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What future for the EU after Brexit?

Paul De Grauwe

How should the European Union react to the decision of the British people to withdraw from the union? This is the question that is at the center of the political debate in Europe since Brexit became a reality. I will first discuss the question of the nature of the reforms that are called for as a result of Brexit. I will then turn to the issue of the negotiating strategy 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. And the latter have come about as a result of democratic elections in each country. MEPs 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 questioned and reformed.

I see a deeper cause of the dissatisfaction with the European Union. I will argue that this dissatisfaction has to do with the inability of the European Union to set up a mechanism that protects the losers of globalization. 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. That prosperity, however, does not benefit everyone. Many are better off thanks to globalization. But many others are not. Some even see their welfare decline because they lose their jobs or because their incomes fall.

As globalization creates material welfare in the countries that participate in it, it is in principle possible to compensate the losers from globalization. That is the argument that most economists find strong enough to defend globalization. But the political obstacles towards organizing redistribution towards the losers of globalization are large. This is a problem in most industrialized countries, but it is made even more intense in the EU.

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

The European fiscal rules not only make it extremely difficult to compensate the losers from globalization. What is worse, they have amplified the hardship of the losers from globalization. Since at least five years the European Commission has pushed all member-countries of the Eurozone into an austerity straightjacket that has produced economic stagnation and rising unemployment mainly of those who had already been hit badly by globalization. It will be no surprise that many turn their backs towards the European institutions that are seen as cold and ready to punish when millions live in hardship.

Not only the fiscal rules but also the structural reforms that have been imposed by the same European institutions are to blame for the rejection of the European Union by millions of people. European policy makers have adopted the neo-liberal discourse. According to this discourse, workers must be flexible (read: they should be happy when their wages fall, when they can be dismissed quickly and when they receive less 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. They are imposed on millions of people, mostly the losers of globalization, by European institutions and national governments alike.

The problem of the European Union today is that, instead of helping those who suffer from globalization, it has set up policies that hurt these people even more. It is no surprise that the losers revolt. If the EU continues with austerity and structural reforms, revolt will spread and will take the form of attempts to exit the Union. It is time the European Union takes the side of the losers of globalization 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 therefore should 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 (De Grauwe and Ji(2015)). This is also confirmed by a recent study of the IMF(2015). 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 the European policymakers should initiate. This should consist in boosting public investment. The latter have suffered severe collateral damage from the ill-conceived austerity programs imposed by the European institutions.

A boost in public investment can only be achieved by changing the fiscal compact that imposes structural budget balance in the member-states of the Eurozone. This compact has the unfortunate implication that public investment can only be financed by current revenues. A more destructive rule for 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 will accrue to future taxpayers (voters) it will not surprise that the political incentives to engage in public investment will be weak. This is what happens today. Thanks to a stupid rule, public investment in the Eurozone is at a historic low level.

It is often said 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 manage to invest in productive assets that have a return higher than zero, our children will inherit assets that create revenues exceeding the cost of borrowing. They will not understand why we have not done so when borrowing was so cheap.

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

What should be the negotiating strategy the EU should adopt towards the United Kingdom since that country has decided for Brexit?

Here is the choice that must be presented to the UK. Either the UK government takes over (a close version of) the Norwegian model or it stands alone and negotiates new trade agreements with the EU and about fifty other countries (or group of countries) in the framework of the rules of the World Trade Organization (WTO). The EU must make it clear that there is nothing between these two choices. There can be no "special deal" with the United Kingdom in the sense of trading off some migration versus 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. But, as is well known, the price the UK pays in this model is 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 things in 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 free migration and Brussels legislation as diabolic and 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 sees few problems in accepting free movement of people and Brussels regulation. But this faction is probably too weak to counter the demands of the hard Brexit supporters.

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 excluded. The EU must insist that the only other option for the UK is to stand on its own feet, and to 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, Brazil, etc., i.e. as sovereign nations that insist on maintaining full sovereignty over their trade agreements. The trade negotiations between the UK and the rest will take years, if not decades. 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. But that is a problem for the Brits who have chosen to embrace full sovereignty.

Here are the reasons why the EU should not accept to be dragged down in negotiating a special cherry-picking deal with the UK. Some EU-countries are tempted today to also organize referenda. I have no problem in principle against such referenda. If citizens of a country dislike being member of a club, they should be able to leave. This will be better for all. There is no point in living 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 what potential exiters should expect. It will be either (some close version of) the Norwegian model or a “standalone-model” in which the newly sovereign nations will face the difficult task of establishing new trade agreements in the framework of the WTO-rules. Clarity is essential for those who consider leaving the EU. This clarity can only be achieved by excluding a privileged trade agreement with the United Kingdom.

When the UK joined the EU in 1973 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 can 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, will signal to other member countries that by exiting they can continue to enjoy the benefits of the union without the costs. Such a prospect would fatally weaken the European Union.