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What Future for the EU After Brexit?

How should the European Union react to the decision of the UK to withdraw from the union? This is the question that has been at the centre of the political debate in Europe since Brexit became a reality. In this article, I will first discuss the nature of the reforms that are called for as a result of the Brexit vote. I will then turn to the issue of the negotiating strategy that the EU should adopt towards the UK.

The starting point in trying to answer the question of how the EU should be reformed is the observation that the European Union has a very negative image today, not only in the UK but also in other parts of the EU. According to many analysts, this has to do with a democratic deficit of the EU.

There is certainly a lack of democracy in the decision-making at the European level. But is the democratic deficit at the EU level worse than at the national level? Legislation in the European Union is made by the Council of Ministers and the European Parliament. The ministers are sent by their national governments, which hold power as a result of democratic elections in each country. Members of the European Parliament are elected directly. Thus, the decision-making bodies in the European Union have the same democratic legitimacy as national governments and parliaments. If there is a democratic deficit, it is the same at the national and European levels, and both national and European institutions should be examined and reformed.

I see a deeper cause of the dissatisfaction with the European Union. I argue that this dissatisfaction has to do with the inability of the European Union to set up a mechanism that protects the losers of globalisation. Worse, the EU has reduced the capacity of national governments to take on the role of protector, while nothing has been done to create such a mechanism at the EU level.

Free trade creates an incredible dynamic of innovation and material prosperity. This prosperity, however, does not benefit everyone. While many are better off thanks to globalisation, many others are not. Some even see their welfare decline because they lose their jobs or because their incomes fall.

As globalisation creates material welfare, it is in principle possible to compensate the losers from globalisation. Indeed, it is precisely this argument that persuades most economists to defend globalisation. However, the political obstacles to organising redistribution towards the losers of globalisation are large. This is a problem in most industrialised countries, but it is made even more intense in the EU.

The European institutions have become major promoters of globalisation. The single market and the trade agreements reached by the European Commission have widely opened the European gates to globalisation. There is nothing wrong with that per se. Unfortunately, there has been a complete failure to organise the necessary compensation for the losers of these policies. The European institutions have no power over social policy, which has remained firmly in the hands of the national authorities. However, the hands of these authorities have been shackled by the same European institutions' fiscal rules.

The EU's fiscal rules not only make it extremely difficult to compensate the losers from globalisation, but they have actually amplified their hardship. For at least the last five years, the European Commission has pushed all eurozone member states into an austerity straightjacket that has produced economic stagnation and rising unemployment – particularly in those countries which had already been hit badly by globalisation. It should thus not come as a surprise that many citizens have turned their backs on the European institutions that are seen as cold and ready to punish when millions live in hardship.

In addition to the strict fiscal rules, the structural reforms that have been imposed by the same European institutions are also to blame for the rejection of the European Union by millions of people. European policymakers have adopted the neo-liberal discourse, according to which workers must be flexible (read: they should be happy when their wages fall, when they can be dismissed quickly and when they receive reduced unemployment benefits). The neo-liberal policymakers that now dominate the European Union preach that social security is unproductive and should be downsized. These policies are euphemistically called structural reforms, and they are imposed on millions of people, mostly the losers of globalisation, by European institutions and national governments alike.

Thus, the problem of the European Union today is that, instead of helping those who suffer from globalisation, it has implemented policies that hurt these people even more. It is no surprise that the losers revolt. If the EU continues with

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its prescription of austerity and structural reforms, revolt will spread and will take the form of attempts in further countries to exit the Union. It is time for the EU to take the side of the losers of globalisation instead of pushing for policies that mainly benefit the winners.

This can be done in two ways. The first one is to stop imposing structural reforms on the member states. The rationale for these structural reforms has been that they promote economic growth and should therefore benefit everybody. The empirical evidence of a positive link between structural reforms and economic growth, however, is very weak. In a recent econometric analysis of the OECD countries, we could not find evidence that reforms in the labour markets and in the product markets boost economic growth.[1] This is also confirmed in a recent study by the IMF.[2] We do find, however, that investment, both private and public, has a strong positive effect on economic growth.

The latter result points the way to the second change in economic policies that European policymakers should initiate: boosting public investment. The severe drops in such investments were collateral damage from the ill-conceived austerity programmes imposed by the European institutions.

A boost in public investment can only be achieved by changing the fiscal compact that imposes structural budget balance on the eurozone member states. This compact has the unfortunate implication that public investment can only be financed by current revenues. A rule more destructive to economic growth has rarely been imposed. When politicians are told that the cost of public investment should be fully borne by present taxpayers (voters), while the benefits of this investment will accrue to future taxpayers (voters), it comes as no surprise that the political incentives to engage in public investment will be weak. This is the situation today. Thanks to an ill-conceived and ideologically based rule, public investment in the eurozone is at a historically low level.

It is often argued that allowing public debt to increase will saddle our children with an unbearable debt burden. This criticism confuses gross and net debt. When productive public investments are undertaken by issuing government bonds, our children will inherit both productive assets and government bonds. Today, the cost of issuing government bonds is close to zero in many eurozone countries. If governments managed to invest in productive assets that had returns higher than zero, our children would inherit assets that created revenues exceeding the cost of borrowing. Future generations will not understand why we have not done so when borrowing was so cheap.

While I am a proponent of more political integration in Europe, grand schemes for "more Europe" should be put on the back burner for now. As long as European politicians continue to follow ill-conceived economic policies, one cannot ask people to follow them blindly for more of the same.

That being said, in response to the United Kingdom's recent Brexit vote, it is evident that the EU must adopt a clear negotiating strategy. Here is the choice that must be presented to the UK: either the UK government embraces (a close version of) the Norwegian model or it stands alone and negotiates new trade agreements with the EU and about 50 other countries (or group of countries) within the framework of the rules of the World Trade Organization (WTO). The EU must make it clear that there is no middle ground between these two choices. There can be no "special deal" with the United Kingdom in the sense of trading off some migration restrictions for improved market access.

If the UK accepts the Norwegian model, it retains full access to the single market. In that case, there are no obstacles for British goods and services in the EU and for EU goods and services in the UK. However, as is well known, the price the UK must pay in this model is to guarantee the free movement of EU citizens in and out of the UK. Without the free movement of people, there can be no free movement of services. This is the core of the single market. Moreover, the Brits will have to accept two other components of the Norwegian model. First, they will have to abide by the rules on standards, health and safety that are decided in Brussels – without being involved in the decision-making process. Secondly, they will have to contribute to the European budget.

Although the acceptance of this model would probably be in the best interest of both the UK and the EU, it is very unlikely that the UK government will accept it. The Brexit camp considers both free migration and the primacy of Brussels legislation as nonstarters, and its members will revolt if the UK government accepts these conditions. True, there is an important faction in the new government that is attached to maintaining full access to the single market and that sees few problems in accepting both the free movement of people and regulations from Brussels. However, this faction is probably too weak to counter the demands of the hard-line Brexit supporters.

1 See P. De Grauwe, Y. Ji: Crisis Management and Economic Growth in the Eurozone, in: F. Caselli, M. Centeno, J. Tavares (eds.): After the Crisis. Reform, Recovery, and Growth in Europe, Oxford 2016, Oxford University Press, pp. 46-72.

2 International Monetary Fund: World Economic Outlook, 2015.

I assume, therefore, that the British government will reject the Norwegian model and will try to obtain concessions from the EU that reduce migration flows while ensuring access to the single market. Here, the EU must make it clear that a special deal with the UK allowing such cherry-picking is unattainable. The EU must insist that the only other option for the UK is to stand on its own feet and start negotiating new trade deals with the EU and other countries in the framework of the WTO rules after Brexit is completed. In other words, the UK must be treated like the US, China or Brazil, i.e. as a sovereign nation that insists on maintaining full sovereignty over its trade agreements. The trade negotiations between the UK and the rest of the world will take years, if not decades, and their outcome is uncertain. It is not clear, for example, whether the UK will be able to maintain free movement of services with the EU, as this freedom is intimately linked to the free movement of people. However, that is a problem for the Brits, should they choose to embrace full sovereignty.

There are a number of reasons why the EU should not allow itself to be dragged down into negotiations over a special cherry-picking deal with the UK. There are other EU member states that are currently tempted to organise similar referenda. I have no problem in principle with such referenda. If citizens of a country dislike being members of a club, they should be able to leave. This will be better for all involved. There is no point in grouping together with people who intensely dislike each other. However, it is in the interest of both parties that the terms of the divorce should be made clear in advance.

That is why the EU should make it clear to other potential exiters what they can expect should they opt to follow the UK's lead. It will be either (some close version of) the Norwegian model or a "stand-alone model", in which the newly sovereign nation will face the difficult task of establishing new trade agreements on its own. Clarity is essential for those countries considering leaving the EU. Such clarity can only be achieved by excluding a privileged trade agreement with the United Kingdom.

When the UK joined the EU in 1973, arguably its main strategy was to prevent the union from becoming too strong. The UK political elite decided that this could best be achieved from inside the union. Now that the UK is departing, the century-old British strategy remains the same, i.e. to weaken the forces that aim to make Europe stronger. The UK can achieve this by insisting on a special deal with the EU whereby it maintains the benefits of the union while not sharing in the costs. Such a deal, if it comes about, would signal to other member countries that by exiting they, too, could continue to enjoy the benefits of the union without contributing to the costs. Such a prospect would fatally weaken the European Union.