and judicial integration and, indeed, to shield European integration from the tide of nationalist sentiments would be to protect national autonomy to a greater extent than is presently being done. Integration among unequals means that a rather diverse set of national welfare and production regimes deserves autonomy protection, even if the respective institutions make the transnational exercise of the European economic freedoms, as the Court says, ‘less attractive’. But this implies that the ECJ would have to interpret the European economic freedoms more narrowly – i.e. the Court would have to gradually revert to the original meaning of the European fundamental freedoms. At present, however, there is neither any indication that the ECJ might engage in such judicial self-restraint nor a realistic path to institutional reforms that would impose such restraint on the Court. The heterogeneity of national welfare and production regimes makes agreement on institutional reforms just as difficult as agreement on policies that incur costs for some but benefits for others.

Notes

1 This paper presents a further developed version of an argument that we first introduced in Höpner and Schäfer (2010, 2012). We would like to thank Alexandre Afonso, Hans-Peter Kriesi, Fritz W. Scharpf, Daniel Seikel, Kathleen Thelen, Benjamin Werner, Arndt Wonka and Nick Ziegler for their helpful comments.

2 To simplify matters, we will use the term ‘European Union’ (EU) throughout, rather than differentiating between the European Economic Union (EEC), the European Community (EC) and the EU.

3 See Weiler (1981) and Scharpf (1999). We use the terms ‘judicial integration’ and ‘integration through law’ interchangeably.

4 Caporaso and Tarrow (2009) have argued that the ECJ case law on anti-discrimination and on transnational access to the member states’ social security systems provides European integration with a social, ‘Polanyian’ drive. Our interpretation fundamentally differs from theirs. Compare the details in Höpner and Schäfer (2012), in which we discuss not only the ECJ’s case law on the fundamental freedoms but also its jurisprudence on anti-discrimination.

5 In his later writings, Haas distanced himself from his earlier unidirectional view on integration and argued that both integration and disintegration pressures coexist, the latter deriving from ‘pragmatic-interest politics’ (see Haas 1967: 315).

6 Haas (1958/1968: 90). Another example is the equal pay principle included in the Treaty of Rome. France advocated inclusion of the principle because it anticipated competitive disadvantage due to the higher wage gaps between males and females in the other member states. This principle became the
starting point for an extensive equal treatment jurisdiction on the part of the ECJ. If the differences between the member states had been smaller in the 1950s, the equal pay principle might not have been included in the first place.

7 Hoffman insisted on a wide definition of interests, not only determined by strictly material gains and losses, but also conditioned by traditions, experiences and cultures. See, for example, Hoffmann (1964: 1256) on the ‘historical memories’ of nations.

8 See the contributions to the volumes edited by Sandholz and Stone Sweet (1998) and Stone Sweet et al. (2001). In addition, see Weiler (1987, 2004) Burley and Mattli (1993); Mattli and Slaughter (1998); Pollack (1997); Alter (2001, 2009).

9 Equally significantly, the Commission has the right to submit to the ECJ cases of potential failure of member state compliance with European law.

10 Mattli and Slaughter (1998: 180). In the words of Schepel and Wesseling (1997: 177), ‘[t]he main stake for the ECJ is to have its authority accepted and expanded. And for the ECJ to expand its authority is to expand the reach of EC law.’ See also Pierson (1996: 133) and Alter (2001: 45).

11 Collective and individual noncompliance must not be confused. Individual non-enforcement frequently occurs and does not hurt the ECJ. Coordinated noncompliance, however, would severely damage the functioning of the European legal system, a scenario that the ECJ would seek to avoid. See Garrett (1992: 558).

12 This argument has far-reaching consequences for other debates in integration theory. For example, the European legitimacy deficit is much smaller than some have argued if agency drift does not exist. See Moravcsik (2002).

13 Mattli and Slaughter (1998: 181). The costs of noncompliance are even higher in situations in which governments would have to defect from cooperating not only with the ECJ but also with the national courts that brought the respective cases before the ECJ.

14 Here we follow supranationalist insights and assume that both the Commission and the ECJ have a strong integration preference. Note that we locate the supranational agencies’ preferences in this dimension rather than in the second (political-economic) dimension. In other words, we do not assume that European judges or Commissioners have a preference for neoliberal policies.

15 German parity codetermination – i.e. one-half rather than one-third of the supervisory board seats being distributed to the employee side – has existed since 1976 (with the exception of the so-called Montanmitbestimmung in the coal and steel sector, in which half of the supervisory board seats have been allocated to the employee side since 1951).


17 See Figure 1 in Genschel et al. (2011: 591).

18 Compare the summary and literature cited in Höpner and Schäfer (2012).

19 The quote is from recital 22 of the Directive.

20 ECJ, C-120/78 (Cassis de Dijon); ECJ, C-8/74 (Dassonville).

21 ECJ, C-55/04 (Gebhard).

22 ECJ, C-212/97 (Centros); ECJ, C-208/00 (Überseering); ECJ, C-167/01 (Inspire Art).

23 In Germany, with its far-reaching codetermination legislation, supervisory board codetermination applies when firms have more than 500 employees, and the proportion of employees’ supervisory board seats increases from one-third to one-half of all seats when the number of employees grows beyond 2,000 employees.

24 ECJ, 196/04 (Cadbury Schweppes); ECJ, 446/03 (Marks & Spencer). Cadbury Schweppes concerned the British taxation of foreign-sourced income; Marks & Spencer involved a ban on cross-border loss offsetting. For an overview of this line of ECJ case law, see Schanmo (2008).

25 Genschel, Kemmerling and Seils (2011) provide empirical proof that the intensity of tax competition between European countries is greater than in the rest of the world. In this policy field, the EU does not shelter member states from globalization, but rather increases the magnitude of its effects.

26 ECJ, C-346/06 (Rüffert). In the Rüffert case, the ECJ declared a public contract bid in which the contracted companies were obliged to pay no less than the regional customary wage to be a violation of the freedom of services.


28 The Lisbon Treaty has made the Charter of Fundamental Rights legally binding. Some had hoped that this, in combination with Art. 152 TFEU (which states that the EU recognizes and promotes the role of the social partners), might prevent the ECJ from applying the proportionality test to the actions of the social partners. However, ECJ, C-271/08 (Commission against Germany) has dashed these hopes.
Anything else would have been a surprise, since the ECJ had begun to judicially develop European fundamental rights in the 1970s and had even recognized the right to strike as a European fundamental right in *Laval* and *Viking*. We thank Florian Rödl for pointing our attention to *Commission against Germany*.

29 We do not claim that all expansionist lines of ECJ case law have a liberalizing impact. On this, compare Höpner and Schäfer (2012), in which we also devote attention to the two ‘left-liberal’ lines of ECJ jurisprudence on equal treatment and on the judicially enforced transnational opening of the member states’ social security systems.

30 *Carrubba et al.* (2008); Brunell and Stone Sweet (2010); Dyevre (2010: 30); Kelemen (2012). Note also that both *Carrubba et al.* (2012) and Stone Sweet and Brunell (2012) agree on this point, but disagree on whether the threat of override is credible in the case of the ECJ, thereby disagreeing on the scale of ECJ autonomy.

31 This is the definition of supranational judicial expansionism provided in Alter and Helfer (2010: 566).

32 As a matter of fact, Lindstrom (2010: 1312–21) shows that the conflict lines behind the observations submitted to the *Viking* and *Laval* hearings were exactly those that had been drawn during the struggles over the Posted Workers Directive and the Services Directive.

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Integration among unequals