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Annette Bongardt and Francisco Torres

The Political Economy of Brexit: Why Making It Easier to Leave the Club Could Improve the EU

The UK exit from the EU represents a qualitative change in the nature of EU membership. On the one hand, it conveyed the lesson that for the Union to be sustainable, membership needs to entail constant caretaking as far as individual members' contributions to the common good are concerned, with both rights and obligations. Countries with preferences that are too divergent for the Union to function properly should then not be discouraged to invoke Article 50 and to opt instead for membership in the EEA or for a free trade agreement. The Union has to deliver to be sustainable, but it cannot do so if there is a constant hold up of decisions that are in the common interest. On the other hand, with the eurozone having established itself as the *de facto* core of European (political) integration, the UK's preference for a stand-alone (and incomplete) economic union became untenable, because the need to make the monetary union work calls for further integration and institution-building in the economic union sphere.

As the UK referendum on EU membership approached, it seemed increasingly likely that a majority would vote for a British exit from the EU (i.e. Brexit), and yet this outcome appears to have taken almost everyone by surprise. The Leave camp won and did so with voter turnout above 70%, which is significantly higher than the turnout for the United Kingdom's European Community referendum in 1975 or the British Parliamentary elections in 2015.

Hardly a surprise

Looking back at the discussions during the campaign, it is probably fair to say that reasoned arguments seemed to carry little weight. As far as the unsuccessful "Remain" side is concerned, the failure was probably less

due to attempts by some members of the "Leave" campaign to discredit it as "Project Fear" than it was to the fact that, on the whole, the Remain camp was campaigning on a negative message. It defended the option to stay in the EU on the alleged merits of a diluted, non-functioning EU/EMU project, conditional upon many exceptions. Even some academics did the same in public debates. It was, of course, also unhelpful that the (now former) prime minister and many members of his conservative party – after having raged against EU membership for years, sometimes very much along the lines of the UK Independence Party, and threatening the rest of the EU club with exit – suddenly changed their tune and began pointing to the perils and costs associated with a Brexit, which did not exactly enhance the credibility of Remain. It should then have come hardly as a surprise that the Remain camp's Eurosceptic-led campaign did not work: people tend to prefer going for the original instead of the copy – in this case, for Leave rather than for "Remain with reservations in a very watered-down EU".

No panic, just different preferences in the UK

We do not see the magnitude of shock to the EU from a UK exit that others seem to perceive.¹ Markets did not panic (but are obviously adjusting to new realities, as illustrated by movements in the external value of the Brit-

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¹ See for instance G. Soros: Statement submitted to the European Parliament Joint Hearing: Budgetary implications of the current refugee and migration crisis, European Parliament, 30 June 2016.

ish pound or UK asset prices), nor did the EU population and polity. After all, the UK was already not participating in many EU policy areas and common goods.

On the other hand, the scope of exemptions granted to the UK and the country's strong opposition to EU integration have been undermining the functioning of the EU. Those exemptions – cherry-picking the club's benefits – were set to increase further; had Remain won, the pre-referendum settlement with the UK, an intergovernmental agreement which enshrined additional exemptions, would have been enacted. At the same time, opposition to EU integration would have probably also risen.² For instance, the eurozone would have risked seeing its legitimate efforts to strengthen the Economic and Monetary Union (EMU) – for example, by deepening the single market where necessary – vetoed by the UK.³ Quite possibly, the EU project was not sustainable with the UK inside.

In the future, Anglo-Saxon and more continental European perspectives will probably tend to diverge ever more on issues such as financial regulation, international trade agreements like CETA and TTIP, and many others. Most EU countries favour a more social model of society, while the UK's manifested preferences in regard to product and labour market regulation tend to be closer to those of the US or Canada.⁴ The issues mentioned above will be another test of whether the UK's preferences are more in line with those of the US and Canada than they are with the rest of Europe. If so, it would constitute another argument in favour of the UK's decision to leave the EU: the divide that already seemed insurmountable would be bound to increase even further given that those issues will soon have to be tackled. The EU's capacity to shape globalisation in line with citizens' concerns (i.e. not merely growth-oriented but in a more inclusive and greener manner) will be critical to the support of the project.

Not as big a divide on the EU within the UK electorate as claimed

Contrary to what is often alleged, and considering that many in the Remain camp do not like the EU and its political project, one can argue that there is not that great a

divide on the EU within the British electorate.⁵ Of course, the UK has repeatedly signed on to the EU project, including the political objective of an ever-closer union of peoples, at the time of accession and at each subsequent treaty revision. However, when the UK joined in 1973 – and one may add ever since – stress was put on economic advantages and not on political commitments, as though the UK thought it was merely joining and operating in an enlarged free trade zone.⁶ Yet, the realisation of the full benefits from deeper economic integration in the single European market requires sharing sovereignty.⁷ Of course, sharing sovereignty in turn also presupposes (a certain degree of) convergence of national preferences.⁸ It is easier among more similar countries.

In a way, the Leave camp (which won the referendum by a margin of almost four per cent, or roughly 1.2 million votes) played it more straightforward, whereas the Eurosceptics who led the Remain campaign would have liked to stay but only in a very different EU. This is, however, not what most other EU members want. There is little doubt that most UK citizens show little support for some of the most important European public goods and that the same applies to the European integration project. The UK government demanded additional exceptions in February of this year – most notably on one of the EU's four fundamental freedoms, the free movement of persons – in order to support the UK's continued membership. The Remain camp then campaigned for UK membership with these new concessions, which came in addition to the UK's continued non-participation in EMU, in the Schengen agreement and in various other EU common goods. In that sense, there was little point in the UK staying in the EU. Even those demonstrating against Brexit in the streets of London in the aftermath of the referendum (some of whom realised too late the costs

2 According to De Grauwe, the Brexit camp would be working from within to undermine the union. See P. De Grauwe: Why the EU would benefit from Brexit, OUPblog, 11 May 2016.

3 A. Sapir, G. Wolff: One Market, Two Monies: The European Union and the United Kingdom, Bruegel Policy Brief No. 2016/01, 2016. See also A. Bongardt: Growth: The Possibility of a Truly Single Market, in: The Future of Britain in Europe, London, IPPR, 2016 (forthcoming).

4 OECD: Economic Policy Reforms 2015. Going for Growth, Paris 2015, OECD.

5 For a poll taken on the day of the referendum, see M. Ashcroft: How the United Kingdom voted on Thursday... and why, Lord Ashcroft Polls, 24 June 2016.

6 According to Davies, the UK's attitude towards Europe has not only been driven by government and party policies but can be attributed to more fundamental misconceptions about its history, which tend to be Anglo-centric and diminish the many interactions with Europe. The UK's first in-out referendum (on EC membership in 1975) already showed a divide within the two main parties. See N. Davies: Not Forever England: A European History of Britain, in: Europe East and West, London 2007, Pimlico, pp. 83-105.

7 L. Tsoukalis: The New European Economy Revisited, 3rd edition, Oxford 1997, Oxford University Press.

8 A. Bongardt, F. Torres: Forging Sustainable Growth: The Issue of Convergence of Preferences and Institutions in EMU, in: Intereconomics, Forum – Convergence in the Eurozone, Vol. 48, No. 2, 2013, pp. 72-77. See also A. Bongardt, op. cit.; I. Begg, A. Bongardt, K. Nicolaïdis, F. Torres: EMU and Sustainable Integration, in: Journal of European Integration, Vol. 37, No. 7, 2015, pp. 803-816; and E. Jones, F. Torres: An 'Economics' Window on an Interdisciplinary Crisis, in: Journal of European Integration, Vol. 37, No. 7, pp. 713-722.

associated with not caring much about the EU, like many others across Europe) would possibly be more closely aligned with the Leave side as far as contributing to European public goods and participating in the political integration project is concerned. This continued unhappiness of the UK with its EU membership is in our opinion based on a misunderstanding of the essence and objectives – above all, the political objectives – of the EU club and the European integration project.⁹

Club benefits

The UK was torn right from the outset between the economic benefits that come with membership in a more deeply integrated club and the perceived political costs in terms of the sharing or loss of sovereignty.¹⁰ The fact that it did join in 1973 testifies to the fact that the prospect of higher economic advantages – brought about by large market scale and the customs union – prevailed over its reservations about the supranational integration model and the political aim of an “ever closer union”, which was (and still is) part and parcel of it.

Over time, the UK has opted to limit its participation in European common goods: in addition to Schengen and EMU, it does not participate in police and justice matters and secured a protocol to the treaty relating to the application of the Charter of Fundamental Rights. For the UK, the benefits to be had from the EU are hence significantly narrowed down to the (incomplete) economic union sphere, and more precisely to the single market, whereas other member states can take a more encompassing view across wider issue areas.¹¹ The UK justified its recent renegotiations with the objective of making the single market work better for it (greater benefits) and with the allegedly high (sovereignty) costs of member-

ship. Yet, in-depth reports carried out by the UK government did not yield any need for the repatriation of competences and concluded that proposals for further improvement could be dealt with within the existing EU governance architecture.¹² On the other hand, from the point of view of the EU club, the UK’s non-participation in many European common goods means that the benefits from UK membership are also more limited, while the UK’s blocking of decisions at the EU level raises costs associated with its membership.

The Brexit vote has already diminished the UK’s influence on the internal market, more precisely on the financial sector, in which it takes a particular interest due to the sector’s large weight in the national economy and where British influence on EU regulation has traditionally been strong. The British commissioner in charge of financial services regulation in the European Commission stepped down after the vote; his entire portfolio came under the responsibility of the Commission Vice-President for the Euro and Social Dialogue, a choice that was swiftly approved by the European Parliament. This opens the possibility that financial regulation in the single market can be better geared towards the public good of financial stability in the euro area, thereby reinforcing the economic union in a crucial area for the monetary union. In the past, the regulatory area under the control of the ECB was smaller than that of the single market in financial services (which benefited the UK).

Unlikely that other countries will follow the UK

One may say that it was irresponsible to call a referendum on the UK’s EU membership, and to the extent that it was called to solve internal and leadership problems within the Tory party, that claim may well be right.¹³ It did have the side effect, though, of providing an occasion (largely wasted in terms of a meaningful debate) to clarify lingering issues in the relationship between the UK and the EU.

The idea that the UK’s departure will trigger a domino effect, prompting other EU member states to follow suit,

9 The first factor for strong British support for Brexit was “a decided political and cultural preference from the very start in the 1950s for free trade over greater political integration”. See M. Emerson: Brexit – A last testament, CEPS Commentary, 23 May 2016.

10 The UK left the Spaak committee in 1955 over disagreements with the supranational model of integration and decided not to join what was to become the European Economic Community (EEC). It then promoted the creation of a rival, intergovernmental club, the European Free Trade Association (EFTA), in 1960. However, already in 1961 it applied for EEC membership in recognition of the higher economic benefits associated with the higher level of economic integration. Baldwin and Wyplosz trace the stances towards European integration, manifested by the EEC/EFTA divide, back to the different lessons that countries drew from the economic dislocation and human loss caused by WWII, i.e. the notion of shared destiny in the EEC (for Germany, France, Italy and the Benelux countries) and the wish to preserve sovereignty (notably for the UK). See R. Baldwin, C. Wyplosz: *The Economics of European Integration*, 5th edition, New York and London 2015, McGraw-Hill.

11 The UK also does not participate in the Euro Plus Pact, the Fiscal Compact or the European Banking Union. See A. Sapir, G. Wolff, *op. cit.*, for a nice graphical representation.

12 The in-depth reports carried out by the UK Government’s Foreign and Commonwealth Office suggest that the UK has little fundamental cause for grief with the status quo and indeed much to lose from leaving the EU. See Foreign & Commonwealth Office: *Review of the balance of competences*, 18 December 2014.

13 For bystanders, it was puzzling that most of the initial criticism in the UK was directed not at the government that called the referendum but at two main scapegoats: Boris Johnson on the right and Jeremy Corbyn on the left, although both had little to do with calling the referendum in the first place. An exception to that view was put forward by M. Wolf: *How Europe should respond to Brexit*, Financial Times, 5 July 2016.

has somehow become widespread. However, the other member states have much higher levels of participation in the EU common goods, stronger notions of shared destiny and/or higher dependence on the EU. While some anti-EU parties will of course go on demanding an exit, most member states' governments and parliaments will think twice – they will reflect on the UK's case and will ponder the wider benefits to be had from their EU membership. In addition, with the UK gone, many of the anti-EU parties across Europe, such as the National Front in France, the Alternative for Germany and similar parties in the Netherlands, Denmark, Austria, Italy, Poland and Hungary, could well have fewer reasons for protesting against the EU, since many of their fears are rooted in the EU's stance on liberalisation and trade – a stance heavily attributed to UK influence. Other anti-EU parties, including the likes of Podemos and Syriza, may also have other motivations but are part of the anti-globalisation movement and strongly oppose the traditionally more liberal and trade-oriented British stance. To the extent that right and left collude against the EU (even forming government coalitions, as in the case of Greece), they do so primarily against an open and liberal EU. In fact, globalisation has been a key factor in motivating discontent at the national level, which has been directed against the EU. While it is true that the EU's modernisation agendas in the face of globalisation (the Lisbon and Europe 2020 strategies) have so far produced mixed results at best (held back by weak governance in areas where competences for reform remained at the member state level and coordination is soft), it is also true that member states can only hope to influence and shape globalisation if they work together. A sufficient convergence of preferences among member states is a precondition for more effective governance.

A divorce rather than an unhappy marriage

What seems best at this point is a civilised and amicable divorce between the UK and the EU, implemented as fast as possible to avoid uncertainty.¹⁴ It does not mean that the two could not be very good neighbours – quite the contrary. They may cooperate better on areas of common interest after having separated (without other matters, such as eurozone integration, being perceived as standing in the way); Norway and Switzerland provide good examples. Until now, the relationship has been complicated and unable to function properly because of constant UK opposition from within.

¹⁴ See S. Koehler: Why the UK must trigger Article 50 immediately, LSE EUROPP blog, 27 June 2016.

The UK-EU relationship has long been something of a mismatch. It is not only that they did not share many interests and the UK was not prepared to contribute to the many European public goods mentioned above; the UK was also unwilling to participate in the European integration process even after obtaining the pre-referendum intergovernmental agreement in February 2016. Thus, it must be clear to all involved that activating the exit clause of Article 50 is not an opportunity to forge a new relationship with the EU; it will simply begin withdrawal negotiations.

Rebuilding the relationship after the divorce

There are various ways in which the UK may want to negotiate its new relationship with the EU.¹⁵ We believe that the Norwegian model – with the UK as a member of the European Economic Area (EEA), which grants it unrestricted access to the single European market – is the one that would best suit the interests of both the EU and the UK. The EU cooperates well with Norway, without political integration needs getting in the way.

A Norway-style deal is, however, only one of the options that the UK can contemplate after invoking Article 50. The conditions for acceding to the EEA are fairly straightforward but feature a sensitive issue for the UK, namely the free movement of persons. The UK will have to define its preferences, which in turn will condition the options that are available to it: the EEA, with full access to the single market; a free trade agreement, which offers more limited privileged access to the single market, and where size matters for relative bargaining power in setting conditions; or basic WTO rules, the fall-back option, which provides no privileged access to the single European market.¹⁶ While the question of free movement of labour will certainly be an important issue for the UK in the negotiations, other factors like the impact on financial services (notably EU passporting rights and access to euro clearing and settlements)¹⁷ or the possible

¹⁵ For a detailed analysis, see M. Emerson (ed.): Britain's Future in Europe – The known Plan A to remain or the unknown Plan B to leave, Brussels and London 2016, CEPS and Rowman & Littlefield.

¹⁶ As Gros puts it, "... real-world examples show, no country that wants to benefit from the European project has been able to have its cake and eat it. Open borders and economic integration require common rules." See D. Gros: Britain's Moment of Truth, Project Syndicate, 7 July 2016.

¹⁷ Thanks to privileged access, UK banks benefited from the ECB's liquidity operations during the global financial crisis. The regulation and oversight of central counterparties (CCPs) – presently done jointly by the ECB and the Bank of England – means that there is a high proportion of euro-denominated financial activities, from which the City of London benefits. See W. den Haan, M. Ellison, E. Ilizetzki, M. McMahon, R. Reis: Brexit: The potential for a financial catastrophe and long-term consequences for the UK financial sector, VoxEU, 20 June 2016.

disruption of intra-community value chains (given the possibility of tariffs that would be applied under WTO rules) are also bound to be relevant. In general terms, it is in the interest of the UK to limit uncertainty with regard to future arrangements with the EU. Article 50 stipulates a two-year timeframe for withdrawal after notification. Negotiating a new relationship with the EU (and third countries) can take rather long, especially for complex trade agreements (and even more so given that there is no more UK expertise at the national level, as it is the European Commission that negotiates EU trade agreements).

As for the EU, it faces a credibility issue with regard to the exact terms that it grants the UK: it cannot simply accept whatever member states or third countries want to do at the expense of the union and the European project. The UK's reported desire for a "Norway-plus" agreement, which amounts to cherry-picking in the internal market, is a case in point. Another is the UK's special status that EU leaders (without any backing from their citizens) granted Prime Minister Cameron to induce him to support Remain rather than fighting for Leave, as he said he was prepared to do; ultimately, these concessions turned out to be of no avail other than setting a dangerous precedent and damaging the EU's credibility. That is why access to the single market, which is at the centre of what the EU does, needs to come with clear conditions and rules, safeguarding all of the four freedoms. This is valid for Norway and should be for the UK as well. Indeed, Switzerland may well be about to lose its access to the single market in the near future due to its failure to respect the free movement of persons.¹⁸

The post-Brexit EU – where to now?

The UK exit from the EU represents a qualitative change in the nature of EU membership. Other countries with preferences that are too divergent to be easily accommodated might more readily consider opting out of the core of European integration, preferring instead membership in the EEA or a free trade agreement. Denmark is a case in point, with various opt-outs, most notably on the euro. What the UK case has clearly shown in our view is that for the Union to be sustainable, membership needs to entail constant caretaking as far as individual members' contributions to the common good are concerned, with both rights and obligations. Countries will

now have to make a constant effort – both with respect to their electorates and to their partners in the Union – to remain members. This is a development that is in itself quite positive, as it is in the interests of both the EU and those discontented member states that do not wish to contribute to the club's public goods. It leads us back to the idea of variable geometry or various concentric circles in European integration.¹⁹

The challenge that the EU faces is that the club has become not only much larger over the years but by many accounts also a lot more heterogeneous. This entails the risk that its decision-making and problem-solving capacities will become (or already are) compromised, as its governance structures will be unable to evolve to enable institutions to function properly. On the one hand, the EU has to come to grips with its member states' different preferences on issues such as regulation or institutions. Substantial differences between states may undermine their trust in one another. Nonetheless, countries could of course trade benefits across issue areas and various common goods. The fact that Brexit has opened the door for any malcontent member state to exit the club ought to reduce any member state's capacity to hold up decisions that are in the common interest. To that extent, it can actually be expected to facilitate decision-making and problem solving.

A more fundamental issue is posed by the fact that the EU is faced with a situation in which successive enlargements brought countries with divergent views on supranational governance and European economic integration as a political project into the same club. This ultimately raises the question as to the optimum size of the club, i.e. whether the benefits at the margin are still larger or merely equal to heterogeneity costs. The eurozone has established itself as the *de facto* core of European integration. Arguably, the UK's preference for a stand-alone economic union became untenable given the need to make the monetary union work, which called for further integration and institution building in the economic union sphere.

¹⁸ This is due to the "guillotine clause", whereby the violation of a single bilateral agreement – and there are more than 120 between the EU and Switzerland – results in the discontinuation of all the others. More generally, the EU is loath to continue "static" free trade agreements that do not allow for automatically updating legislation, as opposed to the dynamic EEA agreement.

¹⁹ At present only six countries participate in all the main EU institutions and reinforced cooperation sub-clubs, namely Austria, Belgium, France, Germany, Portugal and Slovenia. The UK stands out as the least integrated of all member states, followed by the Czech Republic, Sweden, Denmark, Poland and Hungary. See N. Koenig: A Differentiated View of Differentiated Integration, Policy Paper 140, Jacques Delors Institute, 2015. On differentiated integration, see W. Schäuble, K. Lamers: Überlegungen zur europäischen Politik, CDU/CSU, 1 September 1994; and F. Torres: A Geometria Variável da União Monetária, in: A. Vasconcelos (ed.): Portugal no Centro da Europa, Lisbon 1995, Edições Quetzal, pp. 129-148.

The eurozone as the core EU

The fundamental lesson from Brexit is that the EU will need to focus and deliver on EU common goods in order to be sustainable. With divergent preferences across member states, that may have to happen through variable geometry. However, too much differentiation, through opt-outs and reinforced cooperation, offers only a short-term solution, as it puts the cohesiveness of the EU project at risk. Spolaore hints at this tension:

...if further integration is going to take place, Europeans may have to accept a multi-speed Europe, with only a subset of countries within the EU voluntarily moving towards a much closer fiscal and political union, while others keeping looser ties, or even leaving the Eurozone and/or the EU. Rather than resisting this reality, European institutions should be built with much more flexibility, and should include explicit provisions not only for entry but also for exit.²⁰

EMU is a political project that has triggered significant integration yet still requires further integration. Making monetary union work requires completing the economic union so that it can sustain the single currency and deliver on the EU's wider objectives. The single market can therefore not be seen as static. It is in the legitimate interest of present and future eurozone members that it be deepened so as to make the monetary union function well, and indeed to make it sustainable in light of the increased interdependencies among members. This requires advances in institutional modernisation and structural reform in the face of globalisation.²¹ The issue is obviously important for the sustainability of the monetary union, but it goes beyond and right to the heart of the EU project. To be sustainable, the EU needs to complete Economic and Monetary Union and make it deliver economic and social results. Member states should be prepared either to contribute to those aims or to leave the Union and seek alternative ways to follow different and non-compatible preferences, be it in the EEA or in free trade agreements with the EU.

²⁰ E. Spolaore: Monnet's chain reaction and the future of Europe, VoxEU, 25 July 2015. See also E. Spolaore: What is European Integration Really About? A Political Guide for Economists, in: *Journal of Economic Perspectives*, Vol. 27, No. 3, 2013, pp. 125-144; and E. Spolaore: The Political Economy of European Integration, in: H. Badinger, V. Nitsch (eds.): *Handbook of the Economics of European Integration*, London and New York 2015, Routledge, pp. 435-448.

²¹ Thus far, preferences on institutions have been evolving slowly, if at all. See A. Bongardt, F. Torres: EMU as a Sustainable Currency Area, in: N. Costa Cabral, J.R. Gonçalves, N.C. Rodrigues (eds.): *The Euro and the Crisis: Future Perspectives for the Eurozone as a Monetary and Budgetary Union*, London and New York, Springer, forthcoming.