

UNIVERSITY OF WUPPERTAL
BERGISCHE UNIVERSITÄT WUPPERTAL

EUROPÄISCHE WIRTSCHAFT
UND
INTERNATIONALE MAKROÖKONOMIK



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**The BREXIT Dynamics: British and EU27 Challenges after the
EU Referendum**

Diskussionsbeitrag 240

Discussion Paper 240



*Europäische Wirtschaft und Internationale Wirtschaftsbeziehungen
European Economy and International Economic Relations*

ISSN 1430-5445

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May 2017

Herausgeber/Editor: Prof. Dr. Paul J.J. Welfens, Jean Monnet Chair in European Economic Integration

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JEL classification: E00, F15, E6, F5, O52

Key words: Brexit, UK, Global Britain, EU, Disintegration

Summary

The BREXIT dynamics are considerable in a politico-economic perspective. The British referendum of June 23rd, 2016, was a disorderly one as the Cameron government did not include key information in the official government brochure sent to all households across the UK – a study by the Treasury had shown a 10 percent income decline as a consequence of a potential BREXIT, but in the 16-page information brochure distributed to all households/the electorate, this prognosis was not mentioned at all. EU immigration issues played a role not only under Cameron but also under the May government and in the UK government's White Paper on exiting the EU, respectively. Key issues of BREXIT are related to the potential political instability in the EU. As regards the Global Britain approach of the May government, it is shown here that this is unlikely to work. EU27 reforms are quite important, without adequate reforms and much better leadership in Germany and other EU countries, there will be further disintegration in the EU.

Zusammenfassung

Aus wirtschaftspolitischer Sicht sind die BREXIT-Dynamiken erheblich. Das britische Referendum am 23. Juni 2016 ist ein Fehlreferendum, denn die Cameron-Regierung verschwieg, in ihrer 16-seitigen Informationsbroschüre für alle Haushalte, den wichtigen Befund der Studie des Finanzministeriums, wonach ein EU-Austritt Großbritanniens einen 10% Einkommensverlust bedeutet. Die Frage der EU-Zuwanderung spielte nicht nur eine Rolle unter Premier Cameron, sondern auch unter Premier May und im BREXIT-Weißbuch ihrer Regierung. Kernfragen des BREXITS beziehen sich auf potentielle politische Instabilität in der EU. Was den Global Britain-Ansatz der May-Regierung angeht, so wird hier gezeigt, dass dieser unwahrscheinlich ist. EU27-Reformen sind wichtig, ohne angemessene Reformen und eine bessere Führung in Deutschland und anderen EU-Länder, besteht eine weitere Desintegration in der EU.

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1. Introduction

The British referendum on membership of the EU, held on June 23rd, 2016, resulted in a 51.9 percent majority in favor of the UK leaving the EU (i.e. for “BREXIT”). Within a span of one year the UK has held an EU referendum and switched from the Cameron government to the new government under Theresa May who, in April 2017, called for a snap general election to be held on June 8th so that she would have a broader parliamentary majority for the rather complex transition period during the BREXIT negotiations with the EU and to support the new British policy after leaving the European Union at the end of March 2019. With an (expected) broader majority for the Conservative government, negotiations with the EU could become easier and an agreement which results in a settlement less severe than that of a very hard BREXIT could be possible – although the election of Mr. Macron as the new President of France could make the position of the EU less accommodating. The election of Emmanuel Macron is widely seen as a pro-EU and a pro-reform impulse for France – raising pressure for more Eurozone integration. The UK’s exit from the EU thus might become a second-rate point on the EU policy agenda and the British government might find negotiations with the EU to be rather complex. Opinion polls from the Eurobarometer of autumn 2016 suggest that the share of support (“Total Positive”) for the EU has increased in many member countries (not in Ireland, Austria, France with -3, -4 and -7 percent, respectively), while negative attitudes towards the EU have fallen in almost all EU member countries – possibly under the impression of BREXIT and an improvement of the economic situation in all EU countries compared to early 2016 (see Tab. 1).

Mrs. May has argued publicly that a lack of consensus in the British Parliament is one of the main reasons behind her decision to call for early national elections – the strong opposition to BREXIT from the Scottish National Party (in Scotland 62 percent of the population had been in favor of Remain in the EU referendum), the Liberal Democrats and indeed some backbenchers within her own Conservative Party seem to be problematic for the UK government.

As the EU will lose the UK as a member country, the Gross Domestic Product (GDP) of the European Union will reduce by about 1/5th if one considers the figures of 2016, however, if one uses the lower Pound exchange rate of end of March 2017 – after the depreciation – the EU GDP will have reduced by only about 16%. In any case, the economic weight of the EU27 will be significantly smaller than that of the EU28 so that international trade negotiations might become more difficult in the future as the economic and political power of the EU will be diminished – for example, if the EU wants to continue free trade negotiations with Japan. The UK faces an even more difficult problem in that it will have to negotiate free trade treaties with dozens of countries once it has left the European Union. The free trade agreements with almost 50 countries which the EU has thus far already concluded will no longer be valid for the United Kingdom.

In the short-term there have been no major negative economic effects from the BREXIT majority in the EU referendum of 2016. However, the situation in 2017 is already less favorable since the strong Pound devaluation of 2016/2017 (until the first quarter) has raised the inflation rate by about 2 percentage points in the first quarter of 2017 compared to a year ago. This rather unexpected rise of the inflation rate thus reduces the real income of workers

by about 2 percent compared to a baseline scenario without BREXIT. There will be a further decline of the output growth rate in late 2018 once the main EU-UK negotiation results have become known: There will an exit bill for the UK linked to the exit treaty to be concluded, the fiscal burden to the UK could amount to about €40-50 billion (or even more) and this would be close to 2 percent of GDP. Even if payments were to be spread over several years this would be a considerable burden for fiscal policy in the UK. The more decisive treaty will concern future British access to the EU single market; so far almost 50 percent of the UK's export of goods and services, about 12% of UK GDP, were exported to the EU27. With regard to this second field of EU-UK negotiations, one may expect that a favorable compromise for the UK would maintain about 50 percent of the current UK-EU27 free trade in the future based on sectoral free trade treaties, for example relating to the automotive sector and the financial services sector.

Table 1: Eurobarometer Figures (change in attitudes towards the EU, percent change in Total Positive and Total Negative between Autumn 2016 and Spring 2016)

	TOTAL POSITIVE	TOTAL NEGATIVE
Germany	8	-8
Romania	8	-1
Portugal	7	-2
Hungary	4	-7
Poland	4	-5
Slovakia	4	-6
Slovenia	3	-1
United Kingdom	3	-4
Czech Republic	2	-2
Estonia	2	-3
Latvia	2	-2
Luxembourg	2	-3
Greece	1	-6
Lithuania	1	-2
Malta	1	-6
Belgium	0	-4
Finland	0	-2
Italy	0	3
Netherlands	0	-1
Cyprus	-1	-6
Spain	-1	-4
Sweden	-1	2
Bulgaria	-2	-1
Croatia	-2	-1
Denmark	-2	0
Ireland	-3	-1
Austria	-4	-2
France	-7	2

Source: Own calculations using data from European Commission, Standard Eurobarometer 86 Autumn 2016 and Standard Eurobarometer 85 Spring 2016

The UK would therefore have to pay tariffs to access the EU27 market and the EU27 in turn would have to pay tariffs to access the UK and the much more complex trade environment will eliminate specialization gains in both the UK and the EU27. Since the UK is much smaller in economic terms than the EU27, firms from the UK will typically find it more difficult to raise prices in the EU27 single market - which is very competitive – than EU27 firms with exports to the UK. Moreover, one may expect that in the long run foreign direct investment flows (FDI) to the UK will decline; namely after an initial period of higher FDI inflows – which should be raised by the real depreciation of the British pound. In the context of imperfect capital markets, FROOT/STEIN (1991) have argued that a real depreciation of the exchange rate will make international mergers and acquisitions easier for foreign firms competing in takeover bids with domestic firms in the target country – after the real depreciation, the equity capital of foreign bidders expressed in the currency of the target country has increased. This mechanism could already be observed in the nine months following the referendum, namely in the context of the strong real Pound devaluation. There are considerable negative welfare effects for the UK since a higher share of foreign ownership in the UK capital stock means that the growth rate of gross national income will be transitorily diminished. This effect comes on top of the negative real GDP effects that are linked to a loss of specialization gains in the context of weaker access to the EU27 single market after 2019. The negative extra effect on national income comes from the higher future dividend payments that foreign subsidiaries in the UK will have to make to headquarters of multinationals abroad.

The analysis of the Treasury (HM GOVERNMENT, 2016) has estimated that one may anticipate a 6 percent decline of long run UK GDP. A further 4 percent of GDP loss is linked to the non-realization of the British membership in the EU and the envisaged EU single market deepening in the fields of the digital economy, the energy sector and the services sectors as agreed upon in the negotiations of the Cameron government with the EU in early 2016 – these concession are largely only valid in the context of continued EU membership. The message of the Treasury study that a moderate BREXIT scenario entails an income loss of £1,800 Pounds and it is quite strange that such an order of magnitude was not included in Cameron’s information brochure for the voters; in the Scottish independence referendum of 2014 the two government information leaflets for Scottish households informed voters that Scottish independence would mean a £1,400 income loss for every Scottish citizen plus the loss of the benefits of British EU membership (from this it obviously follows that Scottish independence plus EU membership of Scotland add up to a per capita benefit of £400 in Scotland provided that the EU implements the reform package for deepening the single market as agreed upon in the negotiations in early 2016; the EU will normally also offer pre-accession support which could easily bring further Scottish benefits).

There is not much doubt that the long-term negative output effects will come within a longer time frame – say within a decade – and this means that the UK could still experience positive growth rates of 1 to 2 percent in normal circumstances; and negative growth rates in a future recession year. One interesting question is whether or not the Eurozone’s growth rate (or the EU27 growth rate) will exceed that of the UK in the medium term. If this should not be the case there will hardly be a heated British debate about BREXIT in the long run. Here much depends on growth-enhancing reforms in France and Italy where the Italian growth rate slowed down considerably in the two decades after 1995 – only broader Italian reforms could change that problem. At the same time, one may argue that BREXIT raises the political

power of Germany, France and Italy, as well as of some other EU countries, whose votes will become relatively more important in future weighted EU decision-making with majority voting (only in the field of taxation is there no majority voting). The rather complex EU-UK negotiations will take quite some time and it is unclear whether the main issues can be settled in the two years until March 2017; Mrs. May had sent the Exit letter triggering Article 50 to the EU Commission on March 29th, 2017, and from this point a period of only two years is available for negotiations and ratification procedures in accordance with the EU Lisbon Treaty. While a unanimous extension of this two year period is possible in principle, it is highly unlikely politically since in spring 2019 there will be elections to the European Parliament and it is almost impossible to imagine that there will be British representatives elected to the European Parliament in a situation where the UK government is simultaneously pushing for a hard BREXIT: that is, no membership of the EU single market nor of the customs union; and also no further acceptance of rulings of the European Court of Justice. The way forward, as defined by the May government, is to adopt a broad free trade strategy which comes under the heading of a “Global Britain”.

2. The Background to the British Referendum and the Issue of EU Immigration

To allow an understanding of the future BREXIT-related perspectives, it is first appropriate to present a brief overview of the background of UK’s membership of the European Union up to the referendum in June 2016 and one of the defining issues which helped to shape the ultimate result, namely immigration.

In the immediate post-war years, the United Kingdom supported the cause of European integration, a stance which is perhaps best exemplified by Winston Churchill’s famous Zürich speech in 1946 when he called for the creation of a ‘United States of Europe’, which would not include Great Britain, but of which Great Britain would be a friend and sponsor, however over the following decades independence movements in many of Britain’s former colonies lead to the disintegration of the British Empire as the Commonwealth of Nations became a looser collection of states. Britain’s involvement in the 1956 Suez Crisis further isolated the country on the world stage. In 1962 Dean Acheson, former US Secretary of State in a speech at West Point Military Academy said “Great Britain has lost an empire and has not yet found a role. The attempt to play a separate power role — that is, a role apart from Europe, a role based on a ‘special relationship’ with the United States, a role based on being head of a ‘commonwealth’ which has no political structure, or unity, or strength — this role is about played out.” The UK turned increasingly towards Europe, where integration was proceeding since the signing of the Treaty of Rome in 1957. First moves from London with regard to the UK joining the then European Economic Community (EEC) were made in 1961, but British attempts to join the EEC were blocked by French President de Gaulle. The United Kingdom, along with Ireland and Denmark, ultimately joined the EEC in 1973 under Conservative Prime Minister Edward Heath. Following a General Election in 1974, the new Labour government under Prime Minister Wilson held the first Europe-related referendum, and indeed the first ever UK-wide referendum, in June of 1975, which resulted in 67 percent to 33 percent majority in favor of the UK staying in the European Community. The Guardian newspaper of June 7th, 1975, reported that the constituent country with the highest yes vote was England (69 percent Yes to 31 percent No), followed by Wales (65 percent Yes to 35

percent No), Scotland (58 percent Yes to 42 percent No) and Northern Ireland (52 percent Yes to 48 percent No) (THE GUARDIAN, 1975).

During the 1980s, the UK under Prime Minister Thatcher certainly hampered certain integration initiatives at a European level, reluctant to fully commit to a Europe with a Commission which was becoming more politicized under Commission President Jacques Delors. Margaret Thatcher sought and indeed received a rebate on British contribution payments, as the relative importance of industry versus agriculture in the UK meant that the UK was receiving a low share of payments, particularly payments under the Common Agricultural Policy, back from Europe. At the same time, the UK was active as a liberalizing influence and proponent of free trade in Europe counter to more protectionist countries in continental Europe. For this reason, the UK under Thatcher was a driving force behind the creating of the Single Market to spur trade between the member states (BALDWIN, 2016). However during the late 1980s and early 1990s the UK (and Ireland) stayed out of the Schengen Area which allowed and facilitated easier travel between Schengen countries, opted out of the Euro and negotiated an initial opt-out of the so-called “Social Chapter” annexed to the Maastricht Treaty. In 1992, under Prime Minister John Major, the Pound Sterling left the European Exchange Rate Mechanism which stood for a grid of rather fixed exchange rates within the EU countries – the UK had to devalue. Between 1997 and 2007, the UK under Prime Minister Tony Blair was more sympathetic to the cause of the EU and its social market economy with Blair ending the opt-out of the Social Chapter and the UK - along with only Ireland and Sweden – introducing no restrictions on immigration from new member states in the Eastern Enlargement of 2004 with the UK and Ireland in particular enjoying an investment boom and housing bubble and in need of migrant labor.

By 2007, David Cameron was already hinting that a Conservative government would reverse this decision. Coming to power after the Transatlantic Banking Crisis, the first government of David Cameron (a Conservative Party/Liberal Democrats coalition) introduced severe austerity measures and cuts, including cuts to central government transfers to local government which led to reductions in the provision of social services. In 2013, seeking to pacify a Eurosceptic movement within his own party and diffuse the threat of the growing United Kingdom Independence Party, Cameron promised that should the Conservative Party win a majority in the 2015 General Election, they would hold a referendum on membership of the European Union by the end of 2017. The intention was to secure Cameron’s position within his own party and indeed improve the UK’s position within the EU by renegotiating the UK-EU relationship under threat of the referendum. Having won the General Election in 2015 and formed a new government, the British government entered into negotiations aimed at reforming the EU and Downing Street won certain concessions in the areas of certain – now postponed - benefits for EU immigrants, a guarantee that non-Eurozone countries would not have to participate in bailouts and a commitment to reduce red-tape and inefficiencies. With the result of his renegotiations, Cameron confirmed a referendum would be held in June 2016 and backed a vote to remain in the European Union. Contrary to the Conservative Party taking a united stand behind their Prime Minister, a number of ministers in Cameron’s cabinet rebelled against his pro-Remain position – Cameron, however, allowed the rebelling ministers to remain in his cabinet resulting in a split Conservative Party which had no clear party position on the referendum, one result of this was that it reduced the government’s credibility. With the Conservatives appearing to take an official ‘neutral’ stance, all other

parties in Great Britain supported Remain with the exception of UKIP. Signals from the Labour Party were, however, not fully clear.

The campaign which followed Cameron's announcement was characterized not only by misleading claims from politicians, most notably from Boris Johnson (notably his bus campaign indicating that the UK's weekly payment to the EU was 350 million Pounds while in reality the net payments were only about ½ that figure), but also by the almost complete consensus amongst economists that BREXIT would have serious economic effects on the economy of the UK and indeed Europe. While most observers and indeed the markets were predicting a vote to 'Remain' in the weeks prior to the vote itself, WELFENS (2016a) discussed the outcome of a vote for Leave in a contribution for AICGS/The Johns Hopkins University on March 30th, 2016. The information campaign of the Cameron government has also been called into question (WELFENS, 2016b). While prior to a referendum on Scottish independence in 2014 the Cameron government's information brochure for households featured the likely per capita loss of £1,400 Pounds of a vote for independence, the information on the negative real income effects of BREXIT was not conveyed to voters in the official government brochure which was delivered to households across the UK. This is despite the fact that the estimated per capita cost would be much higher (£1,800 according to the medium estimate from the Treasury: HM GOVERNMENT, 2016).

With its publication on the 18th April, 2016, a week after the government's information brochure had been sent to households in England and before they had been delivered to households in other parts of the UK, the study of the Treasury – indicating that BREXIT would bring about an income loss of 10 percent - clearly came too late to have a material effect on the referendum on June 23rd, 2016. WELFENS (2017) suggests the reason for this non-communication of crucial information could be the result of either malicious interference by parties within the Treasury/government or disorder within the Cameron government. Based on standard UK popularity functions, one may calculate that if households had known about the 10 percent income loss to be anticipated in the long run – and higher tax rates – the referendum result would have been 52 percent in favor of Remain. The actual referendum outcome and raises questions about the clarity and legitimacy of the result.

The referendum resulted in 51.9 percent voting for Leave and 48.1 percent for Remain. Amongst the constituent parts of the United Kingdom, the highest vote for Leave was in England (53.4 percent Leave to 46.6 percent Remain), followed by Wales (52.5 percent to 47.5 percent), while a majority in both Northern Ireland and Scotland voted for Remain (55.8 percent to 44.2 percent and 62 percent to 38 percent, respectively), in an almost perfect reversal of the constituent country results in the referendum of 1975

One of the foremost arguments in support of BREXIT was the question of control over immigration. Indeed, Prime Minister Cameron had for a number of years been making the case of reducing the numbers immigrating to the UK, and sought to renegotiate immigration with the EU in 2014 but achieved little in terms of restricting free movement within the EU. Cameron, and Theresa May as his Home Secretary, had stressed the burden on the finances of the United Kingdom caused by inward migration. Population growth as a result of EU migration was marginal and it is difficult to take seriously the claim that one of the largest economies in the world was unable to cope with what was average levels of inward migration. However, it was the aforementioned crucial cuts in transfers to local government

in the wake of the Banking Crisis which led to reductions in the provision of local services, and the rhetoric of British political figures, from the Prime Minister down, which created the impression that services were being stretched as a result of immigration is not supported by the evidence as argued by WELFENS (2017) who refers to ATOYAN ET AL. (2016) who find that UK was not even among the top five Organisation for Economic Co-operation and Development (OECD) destination countries in terms of Eastern European emigrants (even though the UK was one of only three EU countries who chose of their own volition not to implement restrictions on immigrants after the Eastern Enlargement in 2004). Moreover, OECD studies show that EU immigrants actually bring a net contribution to the UK government budget and have higher employment rates than that of native Britons (OECD, 2013; 2016). While it is possible that short-term immigration puts downward pressure on the wages of unskilled workers in the UK, the medium and long-term effect is rather different as workers integrate and upskill unless unemployment would be rising which has not been observed in the UK in recent years (aside from the effects of the Banking Crisis). The effect of the rhetoric from Cameron and May, amongst others, was the create a convenient scapegoat in EU migrants, despite the fact that the new government's own White Paper of February 2017 showed that EU immigration is far below the levels of immigration from non-EU countries (the UK has high immigration levels from countries such as India which is likely to push for more visas etc. as part of any future free-trade deal).

3. BREXIT and EU Disintegration

The withdrawal of the United Kingdom from the European Union after more than four decades of membership represents an unprecedented development in the history of the European Union, and indeed the first real instance of disintegration rather than integration. While Greenland held a referendum to leave the EU in 1982, and eventually left in 1985, it is not a comparable situation when one considers the relative populations, economies and political challenges posed by Greenland and the UK. The UK is the second largest economy in the EU, standing for almost one fifth of the EU's GDP and one eighth of its population. The disintegration dynamics as a result of BREXIT could lead to further withdrawals from the EU or even its demise. Furthermore, disintegration in the EU could destabilize other regional integration projects around the globe such as ASEAN in Southeast Asia and Mercosur in South America. While BREXIT, which is expected to be completed in 2019, is itself an example of de facto disintegration, it can also lead to further disintegration dynamics and politico-economic threats both from within the EU and from further afield in the short term and indeed in the medium term.

Within Europe, and in the short term, Eurosceptics in many EU countries may feel moral support from the pro-BREXIT majority on the UK. Buoyed by the victory of President Trump in the United States and the Leave campaign in the UK, other movements such as the Front National and Marine Le Pen in France and Geert Wilders and the PVV in the Netherlands are seeking to capitalize on an anti-establishment and anti-globalization platform. In the first round of the 2017 French Presidential election, with the right-wing Marine Le Pen and the left-wing populist Jean-Luc Mélenchon, almost 41 percent of the votes went to candidates who supported renegotiating European treaties, leaving the Eurozone or indeed the holding an In/Out referendum on EU membership in France

(MINISTRY OF THE INTERIOR, 2017). Meanwhile, in Central and Eastern Europe the governments in Poland and Hungary might also feel emboldened by a general fear of further disintegration to pursue their own ultra-conservative and nationalistic measures.

From 2020, when the next framework for the finances of the European Union will be finalized, the problem of the United Kingdom's contributions to the EU budget will be pressing. The UK's net contribution of about £7.6 billion Pounds will need to be funded by increased contributions from the remaining member states, or the already inadequate level of spending at the supranational layer will need to be cut further. Facing yet higher contributions, it could become politically difficult in the leading contributor members to convince a skeptical electorate that higher contributions make sense – claims of the amount sent to Brussels every week was key to the BREXIT campaign in the UK, and the need for more money to be transferred from the national level to the supranational level could result in exit referenda in the remaining states. In a mirror perspective, certain Eastern European member states facing reduced transfers and increasing political pressure from the EU may also consider following the UK's example.

Assuming that the UK does in fact withdraw from the EU in 2019 and with the possibility that other countries could follow, one may consider the question of if and how these countries could co-operate outside of the EU. WELFENS (2017) suggests that the UK could try and establish a new and expanded European Free Trade Association (i.e. an "EFTA+"). Such an association may attract other member states increasing disintegration dynamics. Indeed the UK could even invest some of the funds which were going as EU contributions in order to entice particularly smaller states, Eastern European states which historically have had a close relationship with the UK to join them. Thus, the UK could seek to retain some of the economic advantages of liberalized trade with European partners.

From an economic perspective in the medium to long term, the growth dynamics of the EU27 (the current EU less the UK) and the UK will be crucial. Initially, upon exiting the EU, the UK will face considerable costs, including the so-called 'exit bill' and further adjustment costs as the economy re-orientates. However, after a period of reduced growth, the free trade agreements which are heralded by the British government as a core element of their global Britain approach – likely including agreements with the US, Canada, Australia, India and others – will again lead to economic growth. This will be supported by deregulation measures implemented by the Conservative government (assuming re-election in the General Election in June 2017). However, it is as yet unclear if such free trade agreements could sufficiently increase British GDP to offset the effects of an exit from the EU. Meanwhile the EU27, still experiencing Eurozone problems in certain countries, and possibly a sustained period of weak growth, will become a less attractive option. The disintegration dynamics related to BREXIT will certainly have a negative impact on the growth dynamics of the EU so there could be an endogenous anti-EU momentum in some countries. Indeed there seems to be a positive correlation between popular support for EU integration and economic growth. Thus, the higher the economic growth of the UK relative to the EU27 after a certain period has elapsed following BREXIT, the higher the likelihood that other countries could seek to emulate BREXIT in the hope of themselves achieving higher economic growth outside of the integration area.

Moreover, for the first time since the foundation of the EEC, these disintegration dynamics are receiving some measure of support from Washington DC. In the post-war years, the US

supported European integration and has backed the European project over the intervening sixty years. However, with the victory of President Trump in the US, the White House is now occupied by someone who publicly heralded BREXIT as a good development, and would likely also welcome further such developments. On the other hand, Russian banks have been supporting the presidential campaign of Marine Le Pen and it would be in Russia's interest to undermine and weaken European integration and unity. Russia may seek to take advantage of BREXIT and disintegration dynamics in the EU (and possibly also NATO which may also be destabilized by disintegration in Europe) to expand its role in eastern Ukraine and perhaps elsewhere in Eastern Europe. Furthermore, an instable Europe in the twenty-first century will face global pressure, including from a dominant China, the economy of which will continue to grow in the coming years. Whether the UK, US, Russia or China really stand to gain from an instable and conflict-prone Europe in the long term is unlikely.

These disintegration dynamics could mean an end to the European Union and European integration, unless urgent reforms are undertaken at a European level. Such reforms will need to stabilize and grow the European economy, for example with the Digital Single Market (of which the United Kingdom was an enthusiastic supporter), and rekindle support for the EU amongst the electorates of Europe. However, if the EU is capable of developing and instituting the necessary reforms remains to be seen.

4. Post-BREXIT Issues in the UK: Irish Problems and the Scottish Question

While BREXIT represents an unprecedented challenge to the integrity of the European Union from an economic and political perspective, amongst the remaining member states of the EU it poses significant problems for the UK's closest neighbor the Republic of Ireland in particular. Furthermore, the disintegration dynamics caused by the withdrawal of the UK from the EU could be replicated within the United Kingdom itself, with political developments in Scotland and Northern Ireland now strongly related to the BREXIT decision.

The UK and the Republic of Ireland have a long and complicated history. The two countries are deeply linked in terms of a broadly similar culture, language, legal system, and colonial past etc. Thus there have been many studies examining the effects of BREXIT on Ireland, which have had a broader perspective (see, for example, the Department of Finance (2016; 2017) or Bergin et al. (2016)), while others have focused on specific effect channels or sectors, (see Lawless and Morgenroth (2016), Donnellan and Hanrahan (2016)). Within the EU, the UK is Ireland's most important trading partner and indeed Ireland is one of only a small number of countries within the EU with whom the UK has enjoyed a trade surplus. According to data from Ireland's Central Statistics Office, in 2015, 36 percent of Irish service exports to the EU28 went to the UK, while 22 percent of Irish service imports from the EU28 came from the UK. In terms of trade in goods in 2015, 26 percent of Irish exports to the EU28 went to the UK, with 42 percent of Irish imports from the EU28 coming from the UK. Studies have shown that by 2030 Ireland is likely to suffer the significant losses in terms of GDP and GDP per capita as a result of BREXIT, with losses marginally less than those losses found for the UK itself (CEPS, 2017). Meanwhile, it has been calculated that a 'hard'

BREXIT would reduce Ireland's trade with the UK by 30.6 percent and overall trade by 4.17 percent (LAWLESS AND MORGENROTH, 2016). However, Ireland and the UK are also involved in the Northern Ireland peace process with joint political bodies such as the British-Irish Intergovernmental Conference and the North/South Ministerial Conference. It remains to be seen how BREXIT will affect the political cooperation of the two countries with regard to Northern Ireland and the peace process, particularly as it relates to the future of the border between the Republic and Northern Ireland which will be crucial in terms of the free movement of labor (and indeed consumers) and goods/services. In the event of a completed BREXIT, the Republic of Ireland will be the only member state of the European Union to share a land border with the UK, and it may prove difficult to maintain the status quo despite the intentions of government in London or Dublin should terrorism and serious crime re-emerge as a serious problem in the border area. The status of Northern Ireland and its perspectives to immediately rejoin the European Union in the event of unification with the Republic was the subject of discussions at EU level in April 2017. The position of the Irish government is strengthened by the fact that on June 23rd, 2016, a majority of voters in Northern Ireland voted against BREXIT and in favor of Remain.

In Northern Ireland, 55.8 percent of voters voted to Remain in the UK's BREXIT referendum. The campaign for Remain had the backing of the major political parties in Northern Ireland across the political divide, i.e. including both nationalist and unionist parties. This cross-community support indicates a shift in the paradigm in Northern Ireland, as in the 1975 referendum a majority – responding to the No campaign of certain unionist parties – voted against continued UK membership of the EEC. The normalization of everyday life in Northern Ireland since the Belfast Agreement in 1998 is broadly due to the commitment of the governments of the UK and Ireland to work together, but is also in part due to the role of the European Union in supporting the peace process and the Northern Irish economy. According to research by the Centre for European Reform, Northern Ireland is a net recipient of EU funds, and the largest beneficiary in the UK in terms of payments under the EU's CAP scheme (CER, 2014) – BREXIT will make it likely to the UK will need to substantially increase transfers to Northern Ireland in the short term. What was once a “hard” border with the only crossing points controlled by the British army, the border between Northern Ireland and the Republic is now a “soft” open border, with thousands of people commuting daily in both directions, and consumers often crossing the border to avail of benefits due to exchange rate fluctuations between the Euro and Pound Sterling. Any impact of BREXIT on cross-border and security cooperation or on the status of the border itself, could see serious security issues emerge for the UK and indeed the EU27, in particular Ireland.

Apart from terrorism-related security concerns, the economy of Northern Ireland could be seriously impacted as Northern Ireland has a trade surplus with the EU, unlike the UK as a whole. Northern Ireland relies more on exports to the EU and thus could be disproportionately affected by changes in access to the single market, where almost 40 percent of exports to the EU go to the Republic of Ireland, and it has been argued that BREXIT could lead to a reduction in trade between the two jurisdictions on the island of Ireland of up to 20 percent (STENNETT, 2016). The Common Travel Area (CTA) which exists between the Republic and the UK could also be endangered by BREXIT, with both countries currently outside of the Schengen Area, the CTA which to some extent has a historical foundation going back to when Ireland was still part of the UK, allows visitors

from certain countries to travel between the UK and Ireland on a common visa, and allows for reduced security checks and document requirements for Irish and UK citizens travelling by air/sea between the two countries. The CTA, in combination with the soft border to Northern Ireland, could be problematic in the future if immigrants seek to enter the UK via the Republic by crossing a soft border with Northern Ireland. Furthermore, the status of the all-island single energy market (with a unified wholesale electricity market operating on the island) is now also uncertain as a result of the politico-economic challenges of BREXIT. While Theresa May and the British government are seeking to put a significant focus on Northern Ireland in the EU-UK negotiations, under the Belfast Agreement the possibility exists for a future referendum to be held in Northern Ireland on unification with the Republic, and BREXIT may indeed make such a vote more likely, increasing disintegration dynamics within the United Kingdom.

As in Northern Ireland, Scotland also voted in favor of the UK remaining within the European Union (62 percent to 38 percent). Scotland, due to its high dependence on agriculture, receives almost double the share of the EU's Common Agricultural Policy (CAP) payments relative to its share of the UK population (DOWNING, 2016), however a study from the Centre of European Reform found that via the UK's contributions to the EU budget, Scotland is in fact a net contributor: Contributing £8 per capita which, however, is far below the UK per capita average of £117 (CER, 2014). Here, it should be noted that the constituent part of the UK which had benefited the most from EU membership in terms of per capita receipts (including structural funds) has been Wales (CER, 2014). Wales, however, had a majority Leave vote in the June 2016 referendum, indicating perhaps that EU funds spent in Wales were not visible enough to Welsh voters. The fall-out from the BREXIT debate has also reinvigorated the independence movement in Scotland. In September 2014, the first Scottish Independence Referendum resulted in 55.3 percent of the Scottish electorate voting against the proposition that Scotland should be an independent country. In its party manifesto for the 2016 elections to the Scottish Parliament, which took place just weeks prior to the BREXIT referendum, the Scottish National Party (SNP) made a definite reference to the possibility that there would be a BREXIT, arguing that if there was a "significant and material change in the circumstances that prevailed in 2014, such as Scotland being taken out of the EU against our will" (SNP, 2016) it was the party's position that the Scottish Parliament should have the right to hold another referendum on independence. On June 23rd, 2016, the majority in Scotland voted for the UK to remain part of the European Union, where the result was a rather definitive making Scotland the most pro-remain constituent country in the United Kingdom. As the result of the BREXIT referendum became clear on June 24th, First Minister Nicola Sturgeon declared that Scotland had shown its will to remain in the EU intimating that a second referendum vote would be highly likely. Over the course of 2016 and into early 2017 the Scottish government suggested many options such as Scotland remaining in the EU, including a possible European Free Trade Agreement model should the UK pursue a 'hard' BREXIT. On the 28th March 2017, just one day before Prime Minister May triggered Article 50 officially notifying Brussels of the UK's intention to withdraw from the European Union, a majority in the Scottish Parliament voted in favor of Scotland holding a second independence referendum, pitting Holyrood against Downing Street and increasing uncertainty within the UK. A vote for independence could result in a constitutional crisis in the United Kingdom itself resulting in

disintegration dynamics and possibly a newly independent Scotland seeking to rejoin the European Union.

5. Global Britain Approach?

As regards its post-BREXIT policy strategy, the May government has emphasized the goal of a Global Britain approach according to which the UK would conclude many new free trade agreements with major trading partners, for example, the US, Japan, India, China and others. Prime Minister May explained the Global Britain approach in her speech of January 17th, 2017, Lancaster House speech and also in the government's White Paper on the United Kingdom's exit from and new partnership with the European Union. (HM GOVERNMENT, 2017). Formally, the UK will only be able to negotiate a free trade agreement (FTA) with the US and other countries once it has actually left the European Union. One should not overestimate the prospects for strong growth impulses stemming from new FTAs as the British exports to the US are only about 2.5 percent relative to GDP which is only about one fifth of the British exports to the EU.

While the UK has already received assurances from the Trump administration in early 2017 that the US is willing to conclude a UK-US free trade treaty, other free trade options could be rather doubtful. The EU28 is negotiating a free trade agreement with Japan and Japan is now much more interested in such a treaty than previously since the Trump administration has stopped the Trans-Pacific Partnership (TPP) that had been signed by twelve countries, including the USA and Japan; but that treaty could not be ratified in the US once President Trump declared that he would not support TPP. Japan and some other TPP countries have emphasized in early 2017 that they would still pursue TPP possibly without the involvement of the US – in any case, facing less favorable trade liberalization opportunities around the Pacific, Japan's government is now getting more interested in trade liberalization with the EU. Here, the case of the successful trade liberalization between the Republic of Korea and the EU serves as a model. The EU27 is likely to push Japan to assure that Japan would in turn give the UK less favorable market access in a future trade liberalization Japan-UK agreement, largely reflecting the weaker economic weight of the UK compared to the EU27. However, the US, which provides military protection to Japan including a nuclear defense option, might as the UK's new preferred ally push Japan ally to agree to a rather generous free trade agreement in the medium term. A free trade agreement between the UK and China is rather unlikely since here there is some rivalry between the US and China; moreover, a broad British liberalization is hardly possible since economic power of China is already quite impressive and Chinese firms could provide very tough competition in many industrial fields, including steel production where British firms would quickly face serious problems once they would have to open the market broadly to Chinese firms. A free trade agreement with India will not be easy to achieve since a key requirement from the Indian side will be to raise the number of visas made available for Indian citizens; Indian immigrants (about 750,000 in 2016) are already, together with Polish immigrants (which number about 900,000) a very well-represented migrant group in the UK. Given the anti-immigration sentiment of the May government, and the anti-immigration rhetoric of successive Conservative governments, it seems unlikely that a British government could strike a quick and easy compromise with the Indian government involving substantially higher

immigration. It is also unlikely that the UK could play a new leadership role in the Commonwealth; it is uncertain if these countries are eager to follow British leadership.

A serious challenge will come for London's financial sector where banks and other providers have over a number of decades successfully provided sophisticated services to clients in all 28 EU countries (BALDWIN ET AL., 2016). London could lose its attractiveness as a global financial center as the financial services sector is one of the sectors with the highest estimated non-tariff barriers (FRANCOIS ET AL., 2013). About one in every five jobs at US banks in London are likely to be relocated to New York, and several thousand jobs will be relocated to Ireland, France, Germany, the Netherlands and Luxembourg since legal requirements in the Eurozone and the EU27, respectively, will stipulate that most core banking services can be only be offered in the EU27 market if the respective service provider has a separate EU-based equity capitalization and if the European Court of Justice is accepted in the case of legal conflicts. For the EU27, however, there is some risk in the field of certain risk management services for the entire EU that thus far are strongly concentrated in London; this argument also holds for the placement of certain bonds. If there should be disruptive EU-UK negotiation so that the United Kingdom would walk away from the negotiating table, this could undermine financial market stability in the EU27 as the specialized services mentioned would suddenly no longer be available on a broader scale. The EU27 countries should be wise enough to energetically – read quickly - encourage the creation/provision of the aforementioned special services within the European Union since this would reduce the UK's leverage in the negotiations and would also contribute to systemic stability in the Eurozone and the EU, respectively. For the EU27 it seems clear that adequate reforms in several policy fields are urgent; at the same time, the EU partner countries should all consider more carefully which policy reforms should be adopted at the national level. For example, inadequate policy in Germany and France would have negative effects on all EU trading partners and then in turn have a negative repercussion effect on Germany and France, respectively.

With lightly more than 40 percent of the French electorate in the first round of France's presidential election giving their vote to politically radical candidates, the overall political risk in the EU27 is rising. Many EU countries face the rise of populist parties or radical parties – in the German federal elections of September 2017, voting shares of about 10 percent may be anticipated for the extreme left (DIE LINKE) and the extreme right (*Alternative für Deutschland* (AfD)). Populist forces are clearly visible in parts of Eastern Europe as well as in parts of Italy, Austria and the Scandinavian countries.

There are open political conflicts within some Euro countries about the construction of the Eurozone as well as hidden conflicts about the issue of the very high German current account surplus ratio of 8-9 percent which is a clear violation of the maximum 6 percent limit agreed upon in the Eurozone and the EU, respectively. While Germany's minister of finance argues that he cannot change the situation and that the key reason behind the high surplus figures is the outstanding international competitiveness of German firms, the reality is different: Germany's current account surplus is reflecting the difference between the German production of tradables and the domestic demand for such tradables in Germany; reducing the value-added tax (VAT) rate by 2-3 percent could easily reduce Germany's current account surplus to about 5-6 percent of GDP. The considerable German general government budget surplus would allow such tax reforms without creating problems for the budget deficit; if deemed necessary, some environmental taxes might be raised in Germany in order

to achieve an almost balanced budget despite the lower VAT rates. Germany's ministry of finance has not considered this policy option at all. It seems that the German government so far has not adequately emphasized the European dimension of its economic policy and also not pushed for modern institutional reforms in Brussels.

6. Reforms and EU Deepening vs Further Disintegration

Necessary reforms in Europe will have to consider the fact that BREXIT – plus Eurobarometer findings – signal that amongst the electorates of many EU countries the political backing for EU integration is weak on the one hand. On the other hand, the international influence of the EU is reduced by BREXIT in line with the reduction of EU GDP: after 2019 it will be only 4/5ths of what it was before the UK's exit and hence the benefits of the EU's influence on globalization will be reduced. From this perspective, it will be important that EU reforms address the obvious internal conflicts and contradictions within the EU27 and also reform the EU's tasks, expenditures and modes of financing. Some reforms at the national policy layer are also crucial in order to achieve a balanced overall package.

The German government and indeed several other countries will push for the fiscal rules of the Maastricht Treaty to be respected more by national governments in the future. In return, assuming the election of new President Macron, one may anticipate that France will push Germany to become more serious in reducing its very high current account surplus ratio. Germany's government has not considered serious measures to reduce the current account-GDP ratio which has now hovered above 8 percent for many years. An easy way to bring the current account position in line with the 6 percent upper limit agreed upon in the EU would be to reduce the value-added tax rate by 2-3 percent (while the German minister of finance has argued that it is impossible for Germany to correct the high current account surplus). A lower VAT rate will raise the aggregate demand for tradables so that with a given production of tradables, the sectoral excess supply and hence the current account surplus will be reduced.

The EU has expenditures of just 1 percent of GDP which is very low – for example, the federal government expenditures in the US is about 9 percent of GDP plus another circa 11 percent for federal social expenditures. From the perspective of fiscal federalism (e.g. OATES, 1999), it would be appropriate to have military expenditure and part of infrastructure expenditure plus some income redistribution activities at the supranational level. In the present institutional setup one has not considered a serious enhanced military cooperation among EU member countries thus far. It was the UK that for many years has prevented the possible implementation of stronger military cooperation among EU member countries. With the UK leaving the EU, the military role of France – the only EU country after 2019 with nuclear military capabilities – will be reinforced in the EU. France and Germany, as well as other countries, are willing to shift part of defense expenditures to the supranational policy layer and joint public military goods procurement could save considerable expenditures (McKINSEY, 2015). The willingness of EU countries to transfer power to the EU Commission and the European Parliament is fairly limited. If the EU would have broader tasks and economic policy power, one could expect that the EU would enjoy a

stronger visibility among European voters and this in turn would mean a lower percentage share of radical political parties at European elections. The *Forschungsgruppe Wahlen* – a leading political science research group on voting behavior – has emphasized that the “political invisibility of the EU” for most German voters encourages a voting behavior which favors small, radical parties at European elections.

Among the fields that stand for EU economic benefits for EU member countries is the supranational negotiation of international free trade agreements. Here the EU had failed – largely due to lack of support from Germany and France – to achieve a transatlantic FTA with the US under the Obama administration. These TTIP negotiations are unlikely to be revived under the Trump administration as president Trump has reinforced national procurement rules in the US and also has a rather protectionist policy stance. It is thus all the more important that the EU accelerates and reinforces the negotiations for an FTA with Japan and ASEAN countries – in Asia, the EU currently has a fully concluded treaty only with Singapore among the 10 ASEAN countries.

In the field of digital economic integration, the relevant market is often the global economy so that the digital single market should be important for stimulating rapid efficient digital innovation. While the Juncker Commission has emphasized digital modernization as part of its EU economic policy, the speed of digital project creation and the drafting of the appropriate directives (EU legislation) has been rather slow and the leading global companies – with very few exceptions – are from the US, China, Japan and Korea. Very short digital innovation cycles outpace the slow EU legislative process in the sphere of the digital economy.

A key field of economic policy will remain the EU’s control over subsidies which has helped to avoid high national subsidies on ailing industries in the tradable goods sector. As the UK will leave the EU, future British governments are more likely to spend taxpayers’ money to support the ailing British steel industry – as was already announced in 2017 by the Labour Party leader Mr. Corbyn. As the UK enjoys full policy autonomy outside the EU, this would then generate certain pressure in EU27 countries to also come up with parallel new subsidies. One field of concern in the UK-EU relations is British tax policy. The UK will want to implement lower corporate tax rates in order to attract higher FDI inflows and to compensate for the declining attractiveness of the UK as a location for industrial production – open for free exports to the EU single market before BREXIT. Rules for minimum corporate taxation in the EU27 might be considered in order to a further ‘race to the bottom’ in terms of corporate tax rates as a result of BREXIT.

If the EU27 club should not be able to modernize the institutions and vertical political division of labor, the EU is likely to experience additional disintegration. The BREXIT would provide not only a role model, but cooperation with the UK could also be attractive for nationalistic populist parties in certain EU countries. Once EU disintegration continues, the anticipated lower EU global economic weight is likely to reinforce the impression that the benefits of EU membership are declining. The benefits from EU membership will also be affected by the potential demise of multilateralism – with the US Trump administration obviously undermining part of the international organization network (for example, the World Trade Organization, the Bank for International Settlements etc.). If the EU faces a diminished formal or informal role in such organizations because there is a demise of the international organizations themselves, this international aspect of EU power could become

critical in the future. Diminished opportunities for EU-UK cooperation in international organizations will reduce the EU27's willingness to consider soft compromise lines in the coming EU-UK exit negotiations.

As much as most observers in the EU were surprised that the British electorate showed a majority for BREXIT at the referendum in June 2016, it seems obvious that other X-EXITS (with X standing for other members of the EU27) could follow. This course of action will be more attractive the softer the conditions the EU27 offers the UK for EU single market access. The British exit letter of Prime Minister May has emphasized that the UK government considers a link between EU-UK trade agreements and cooperation in security policy as a key perspective of the EU-UK negotiations. This clearly points to the British interest in mobilizing Eastern European EU countries with their own relatively weak military defenses – i.e. those countries which rely to some extent on the recent presence of NATO troops, including military personnel from the UK – in order to divide the EU27 countries negotiation position. One may, however, argue that it is in the EU27's own interest to adopt a hardline approach in the negotiations with the UK in order not to give incentives for further X-EXITS.

A soft negotiation line with the UK would reward not only a disorderly referendum under the Cameron government but would also be a signal to the EU27, and to many other regional integration clubs around the world, that one can easily leave a regional integration club whose member countries have over many years continually sought to integrate with each other. A tough EU stance in the negotiations with the UK is not only appropriate in the interest of the European Union but also in a global interest in maintaining regional integration clubs which have not only created regionally densely woven trade networks but have also contributed to prosperity and peace in the respective regions. The EU, Mercosur, ASEAN and several other regional integration schemes are relevant here.

For the EU, BREXIT might be considered to be a warning signal that an integration approach which leaves certain countries behind – such as the UK in the case of the Eurozone project – is not viable. Sooner or later this institutional rift implies instability in the club membership. The EU can indeed be criticized for not having included the standard criteria of optimum currency area analysis – a filter that would, for example, have left Greece outside the Eurozone since its degree of openness is fairly small given the size of the country. After the French elections, and indeed the German elections in 2017, the EU has a short window of opportunity to adopt broad national reform agendas and supranational reforms as well. A growth-enhancing set of reforms is necessary in all EU27 countries and one could draw here on the approach of the G20 Brisbane agenda under which the OECD checks the implementation of promised national policy impulses for more growth and also runs simulations for alternative policy options if a G20 country desires such activity. Germany, France, Italy and Spain plus other Eurozone countries should in particular adopt ambitious interlinked growth policies; not least to demonstrate that the growth differential between the Eurozone and the post-BREXIT UK is considerable. If the Eurozone would be unable to deliver a clear growth advantage over the next decade, then currency union and the EU, respectively, are unlikely to survive. Given the fact that a majority of the elderly in the UK have voted for BREXIT, one may emphasize that the greying of the EU population is undermining long run support for EU integration. A conclusion to be drawn here is to implement joint EU e-health approaches with a specific focus on health programs and e-health innovations for the elderly strata of society. One may anticipate a majority for EU

membership at EU referenda only if there are clear benefits from EU membership. Hence part of the new social dimension should consider appropriate innovative e-health programs in Brussels.

A small, “shallow” EU – with just 1 percent of supranational EU expenditure relative to EU GDP – will not survive as voters will continue to nurture radical populist parties due to an inability to understand the key functions of the EU. If the EU disintegrates (and this could be a process occurring over the course of less than two decades), Europe would be roughly back to sharp nationalist economic, military and political competition that was characteristic of the late 19th century.

If there were disintegration, Germany is likely to try building a “*Mitteleuropa*” group under its leadership and this would compete against a France-centered group of countries. Such a middle Europe approach by Germany would expose Germany more than any other country to pressure from Russia and therefore Germany is likely to increasingly rely on cooperation with Russia which, in turn, would bring Germany into a position that would be difficult for Russia to accept. The European countries should be well aware that the EU is not only competing with the US, but increasingly also with China and the ASEAN countries. Failure to carefully consider these new challenges could lead to EU disintegration and dangerous instability in Europe and worldwide.

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Note for those interested in checking the contested government brochure and the link to the Treasury Study with the key findings on UK benefits from EU membership:

The 16-page information brochure of the Cameron government mailed to households in England, April 11-13th, 2016 can be found under the following link:

HM Government Information Brochure: No figures included on long-term per capita benefit of staying in the EU (information brochure):

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/515068/why-the-government-believes-that-voting-to-remain-in-the-european-union-is-the-best-decision-for-the-uk.pdf

Links to HM Treasury’s Studies on the Economic Impact of BREXIT

HM Treasury study, “The Long-Term Economic Impact of EU Membership and the Alternatives”

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/517415/treasury_analysis_economic_impact_of_eu_membership_web.pdf

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