# Britain and EUexit – The People Versus the EU

## 3.1 Introduction

The outcome of the UK referendum of 23 June 2016, which sent shockwaves across the nation, Europe, and indeed the industrialized world, was widely interpreted as the manifestation of a new wave of "populism". The British government certainly did not reckon with a "no" to continued EU membership when it called the referendum. David Cameron's cabinet was shockingly unprepared for a "Brexit" (Britain's exit from the EU) and had no specific plan as to how it might be implemented. Opinion polls, financial markets, and even betting markets had anticipated a win for the establishment, and, as in the case of the US presidential election in November 2016, they were proven wrong.

The unexpected "Leave" majority and the process that will ultimately terminate Britain's membership of the EU initially produced a substantial body of commentary and analysis.[1] But much remains to be understood, and Brexit is only one symptom of a deeper, broader, and complicated malaise. The prospect of Brexit is not only proving difficult to digest in the UK, but across Europe. It poses an existential challenge to the European integration process. Angela Merkel remarked in response to Brexit, "We must face the consequences [of Brexit] and consider the future of the EU," adding that "Citizens will only accept the EU if it makes it possible for them to prosper."[2] In the wake of Brexit, and after Donald Trump's election, the EU seems to be the only viable and powerful defender of the principles of a liberal international order.

This chapter examines the determinants and consequences of Brexit, as well as of more general, negative views of the EU's past development and future configuration. We discuss the reasons why the British electorate voted in favour of Brexit, and the implications of that outcome for the country's own economic well-being, as well as that of other EU member states. We interpret Brexit as an extreme instance of more general scepticism about European integration, and hence as an opportunity to reflect upon the interaction of narrow and short-term political perspectives with the cumbersome and incomplete economic policy framework of the EU.

## 3.2 What does Brexit actually mean?

Theresa May, Prime Minister of the new British government formed after the referendum result that prompted David Cameron's resignation, has tried to minimise speculation over Britain's negotiating strategy, and over whether the government may choose to ignore the mandate of the British people. She has repeatedly asserted that "Brexit means Brexit," but this obvious tautology has not helped citizens or markets to better understand what is likely to ensue.

The referendum outcome initially induced a widespread fear of an immediate economic meltdown, comparable to the aftermath of the 2008 Lehman collapse. Stock markets instantly fell all over the world, and the British exchange rate depreciated. The UK stock market then recovered, and growth for the second half of 2016 was surprisingly strong.

Sober estimates of the purely economic costs of UK exit from the EU do not generally predict the kind of catastrophe that would justify the dramatic reactions seen immediately after the Brexit referendum. Large stock market declines may have foreseen much broader and deeper disruption, perhaps because traders (if not the majority of voters) were persuaded by the main theme of the Remain campaign in the UK, and by the far more dramatic estimates of the costs of Brexit produced by the UK Treasury (2016a, 2016b) before the election. The UK Treasury summarised these costs in the spuriously precise headline figure that Brexit would cost each British household an annual 4,300 British pounds by 2030. These figures combine a negative view of the long term consequences of Brexit with a dramatic warning as to the severity of

[1] See in particular Begg (2016) and Baldwin (2016).
[2] Foy, H., "Merkel says Brexit could be a 'breaking point' for EU," *Financial Times*, 26 August 2016, https://www.ft.com/content/ad3d4cc9-5c8b-36cd-b6c5-efd57842909b.

the immediate shock, with a 3.6 percent fall in GDP after 2 years and 500,000 jobs lost (or, in the case of a severe shock, a 6 percent fall in GDP and 800,000 additional unemployed).

The forecasts depended heavily on *ceteris paribus* assumptions. The UK Treasury's publications looked as if they were politically tweaked, because they did not allow for a fiscal and monetary effort to offset the contractionary effects of the immediate shock, while in reality the Bank of England cut rates and the new government announced a large fiscal expansion programme.[3] Moreover, in the long term, the Treasury's figures were based on a gravity model of the trade effects, which may have over-estimated the extent of losses and under-estimated the possibilities of new trade creation (Blake, 2016). Conversely, the more optimistic estimates only considered trade effects (which hardly ever exceed one or two percent) without allowing migration to change, even although restrictions on migration had been a core element of the campaign for Brexit.

It is not so much that forecasts are "wrong," but that the models used did not cover all of the uncertainties that apply in reality. As a result, it is easy to conclude that economists are simply not good at predictions, and that the popular or populist suspicion of experts is fully justified. The Remain campaign's reliance on scare stories about a Brexit – what was termed "Project Fear" – miscalculated its own impact on voter opinion in the UK. As was the case in the US presidential election, the final stages of the campaign saw stock market prices climb with Hillary Clinton's estimated probability of winning; but they rose even further when voters elected Donald Trump. No major catastrophe occurred immediately after the referendum. The markets have recovered recently, and the UK economy is doing well, which is at least partly due to the pound's depreciation. This is not to say that Brexit has little impact, because in an obvious sense Brexit has not yet happened. The formal mechanism to discuss the UK's departure from the EU will only begin when the UK government declares its intention to withdraw by invoking Article 50 of the EU Treaty.[4] The institutional setting in which Brexit will take place remains nebulous. As we discuss below, EU membership means far more than free trade, but the UK government has not yet announced any plan on how to extricate the country from its deep integration with the EU's single market.

Various options for managing the UK's future relations with the EU have been floated, including membership of the European Economic Area (which would require making payments and accepting freedom of movement), or a trade and investment treaty of the kind currently being negotiated by EU and Canada. The first option is attractive to financial interests in the City of London who would like to keep "passporting" rights in the EU, but it is unlikely to satisfy the voters and politicians who supported Brexit. The EU is also reticent about negotiating new trade treaties, and there is even controversy over the Canada treaty and the proposed TTIP agreement. To complicate matters, alternative trade agreements cannot be negotiated while the UK is still an EU member, and certainly not before the UK has invoked Article 50.

The economic test of what Brexit precisely means is still to come, and the politics are fuzzy. How the remaining EU members will respond – and the extent to which voters in these countries will see parallels to their grievances – is also unclear.

### 3.3 Exit, from which EU?

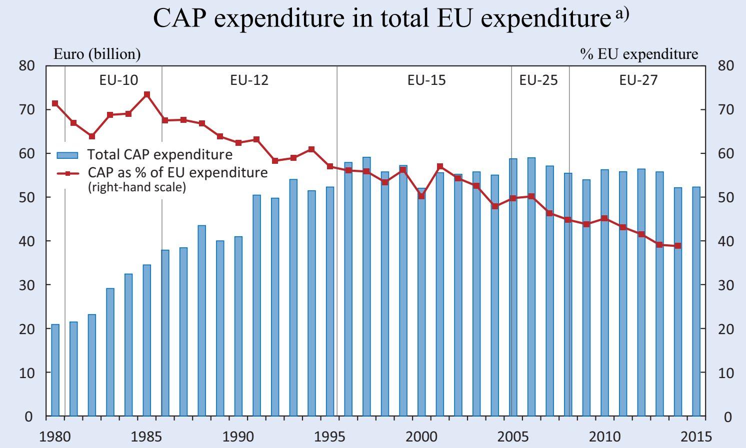
There are many UK particularities that distinguish it from continental EU members. Not only does the UK have no written constitution or identity card system, it also has a rather lightly regulated labour market, far more developed financial markets than continental bank-centric systems, and a welfare state that is less generous, but more easily accessible than continental contribution-based schemes.

Britain's vision of the EU differs from that of other members, and the UK interprets its interests as diverging in fundamental ways from those of most continental European countries. The UK tradition is less regulated, hostile to the idea of Europe-wide fiscal centralisation, less concerned with the fortunes of the agri-

[3] Giles, C. and G. Tetlow, "Fact-Checking the Treasury's Latest Brexit Report," *Financial Times*, 23 May 2016, https://www.ft.com/content/d05c4b60-20d8-11e6-9d4d-c11776a5124d.

[4] "A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. […] The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period."

Figure 3.1




a) Annual expenditure in 2011 constant prices.

Source: CAP expenditure: European Commission, DG Agriculture and Rural Development (Financial Report); EU expenditure: European Commission, DG BUDG-2008 EU Budget Financial Report for 1980-1999, DG BUDG-2015 EU Budget Financial Report from 2000; Annual expenditure in 2011 constant prices; https://ec.europa.eu/agriculture/sites/agriculture/files/cap-post-2013/graphs/graph1_en.pdf.

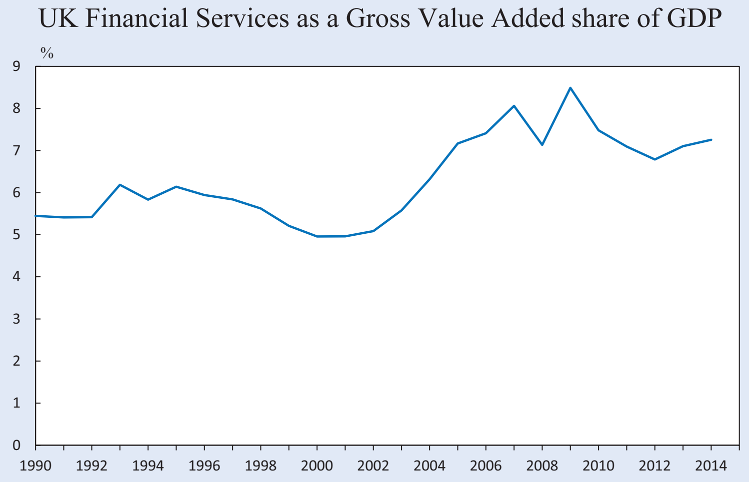
cultural sector, and more dependent on financial services.

The structure of the EU's economic policy framework was established long before the UK's accession in 1973 and is based on the model of European nation states, where market interactions are framed by a pervasive institutional infrastructure. The EU wants market competition to transcend boundaries and prevent inefficient competition among policymakers, but at the same time recognises that markets need to be supervised. Antitrust policies are needed to prevent monopolistic inefficiencies. The regulation and standardisation of product specifications helps to ensure that market participants are well informed. In all advanced countries, and all EU member states including the UK, welfare schemes shelter individuals from the risk inherent in participating in complex and wide-ranging market interactions, fiscal and monetary policies offset aggregate demand fluctuations, and deposit insurance prevents runs on bank deposits.

The challenge for the EU is to maintain and develop these safeguards in cases where markets span national borders. This calls for complex compromises because, even when market structure and institutional frameworks are broadly similar across countries, traditions differ, especially in terms of social and labour policies that remain a pillar of industrial and post-industrial nation-states. The EU's ever-closer-union trajectory uses economic instruments to promote stability, cohesion and growth; and emphasizes cultural convergence around democratic common values. For continental European countries, integration was primarily meant to heal the scars of war and rule out the possibility of future armed conflict.

The British perspective on the need for regulatory and redistributive policies and the historical process leading to European integration differs significantly. For the people and the political leaders of a country that has not, in the relatively recent past, experienced dictatorship, revolution, or serious macroeconomic instability it is natural to value growth more highly than stability or cohesion. It is therefore unsurprising that the UK opted out of the single European currency project, which had been intended to foster market integration and price stability, but also to strengthen identification with Europe. The UK strongly supported enlargement, rather than any deepening of the EU. The logic underlying this strategy was that the accession of heterogeneous, relatively poor countries in Central Europe would make it more difficult to envision a stronger and more cohesive policy framework on the one hand, and would dilute public support for integration with relative strangers on the other. The UK vetoed proposals to harmonise capital taxation. It also declined to sign the Social Charter accompanying European treaties, ensuring that social, labour, and fiscal policies were squarely assigned to the national level, and hence exposed to race-to-bottom tensions. In most of Continental Europe, EU efforts to harmonise and constrain these policies tend to be unpopular with left-wing parties, and attract support for their market orientation from business and elites. In the UK, conversely, EU regulations on working hours and union rights have proven binding enough to draw the criticism from those who feel they unduly constrain individual freedom. The fiscal component of EU economic policies is both underdeveloped (the budget is less than 1 percent of EU GDP) and imbalanced, in that the Common Agricultural Policy still swallows up almost 40 percent of the overall budget (see Figure 3.1). The focus on agriculture is rooted in the history of France and Germany and other continental European economies. In the interwar period, farmers worldwide saw their incomes plunge as new areas started to produce. Food prices, and then farm prices, collapsed. Over-indebted farmers lost their farms, and the banks to which they

Figure 3.2




Source: Bank of England and EEAG calculations.

owed money cut off their credit lines. The interwar period remedies – trade protection through tariffs and quotas – proved ineffective. The European Economic Community's prime fiscal mechanism, the Common Agricultural Policy, set prices for farmers, and offered an elaborate system of subsidies. Managing rural decline proved the most important political payoff of the European process. The UK, by contrast, did not really need this peasant class management system, with only 9.2 percent of employment in agriculture in 1900 and 4.1 percent in 1958. For France, agriculture accounted for 42.2 percent of employment in 1900, a figure that was still high at 22 percent, when the European Economic Community was founded in 1958. Today, only 2.8 percent of French workers are employed in agriculture (2010). For Germany, the equivalent figures are 33.8 percent in 1900, 16.1 percent in 1958, and 1.6 percent in 2010; while for Italy they are 58.7 percent, 32.9 percent and 4.0 percent (Wingender, 2014). A reform should be based on significantly lowering the importance of agricultural transfers.

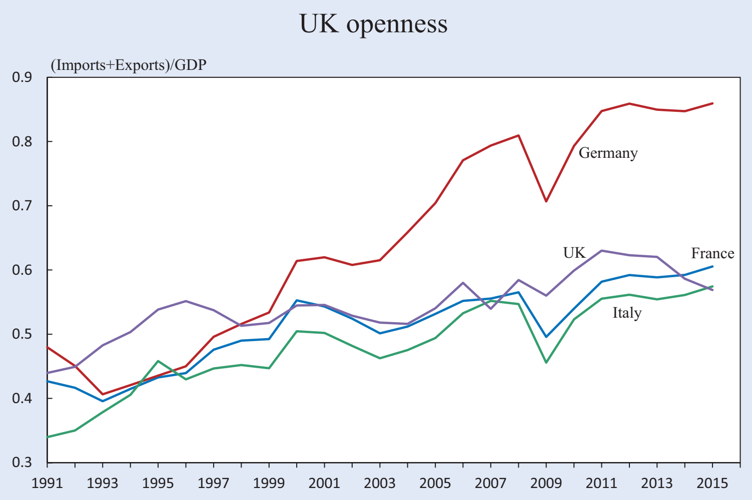
Britain has consistently pursued a half-hearted or semi-detached position with respect to European fiscal integration. The issue of European fiscal capacity surfaced during the Greek rescue package in 2015, when Prime Minister David Cameron refused to participate in financing via the European Financial Stability Mechanism, and Chancellor George Osborne noted that, "the euro area needs to foot its own bill." Cameron had deeply internalised the "money back" lesson established by Margaret Thatcher in the 1980s: Great Britain needs to defend itself against budgetary claims from Europe. At the same time, he and George Osborne were also impressed by American economists who told them that a monetary union without a full fiscal union was inherently unstable, and, as a result, Europe could only save itself by proceeding quickly towards a real fiscal union. The UK therefore found itself in the awkward position of arguing in favour of a drive towards the very fiscal centralisation that it had previously sought to undermine.

The fiscal debate embodied an increasingly apparent policy incoherence that highlighted the anomaly of the British position. As signatories of the Maastricht Treaty, or as later accessories, all EU members without an opt-out (the UK and Denmark obtained an exemption) were obliged to eventually join the monetary union. The euro area itself had no fiscal capacity at all – only the EU did. Thus, in pushing for an approach to the European debt crisis modelled on Alexander Hamilton's system of the early years of the American Republic, the UK was setting itself up for the fundamental choice about whether it should really be part of an ever-closer union along Hamiltonian lines.

There is another key area of policy incoherence in which the UK and continental Europe appear to have conflicting traditions and interests. Financial services form a large part of the UK economy (see Figure 3.2). In terms of value added, the share of financial services in the UK economy rose in the 2000s, but contracted somewhat in the aftermath of the financial crisis. One of the first moments of tension between David Cameron and the other European heads of government occurred in December 2011 when Cameron vetoed proposed treaty changes because they did not provide adequate safeguards for the City of London.

There are two conflicting views of the future of UK financial services and their interaction with the European market. In one interpretation, the UK is successful as a European financial centre, but needs access to the European market. The most straightforward way to grant such access would be the passporting of UK-based institutions in Europe, but this outcome would require UK compliance with Europe's bundling of four freedoms: the free movement of goods, services, and capital accompanied by the free movement of persons. Some argue that there is no logic to this association, and that many societies in a globalised world are open to the first three forms of movement, but not the latter (Pisany-Ferry et al., 2016). Alternatively, in the other vision, the UK's future is as a provider of global financial services, and it would be limited or constrained if it accepted the European regulations that would come with passporting. It could rely on the EU's acceptance of a principle of equivalence, whereby US, Japa-nese, and even Chinese financial institutions have access to the European market when their regulations are accepted as being equivalent to those of the EU. This view suffers from the problem that equivalence is currently being redefined, partly as a response to the Brexit debate, and partly reflecting a trend towards growing nationalism in financial regulation. The out-option for financial services may also draw on the experiences of other small offshore financial centres: Hong Kong and Singapore depend on a good relationship with China, as do Switzerland and Liechtenstein with Europe. In the future Europe would be likely to react with scepticism and hostility to a UK attempt to build a very lightly regulated (and thus potentially risky) offshore financial centre to work with and in Europe.

**Figure 3.3**




Source: AMECO and EEAG calculations.

It is also questionable whether the focus on UK financial services reflects the aspirations of most Brexit voters, who largely disapproved of London's economic, financial and social liberalism, and favour traditional values to the glittering dynamism of a global mega-city.

### 3.4 British visions of exit

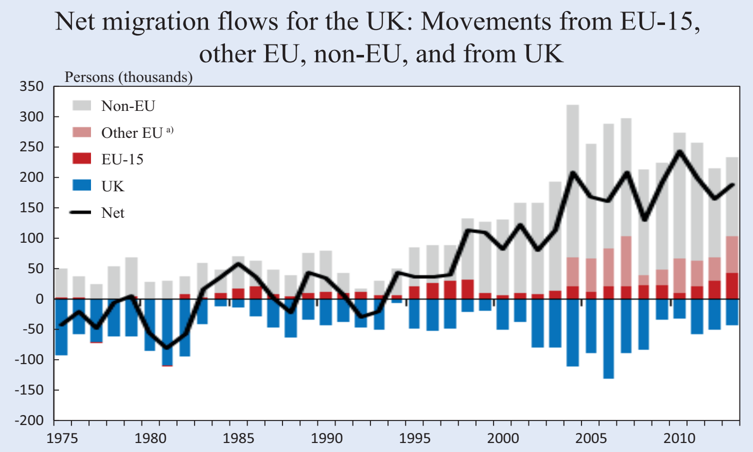
The UK electorate's policy views and referendum vote did not really reflect the difficult relationship between the UK and the EU's complex and nuanced approach to regulation and the market economy. Most British voters own no stocks directly and may be blissfully ignorant of the indirect impact of market interactions on their welfare. Their decision, like the renaming of the South African national rugby team criticised by Nelson Mandela in the movie *Invictus*, was perhaps "based on insufficient information and foresight." Cameron's initial move to hold a referendum on EU membership was driven by concern over electoral competition to the Conservative Party from the radical populist party, UKIP (which participated in and promoted an international spin campaign of the "alt-right" which relied on the distortion of news and the propagation of catchy misrepresentation (Shipman, 2016).

The consequences of Brexit are potentially far more dramatic for British citizens than they perceived when voting. This is because the UK is an exceptionally globalised country in terms of its integration in capital markets (Figure 3.3), and due to large migration flows (Figure 3.4).

In terms of trade integration, Figure 3.3 shows that the UK is comparable with other large EU countries. As of 2000, however, Germany's openness stands out in this group of comparably sized countries. Interestingly, the single currency, enlargement, and the great recession that challenge the EU's institutional structure and decision-making processes are also associated with the far more important role played by international trade in Germany's economy.

Dwelling on aggregate statistics, however, does not help us to understand the revolt against integration expressed by the referendum results. It is far more fruitful to consider what sort of information is available to individual voters and how that informs their point of view.

Figure 3.4




a) Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia.
Source: Nickell and Saleheen (2015).

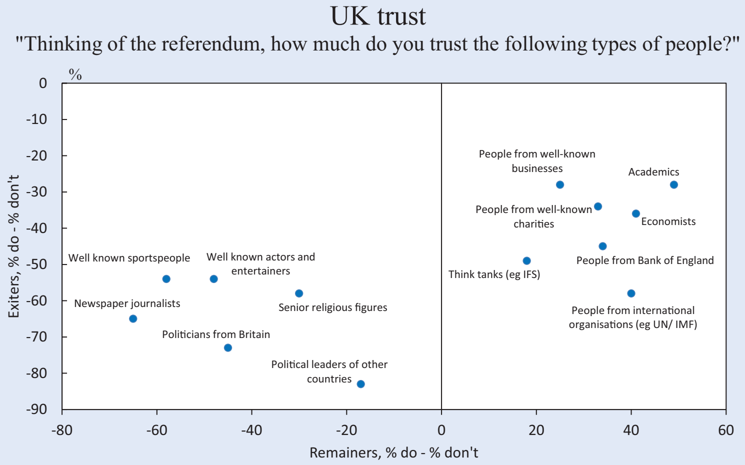
To comprehend why many voters rationally chose "leave", despite the threat of a potential overall economic losses, it is worth remembering that much larger individual consequences tend to be included in an overall average of gains or losses. Economic integration opens up goods and factor markets to foreign competition. Competition increases efficiency and lowers the cost of final products, but also displaces those producers who could supply relatively scarce and expensive services in autarky. Removing import barriers generates widespread benefits, for example in the form of cheaper clothing, and concentrates damages, such as job losses for clothing manufacturers. Survey evidence reveals that international economic integration is perceived to be risky, and that attitudes towards it are related to individual characteristics in ways compatible with the theory of competitive advantage (e.g. Mayda et al., 2007). In advanced countries with more generous welfare schemes, highly-skilled individuals are less in favour of immigration, quite possibly because, as relatively high-income taxpayers, they feel threatened by redistribution towards relatively poor immigrants. More intense foreign direct investment activity is also associated with satisfaction or dissatisfaction with the respondent's present job security in the British worker survey analysed by Scheve and Slaughter (2004). They find that variation over time within a sector of indicators of Foreign Direct Investment activity, controlling for the aggregate cycle, has an effect on perceptions of job security that is statistically very significant and roughly twice as strong as that of worker unionisation, education, and income.

Differences of opinion within the UK are not difficult to rationalise in terms of these simple economic insights into integration's distributional impact, and voters' socio-economic characteristics. Low-skilled workers are theoretically expected to oppose immigration more strongly than high skill workers in countries where immigrants are more markedly less skilled than residents; in the UK, more educated voters voted Remain and geographic and demographic factors also played a significant role (see e.g. Darvas, 2016). Although workers in heavily export-dependent manufacturing areas that enjoy large-scale European corporate investment, such as the aerospace manufacturing city of Derby, opted for Brexit, it makes sense to remain in the EU for Londoners and other city dwellers who can rely on the help of unskilled immigrants if they are not themselves immigrants, and who derive their income from the international sales of financial services. Conversely, short-termist populist positions are coherent choices for elderly voters who will not be around in the longer run, and do not worry about large future demographic and skills imbalances as a result.

Diverse views are very imperfectly aggregated by a narrow overall majority on a single yes/no issue. In fact, leaving the EU appealed to Brexit supporters for a broad spectrum of very different reasons. The coalition that narrowly won the referendum included pro-business, market-oriented voters who resent the EU as a source of bureaucracy and regulation, as well as the elderly and the poor, who support social welfare policies and fear competition. It is far from clear that the Brexit supporters agreed on much else. Interestingly, Prime Minister May has expressed views that are aligned more closely with those of Brexit supporters who fear competition than with those of free-trader business, but her government has also (drawing a sharp rebuke from Germany) outlined plans to sharply reduce corporate income tax rates.

Let us now consider the information on which voting was based. Many myths published by the British tabloid press and propagated by UKIP and other EU critics are collected at the Euromyths index, where European Commission officials patiently explain the rationale of regulations that, in any case, are not as extreme as eurosceptics are led to believe by their infor-

Figure 3.5




Source: YouGov, A. Kirk and D. Dunford, "EU Referendum: Leave Supporters Trust Ordinary 'Common Sense' more than Academics and Experts," Telegraph, 22 June 2016, http://www.telegraph.co.uk/news/2016/06/16/eu-referendum-leave-supporters-trust-ordinary-common-sense-than/; and EEAG calculations.

mation sources.[5] The results of a YouGov survey help to address the perplexing issue of why voters chose Brexit (cf. Figure 3.5), despite the fact that not only most experts and financial markets, but also most of their political leaders and democratic representatives thought it was bad for Britain.

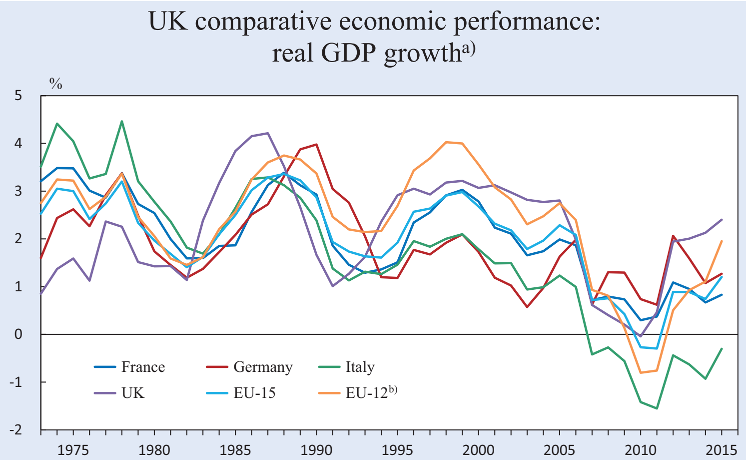
Even among voters who voted for Remain, the figure that expressed trust in academics, economists, businessmen, the Bank of England, the International Monetary Fund, and other policy research organisations was only around 30 percentage points higher than the number of Remain voters who distrust such expert advice. Among Brexit supporters, distrust dominates trust by between 30 and 60 percentage points, putting international organisations on the same level as actors, entertainers, and sports champions; with journalists, UK and foreign politicians, earning the almost unanimous distrust of Leave voters. One common criticism in the campaign was that the experts were part of an international elite, whose advocacy of globalization was preeminently self-interested. It appears that the referendum vote was indeed chiefly motivated by individual gut feelings and that, perhaps as a result of previous communication mistakes, efforts to inform voters were doomed to fail.

### 3.5 The bottom line: what will Brexit cost Britain?

The UK has apparently been slightly more successful or dynamic in terms of GDP growth than most European economies in recent decades, but over the last ten years it has performed relatively poorly in terms of productivity (Figure 3.6) and wage growth (Figure 3.7), with the gap between the UK and other major economies (France, Germany, or indeed the US) widening in recent decades. These facts are interpreted differently by Brexiteers, who think productivity would improve if it were free of EU shackles, and by Remainers, who think the UK has largely benefited from membership of the European Community/EU. Indeed, the Remainers believe that Britain may stand to benefit even more from additional labour market regulation, not least because Britain's relatively strong employment performance relies on low wages and job insecurity, which fuel discontent and political populism; and hence may cause present and future protest votes against the British government (Tilford, 2016).

The critical question is thus how far EU market access, and integration in a labour market that allows or encourages the free mobility of labour, affects Britain's economic performance. There may be major weaknesses that make life outside the EU problematic, including low historical investment in infrastructure,

Figure 3.6




a) Moving averages (5 years, unless restricted by data).
b) Calculated as unweighted arithmetic mean.
Source: OECD and EEAG calculations.

5 The Euromyths A-Z index is available at http://blogs.ec.europa.eu/ECintheUK/euromyths-a-z-index/.

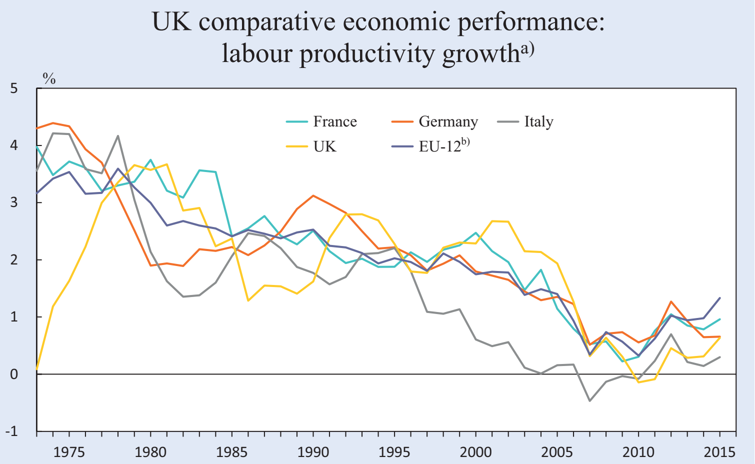
low investment in housing (leading to a housing shortage and very high prices that largely exclude first time buyers), and low educational attainment (see Tilford, 2016). The last shortfall, in particular, points to foreign skilled and unskilled workers as an essential driver of UK dynamism in the future.

The longer uncertainty prevails over the UK's access to markets, and the nature of its future migration policy (including the position of current EU nationals working in the UK), the higher the costs to the UK economy will be.

Of the UK population (63.7 million), 5.3 million (8 percent) are non-British, and just over half of this figure i.e. 2.9 million (5 percent) are from the EU. 2.15 million of these Europeans have a job. The by far largest group of European immigrants is from Poland (853,000), followed by the Irish (331,000).[6] These large numbers can easily be seen by natives as congesting their common goods, straining infrastructure, health services, and housing, as well as threatening their cultural or national identity. However a dramatic reduction in the number of immigrants would cost everybody in Britain. A repatriation of these migrants would lead to substantial labour shortages in some sectors (cf. Figure 3.8), including the National Health Service, but also in the hotel and hospitality industry, and in agriculture. 45 percent of workers in elementary trades are foreign, with the vast majority coming from the EU (the famous Polish plumbers and carpenters). Nickell and Saleheen (2015) have tried to calculate the wage effects of their presence, and noted only a modest decrease during the period of immigration. There are also substantial numbers of Europeans working in highly-skilled jobs in financial services. Over 30 percent of health professionals are immigrants, although mostly non-EU. Their departure would presumably lead to higher wages for UK natives with the appropriate skills or inclination, but also to higher prices for services.

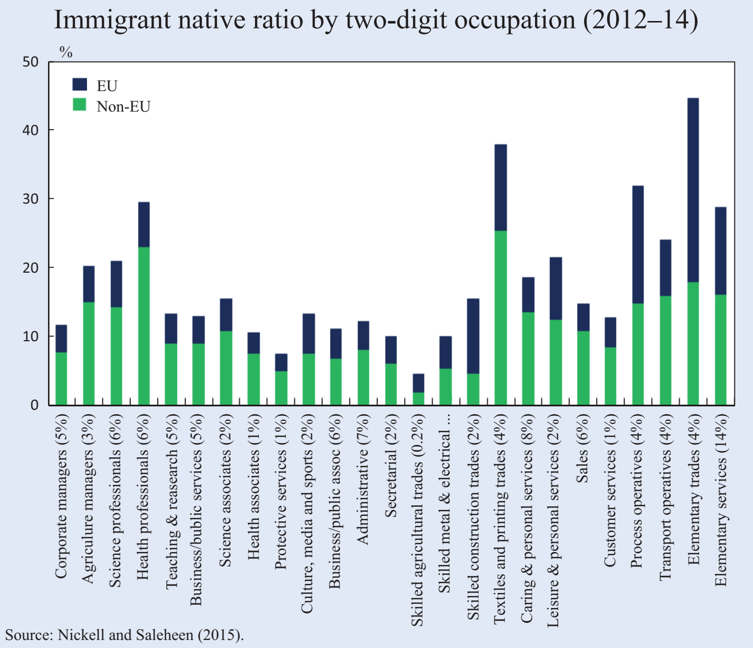
The status of these migrants is unclear, partly because the UK government would like to obtain concessions regarding the position of UK nationals in other European countries, primarily in Spain, Ireland and France. A total of just under 1.2 million UK nationals live elsewhere in the EU. So a very substantial part of

**Figure 3.7**




a) Moving averages (5 years, unless restricted by data).
b) Calculated as unweighted arithmetic mean.
Source: OECD and EEAG calculations.

**Figure 3.8**




Source: Nickell and Saleheen (2015).

[6] Data from UK Office for National Statistics, *Population of the United Kingdom by Country of Birth and Nationality*, http://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/internationalmigration/datasets/populationoftheunitedkingdombycountryofbirthandnationality.

the UK economy is being held hostage to the bargaining process.

### 3.6 Euroscepticism in the rest of the EU

The British ballot choice was narrow-minded and short-termist; or "populist" by this EEAG report's definition, and based on very imperfect information. The UK peculiarities discussed above make it unsurprising that, of all member countries, it would be this one to make the unprecedented choice to leave the EU. Some features of the anti-EU vote in Brexit, however, reflect the more general populist wave that is sweeping many industrialised countries, including the US. The migration debate is a focus for criticism of the EU in the UK, where it explains both Britain's longstanding refusal to join the Schengen border-free group of countries and recent popular support for Brexit. But the same debate is dividing other countries: Angela Merkel's post-2015 refugee policy attracted a great deal of criticism in the UK referendum campaign. Opposition to her policy has also fuelled anti-EU sentiment in Germany, where the populist and xenophobic AfD party is doing remarkably well in Länder elections, and will run in Federal elections on a promise of calling for a Dexit (German exit from the EU) referendum, as well as in France, where each foreign populist success (Brexit, Trump) strengthens Marine Le Pen's Front National.

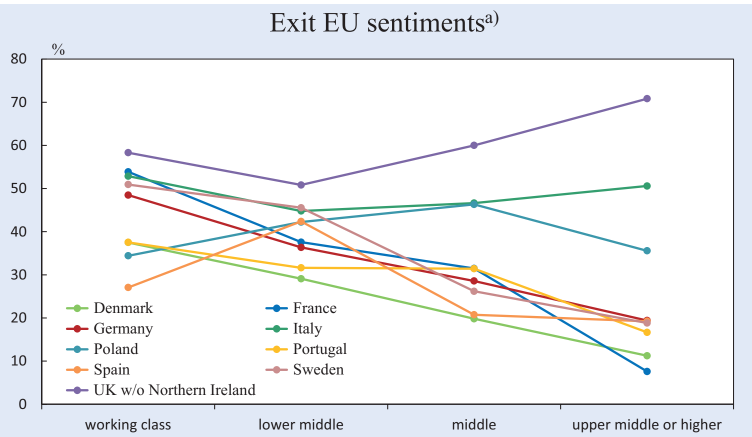
Other countries' citizens have not yet been asked to vote in a referendum, but the Eurobarometer survey elicits the opinions of about 1,000 respondents in each country or region (cf. Figure 3.9; a smaller sample is polled separately in East Germany and Northern Ireland). The most relevant Eurobarometer question asks respondents whether they more or less strongly agree or disagree with the notion that their country would be better off outside the EU. The question does not explicitly ask whether respondents are personally in favour of leaving the EU. As in the UK referendum, however, that is a natural interpretation, and opinions are effectively strongly related to the respondents' socio-economic status.

Higher-class individuals are generally more likely than their less privileged peers to think that EU membership is a good thing within most of the countries shown in Figure 3.9 (but not in the UK, where Brexit already loomed clearly in the 2015 Eurobarometer, and to a lesser extent in Italy and Poland). This gradient is strong enough to make opinions differ as much across classes within countries as they do across country averages. Middle-class French, Italian, Swedish, and German respondents like belonging to the EU just as much as Spanish, Polish, Portuguese, and Danish working-class respondents, even although their working-class compatriots are far less enthusiastic about EU membership.

A similar heterogeneity of opinions is undoubtedly present along other dimensions. Some are also observable in the Eurobarometer survey, where age makes a noticeable difference in many respects. For example, when asked "QA11: what does the EU mean to you personally?", one-third of respondents aged 60+ mention "Peace", but only one quarter or those aged 30 or under do so, suggesting that the crisis of the original EU project may also reflect fading memories of war. Opinions on EU membership are likely to be far more similar among well-educated residents of large cities across the EU than the views of Londoners and rural English people. However, the absence of Europe-wide political debates and decision processes makes it difficult, if at all possible, for the opinions of international groups to be heard; or indeed voiced in a mutually comprehensible language.

An interesting feature of opinion polls on EU membership is that even in relatively poor countries,

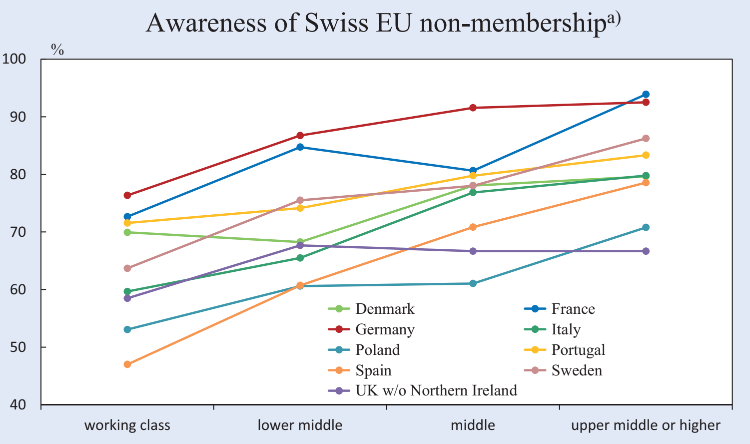
**Figure 3.9**




[a)] Proportion ("don't know" responses excluded) of respondents who Agree or Tend to Agree with qa18a_5 "(OUR COUNTRY) could better face the future outside the EU" plotted against the response to d63 "Do you see yourself and your household belonging to…?" … class of society.

Source: Eurobarometer 84.3 (November 2015) and EEAG calculations.

Figure 3.10




[a] Proportion of respondents who reply "False" to qa14_3 "Switzerland is a Member State of the EU" plotted against the response to d63 "Do you see yourself and your household belonging to…?" … class of society.
Source: Eurobarometer 84.3 (November 2015) and EEAG calculations.

where integration should be most beneficial to the lower classes, the rich support the EU more than the poor. As in the case of the Brexit referendum results, so everywhere else in Europe individual opinions may in fact reflect not only an objective assessment of personal pros and cons, but also a degree of ignorance (or misinformation) about the issues at stake.

The Eurobarometer asks respondents some questions about the EU's structure and institutions. It finds that a substantial proportion of European citizens do not know that Switzerland is not an EU member. Figure 3.10 shows that such ignorance is interestingly correlated with negative views about EU membership. To some extent this is the case across countries, with British respondents (especially in the more privileged strata of the population) displaying both the most negative views about the EU and the lowest familiarity with what the EU means. More interestingly, the correlation is similar across social classes: in each country, those higher up the social ladder tend to be better informed (which may explain why they more strongly favour EU membership even in relatively poor countries). Within each class ignorance also seems to beget rejection of the EU. In both Denmark and Portugal, for example, 37.5 percent of working-class respondents think their country should exit the EU, but in both countries only about a third of those respondents know that Switzerland is not in the EU, while about two thirds of working class respondents who think their country is better off inside the EU are aware of this fact.

### 3.7 EU responses: special deal versus damaging divorce

The Brexit referendum outcome and Eurobarometer opinions give grounds to reflect on how the EU might be improved, rather than destroyed by widespread scepticism or hostility. Ignorance may be at least partly excused because the EU's structure is complicated and can seem obscure. It mirrors the problems that the EU tries to solve, which are often complex and unclearly defined. As a result, EU regulations are widely perceived as an occasionally perverse set of bureaucratic constraints imposed from a distance.

Theoretical inconsistencies abound in the EU's policy framework. There is supposed to be no supranational competence on taxation or social policy, except when these distort a level playing field for trade (as is almost always the case, and has recently been recognised by the European Commission in the case of a multinational, company-specific tax ruling). Popular political sentiment typically favours the notion that policies are right (or better) when they are decided at the national (or lower) level. Such opinion is based on fears that more distant policymakers cannot be effectively monitored, and on the belief that politicians who live in an isolated bubble may only too easily ignore the day-to-day problems of ordinary citizens, and be swayed by the lobbying efforts of special interests. Improving transparency and accountability is hence a vital part of an EU reform agenda.

The widely-expressed preference for local decision-making and the belief that politics should always be local, rather than centralised, is problematic for two reasons. The first is that the effects of some policies transcend national borders. Just as it would be absurd to let each household decide how its own income should be taxed, so it is advisable to coordinate tax policies at the same supranational level at which markets operate. Uncoordinated choices in these respects generate spillovers across borders and justify moral hazard suspicions. For European public goods, from defense and border controls to long-range transportation and energy networks, the costs of common production are also obviously lower, and should be shared across all beneficiaries. It is not easy to transfer such decision-making and implementation powers to supranational bodies in the absence of an accepted political aggregation process like that of sovereign nations.

The second reason is that, even when policies have only local effects, they may not be chosen appropriately by local political processes: just as markets can fail, so can governments. Let us consider, for example, taxi regulations (a topical policy problem in the Uber era). Delegating the power to decide on the number of taxi licenses and the structure of taxi fares in cities they know little about to bureaucrats in Brussels would reduce the amount of useful information available to policymakers, but would also prevent capture of local regulators by powerful local lobbies.

These two principles give a rationale for many of the EU's competencies. From limitations of deficit spending to cucumber size and shape regulations aimed at standardising and easing trade, EU nations have more or less grudgingly accepted that EU bureaucrats should be in charge of setting many of their own policies. A large proportion of EU legislation now stems from community decision-making methods, characterised by a complicated hierarchy of unanimities and majorities and co-decision powers meant to endow the EU with its own political legitimacy and personality.

In many cases, however, and especially in crisis situations, national governments want to play a far more important role than that of the Council in a co-decision-making process, and would like European choices to be rubberstamping the outcome of intergovernmental processes. Brexit may again illustrate the more general issue. British Prime Minister Theresa May has been engaging other national leaders while ignoring Brussels, the Commission, and the newly appointed chief EU Brexit negotiator Michel Barnier. However, the conditions of eventual secession will have to be agreed upon by the Union, rather than by individual member states; and it would be disastrous for the negotiations to have to respect deals struck by the UK with specific countries.

How the rest of the EU reacts to Brexit is crucial to its future development. Accepting UK participation in the single market without personal mobility would dilute the project. A bitter divorce could consolidate the remainder of the EU as it rethinks its core purpose. But a push towards further political integration as a response to Brexit (as well as to Putin and Trump) may not be credible or politically feasible: public opinion currently favours national sovereignty, so an attempt to build a more coherent EU may well trigger a disastrous sequence of acrimonious exits. For many years the EU has been leapfrogging obstacles, turning every crisis into an occasion to strengthen its policy framework. The same process, however, can quickly shift into reverse, turning even minor nuisances into an occasion to dismantle some community powers.

Europe's position in the forthcoming negotiations over Brexit represents a deep strategic puzzle. Given that cutting the UK out of the single market would damage the remaining EU member countries, not least by depriving their economies of easy access to an efficient global financial center, it is tempting to think that the EU-27 should adopt a flexible attitude in a bid to preserve as much of the remaining countries' economic surplus as possible. Perhaps the EU-27 could let the UK stay in the single market, and exercise lenience over labour mobility and budget contributions in the upcoming negotiations. An advantage of this strategy would be that, in the current political environment, insisting on the four freedoms as a package may counterproductively fuel resentment at the EU's centralistic approach in other countries, and risk provoking a general backlash. In Angela Merkel's words, perhaps the EU should not be "garstig" (hateful or ugly) to the UK.

Unpacking some elements of EU membership to give the UK a special deal would, however, be complicated and dangerous. Labour market and financial market access have different importance for different countries. A deal that treats the UK kindly, by granting a single market "passport" to British financial services even as the UK is allowed to select incoming persons for instance, may well suit the richer and most industrialised areas of continental Europe. However, it would be unacceptable to Central and Eastern European member countries. As each country (or region) tries to defend its own interests, it would be hardly possible to refuse similarly special deals in other policy areas once such flexibility is displayed towards the UK. Stepping back from the degree of integration that has already been achieved would thus make it very difficult to develop the single market in areas where it is still very incomplete, such as personal and digital services The most worrying prospect of all is that a soft Brexit might provoke other imitators, especially in countries with similar social dynamics (Sweden would be an obvious candidate), in a falling domino pattern that turns the EU into a jumble of multilateral (or even bilateral) international deals.

It is therefore only a matter of self-preservation for the EU to adopt a clear stance at this pre-negotiation stage: the UK can participate in the single market only if, like Norway or Switzerland, it essentially embraces all of the other key EU policies. The only clear feature of the UK's position is that this would not be acceptable to its electorate and government. Other than that, the UK's negotiating strategy remains very unclear as this EEAG report goes to print. It is, in fact, difficult to envision what outcome would be both realistically possible and acceptable for the UK. The British public may very possibly interpret the European position as one of cruelty, meant to make Britain's path to economic and political stability rockier. British negotiators, responding to that clear European negotiating logic, may retaliate by attempting to make the process as painful as possible for the rest of the EU. The referendum campaign for Brexit was already driven by a firm belief that the UK would be better off on its own, and that the decision to leave would hurt Europeans far more than Britons.

As a fear of domino effects tilts EU negotiating strategies towards intransigent attitudes, and British popular sentiment similarly rejects sensible flexibility and demands fulfilment of that European disaster prophesy, the UK and Europe head towards a bitter and contested divorce: a Brexit that will be hard for Europe, too.

Faced with the likelihood of a damaging divorce, the UK may well try the equivalent of unilateral disarmament, giving the EU-27 open access to the British market for goods and services, in the belief that such openness might produce a rethinking of the continental European position. Such reconciliation might appear more attractive in the context of an increasingly politically insecure world and of the perception that the UK is a vital part of the overall European security structure. That benign outcome, however, depends in turn on an EU that has a more effective view of its own best interests and indeed of its fundamental coherence.

### 3.8 Crisis threats and EU development

Could Brexit offer the EU an opportunity to streamline itself and become more effective in dealing with numerous policy challenges, and more successful in attracting the support of its citizens? On the one hand, even in the absence of actual further exits, the political climate at present seems inclement to further integration. On the other hand, Brexit removes a powerful opponent to integration.

For example, plans to try and enhance cooperation among EU countries in defense and security (an obvious European-level public good) were kept on hold by the Commission until after the Brexit referendum, for fear of fostering negative sentiment in Britain. But given that UK opposition was the reason for the demise of earlier efforts in that direction (most recently by the Franco-German-Polish "Weimar triangle" in 2011), and in view of the need to reorganise European defense in the changed atmosphere created by Donald Trump's distancing of the US from NATO, Brexit means that proposals for permanent enhanced cooperation in defense are being made by the High Representative of the Union for Foreign Affairs and Security Policy at meetings of defense and foreign ministers.

Given that Brexit also removes obstacles to further fiscal integration in the EU, countries that wanted more fiscal integration and more transfers consequently see it as an opportunity to exert greater influence. Since Europe can't afford another "exit", other potential candidates are effectively deriving strong political leverage from the precedent set by Britain. Portugal and Spain have already escaped sanctions for violating the fiscal pact, largely due to uncertainties generated by Brexit. Perhaps the most obviously vulnerable country is Italy, one of the three largest EU countries, along with France and Germany, and one eager to play a greater role in European intergovernmental dealings (as the former Prime Minister Renzi made clear at the tripartite meeting to relaunch post-Brexit Europe on the symbolically important island of Ventotene, where Altiero Spinelli coauthored the European federalist manifesto as a prisoner of Fascism). The Italian government, however, is deeply frustrated (to the extent of threatening a veto in EU budget negotiations) by what it perceives as blatant disregard of its views on the revision of immigration and fiscal policies.

### 3.9 Common problems, common solutions?

There should be a better way forward to striking a balance between widespread scepticism over deeper integration on the one hand and the global challenges – both in economic and security terms – that make further integration almost inevitable on the other. The post-war European integration process was meant to result in a wider and more politically acceptable club of equals, within which France and Germany could work on their relationship in a more cumbersome, but also more constructive way than the wars which, not least due to British interference, had for centuries failed to yield a clear conqueror and a larger unified continental European state. Perhaps because of enlargement, and certainly as a result of the euro crisis, the EU's decision process and bureaucratic powers have taken a back seat to national policy priorities over the last decade.

Unfortunately, intergovernmental bargains cannot be as forward-looking and comprehensive as the EU is ideally envisaged to be. They can be more flexible, in the same way as speed dating is more flexible than a marriage with its cumbersome decision processes and complicated divorce procedures. Flexibility has short-run advantages, but a lack of commitment makes it difficult to coordinate the plans needed to achieve longer-term objectives. A promise to be together for better or for worse can be credible if divorce is difficult, fosters solidarity, and provides incentives to smooth out differences and invest in forward-looking projects.

Intergovernmental policy negotiations are useful when crises require immediate actions. However their appeal is generally stronger in a populist political environment that targets immediate self-interested benefits with no regard for their side effects and ultimate consequences. Moreover, deals struck between country leaders balance powers in conflictual ways and can engender resentment against the EU in smaller countries: if EU action is perceived to be the outcome of negotiations between French and German leaders, it cannot easily be accepted by the Italian or Dutch public.

In any integrated economy, it is necessary to find long-lasting and constructive compromises that bring together often contrasting views of how the economy should be managed. Can effective state interventions be sufficiently controlled and monitored so as to ensure that they are not simply a breeding ground for fresh corruption and inefficiency? In what ways can the private sector be involved? There are clearly important public goods that could be realized, and gains that could be reaped.

An obvious project is the integration of the flow of refugees, an area in which precedents are also to be found in moments of deep crisis such as Germany in the aftermath of 1945, or France in the wake of decolonisation, when millions of newcomers generated prosperity and dynamism. Another genuinely European project would lie in building infrastructure to connect local and national energy systems, which currently have incompatible pricing structures. In this field there are clear gains to be made from integration: the greater the diversity of supply and the more market alternatives exist (including different forms of energy), the more resilient the energy economy becomes against unanticipated events, including attempts to blackmail energy users.

### 3.10 How Brexit shifts the balance of EU voting power

In some European countries, notably Germany and some Central European states, the UK was seen as an important ally in a struggle to impose market principles, whereas in France and other countries it was largely seen as a blocker. National views of the consequences of Brexit largely reflect its possible effects on more or less desirable implications for EU. If Brexit moves the EU towards a more cohesive and dirigiste configuration, this is a positive development in the eyes of those who, as is often the case in France, think the state should play a strong economic role that is threatened by international competition. In countries where public opinion no longer favours ever closer integration (except perhaps with regard to a common army) and feels that taxpayers have been unfairly forced to pay for insolvent debts, as is typical in Germany, the fear is that without the UK, the EU will become "too Southern": not sufficiently market-oriented and, above all , not fiscally austere. Both Donald Trump and the new British government are making fiscal expansionism a key part of their agenda.

For those who worry about a return to fiscal profligacy, their main concern relates to the process of decision-making in the EU, and in particular the voting mechanism. On many issues the European Council decides on a system of Qualified Majority Voting, which requires a majority both of member states and of the EU population: 55 percent of members states representing at least 65 percent of the EU population need to approve a measure (or conversely a blocking minority in the European Council requires states representing 35 percent of the population). With the presence of the UK, and as long as the British government was firmly in the hands of market liberals, Germany could be sure that it could block efforts to introduce not only anti-market policies, but also and especially to endow the EU with a fiscal and banking framework that would allow public money to cross national boundaries. Without the UK's 65 million people, the EU balance shifts. Some formerly communist countries in Eastern Europe (Poland, and especially Latvia, Lithuania and Estonia) are strong supporters of market liberalism, but as net recipients of European structural funds, they may support the expansion and centralisation of supranational economic policies. Germany and its neighbours Austria, Belgium, Luxembourg and the Netherlands, plus Denmark, Finland and Sweden, have a population of 141 million, or 31.7 percent of the population of the remaining EU-27. This figure falls short of the 35 percent blocking vote.

No phrase causes greater political allergies than "transfer union" in Germany, where prevailing views involve resistance to higher debt levels and expansionary monetary policy. In France or Italy, the opposite is the case: popular opinion tends to hold public spending, preferably resulting in large deficits, for an economic policy panacea. Such simplistic viewpoints, rooted in narrow and self-interested perspectives, stand in the way of constructive compromises that, within both the EU and nations, should take a broader, longer-term approach to economic policy and taxation and recognise the broader and deeper economic and social advantages of sticking together.

Similarly, attempts to set up a suitable financial infrastructure, especially in the form of a proper banking union, are also being hampered by narrow-minded and shortsighted policy perspectives and political interactions. In an integrated monetary and financial market, banks are allowed to operate everywhere regardless of their nationality. Supervision and resolution should accordingly be carried out at the market-wide level. In the euro area, conversely, governments resist international bank takeovers and mergers, and are tasked with preserving the viability of their own countries' banking infrastructure. Insurance premia should be pooled across all deposits in the integrated money market, and deposit insurance funds should be a standby facility designed to preempt self-fulfilling crises, rather than to be tapped in order to shore up weak banks. Eurozone banks also lack a risk-free reserve asset like federal debt in the US, with the unfortunate consequence of vicious bank and government financial solvency spirals.

In the past EU crises have often been seized upon as an opportunity to leap forward and resolve such inconsistencies. More recently, by contrast, financial problems have tended to induce the repatriation of assets and liabilities and the renationalisation of banking systems. Progress towards resolving this problem is particularly hampered by Germany's resistance to supranational supervision of all of its banking sector and suspicion that any insurance scheme would imply resource transfers. This attitude is understandable in the light of other countries' symmetric tendency to try and tap common funds, but the resulting policymaking process is clearly not farsighted enough to keep the Union on the safe side of the brink.

### 3.11 The EU as an antidote to populism?

Only accurate and credible information on long-term policy trade-offs and disciplined politics can remedy short-termist populist tendencies to seek narrow, self-interested instant gratification, and rectify the resulting myopic behaviour that accelerates crises and makes it difficult to resolve them.

In principle, the EU's long-term, slow, cautious, wide-ranging policymaking process could help to offset such tendencies in national political processes. Indeed "Europe" was for a long time a useful excuse for politicians not to indulge in deficits and other popular policies. Just like bank runs can be prevented and controlled by wise regulators, so policymaking based on narrow and nearsighted self-interest can be kept in check by requirements to abide by European rules, justify policy decisions, and submit them to supranational audits. National policy makers (at least in large countries) also fear the public might not like such supranational accountability. This, however, is merely another instance of populist thinking. If European level policies are the only way to address many of Europe's long-term problems, then European-level issues do need to be discussed from a pan-European point of view, and not from a nation-state perspective.

The European co-decision policymaking process, involving the Commission, Parliament and Council, is cumbersome, but may take that point of view more naturally than summits of national leaders, which tend to produce lowest-common-denominator compromises of different, but equally narrow perspectives. The intergovernmental decision process and the particular importance of Franco-German negotiations is a child of Germany's reunification, just like the euro. Both may destroy the EU, but at least the euro makes it stronger if it does not destroy it.

Europe needs to deliver. It certainly needs a vision, and needs to communicate that vision effectively. But equally importantly it needs evidence that the vision produces results. It may be unfair, but is very natural for citizens to blame the EU for economic problems even when they originate elsewhere. Recognising that the most popular policies are now those with the most immediate and visible effects, the European Commission has prioritised capping mobile telephone roaming charges: certainly a minor issue, but an achievement nonetheless (as British tourists will notice when they are charged what is now paid by Swiss visitors on the Continent and Cyprus after Brexit).

Without substantial results and visible gains from co-operation, ordinary Europeans will lose sight of the European vision and their sense of a shared identity. The populist political equilibria arising from an "all is lost anyway" sentiment can be preempted if the EU monitors policy and can convincingly promise that sound policies will yield a brighter future that is well worth some short-term sacrifices. Unfortunately, that promise itself lost credibility during the crisis, in which the EU's incomplete institutional structure has appeared unable – not only in populist eyes, but also in the eyes of those who see an "ever-closer union" as the only robust solution to Europe's problems – to formulate and implement sensible and constructive compromise solutions. When unruly nations ignore supranational constraints, populist leanings are not only insufficiently controlled, but may even be reinforced by EU institutional failures. EU constraints, previously invoked as a reason to reform, are now often presented as something to be removed, possibly by exiting the EU. This new balance of bargaining power is well exemplified by the cases of Austria in the early 2000s and Hungary more recently. The former was sanctioned when its populist election results threatened democracy.[7] The latter escaped reprimands even as it meddled with the balance of judicial and monetary and political powers enshrined in the acquis communautaire and refused to participate in the European refugee relocation program. Similarly, a recent attempt by the Commission to reprimand the Polish government's grab for control of the constitutional court was met with scorn in Warsaw. A Europe that is being pushed conceptually back to a narrower core might find it hard to respond effectively to global problems.

[7] Article 7 of the Nice Treaty states that the European Council can declare the existence of "a serious and persistent breach of fundamental rights". If this occurs, the Council may, by a qualified majority, suspend certain of the rights of the country concerned. This procedure is supplemented with a 'preventive instrument' that is very hard to activate. The text reads: "On a reasoned proposal by one third of the Member States, by the European Parliament or by the Commission, the Council, acting by a majority of four fifths of its members after obtaining the assent of the European Parliament, may determine that there is a clear risk of a serious breach by a Member State of principles mentioned in Article 6(1), and address appropriate recommendations to that State." The values and principles are spelled out as follows: "The Union is founded on the principles of liberty, democracy, respect for human rights and fundamental freedoms, and the rule of law, principles which are common to the Member States."

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