04

BREXIT VOTE: AVERTING DAMAGE, STRENGTHENING EUROPE THROUGH SUBSIDIARITY

This is a translated version of the original German-language chapter "Brexit-Votum: Schaden abwenden, Europa durch mehr Subsidiarität stärken", which is the sole authoritative text. Please cite the original German-language chapter if any reference is made to this text.

SUMMARY

In June 2016, the majority of the British electorate voted to leave the European Union (EU). The British government plans to have triggered the **exit procedure by the spring of 2017** and to have officially left the EU by the spring of 2019. The exit of one of the three largest member states would mark a significant break point in the European project.

The German Council of Economic Experts (GCEE) expects the **economic impact** of these events to remain **moderate in the short term**. While the UK economy is showing signs of clouding over, a drastic slump does not appear very likely. At present, it is very difficult to forecast the long-term economic implications of Brexit. They largely depend on the nature of the future economic relationship between the EU and the United Kingdom.

The UK itself is expected to be the hardest hit by any negative economic impact. The remaining EU member states and Germany, in particular, would likely be less affected. From an institutional perspective, the **balance of power would shift** if the United Kingdom - one of the most market-oriented member states - were to break away from the EU. The EU would also lose one of the biggest net contributors to its budget.

The negotiations on the United Kingdom's exit will involve striking a balance between efforts to maintain close economic links and the risk of setting a precedent that could inspire other countries to follow in the UK's footsteps. The GCEE advocates constructive negotiations to either prevent an exit or at least to conclude a successor agreement that will minimise the damage for both sides. It also, however, takes the view that the **four fundamental freedoms** of the EU **must not be compromised**. Concerning the free movement of people, this could potentially allow for administrative adjustments along the lines of the "priority for domestic labour force/freedom of movement light" system that is planned in Switzerland. Delayed integration into social welfare systems, on the other hand, does not constitute a breach against the freedom of movement of persons.

Just as in the United Kingdom, eurosceptic movements are on the rise in other member states too. In a quest to find ways of responding to this development, the public debate is currently focusing on fundamental reforms of the EU. Premature integration, however, would be the wrong political response, particularly in areas such as fiscal, labour market and social policy. Instead, the GCEE advocates a stronger focus on the **principle of subsidiarity** so that the EU can concentrate more efficiently on its key tasks. The EU should assume greater responsibility in matters relating to internal security, external border controls and climate policy. Measures should also be taken to move forward with the capital markets union.

I. INTRODUCTION

287. On 23 June 2016, a majority of the British public voted in a **referendum** for "Brexit", the country's exit from the European Union (EU). Of the 72 % of British eligible voters who turned out, 52 % voted for Brexit. A few weeks after the referendum Prime Minister David Cameron resigned. In October 2016, the new Prime Minister Theresa May announced that the British government would launch the official exit process by triggering Article 50 of the Treaty of the European Union (TEU) by March 2017.

288. If Brexit materialises, the EU will lose one of its biggest member states, one that accounts for 13 % of the EU population and 18 % of its gross domestic product (GDP). This would represent a major **setback for the European project**, which has served as a guarantor of peace and a catalyst for prosperity in the decades since the Second World War.

Firstly, Brexit is expected to have a negative **impact on the economy**. Although the short-term effects would likely be moderate, the long-term negative impact could be substantial, particularly for the United Kingdom, depending on the nature of the country's future economic relationship with the EU. The remaining EU member states would also be negatively impacted by Brexit, albeit to a much lesser degree. Secondly, the move would have **institutional implications**, particularly given that the UK's exit would see the EU lose a major proponent of market-oriented positions and its second-largest net financial contributor.

289. Given the ramifications, the German Council of Economic Experts (GCEE) has the view that policymakers should **not be too hasty in accepting the prospect of Brexit as a done deal.** The exit could still be stopped even after notice of the intention to withdraw has been submitted according to Article 50 TEU. There is no unanimous legal opinion on whether the United Kingdom can unilaterally reverse this process. Sir David Edward, former member of the European Court of Justice (ECJ), told the House of Lords (European Union Committee, 2016) that it was possible to reverse a decision to withdraw, an opinion that is contested by constitutional lawyers Barber, Hickman and King (2016). The European Parliament's legal service (2016) has not arrived at any clear conclusion. However, revoking an exit even after Article 50 TEU was triggered would be possible together with the other member states.

This means that there is still a chance that constructive negotiations could either prevent an exit or at least enable a successor agreement to be concluded that would minimise the damage for both sides. It is ultimately all about striking the right balance. While making concessions to the UK in the details of the agreement should not be entirely off-limits, the GCEE argues that the **four fundamental freedoms** must be indispensable. An overly accommodative stance could send out signals with unpredictable consequences by encouraging others to follow in the United Kingdom's footsteps.

290. A critical attitude towards the EU is not unique to the British public. **Eurosceptic political movements** have attracted a significant following in many other member states. A helpful reaction to the vote involves trying to understand the reasons motivating the British who voted for the Brexit. ↘ BOX 8 This analysis reveals that many proponents of Brexit are likely to have held the country's membership of the European Union responsible among others for their own economic plight, or that suffered by their region. This line of thinking is likely to strengthen opposition to European integration also in other member states.

291. So it is more important than ever to put a suitable framework in place to boost the EU's economic strength. The GCEE argues that the EU should restrict itself more to its **core tasks** and **focus on the principle of subsidiarity**. Certain elements of internal security, protection of external borders, climate policy and financial market supervision, for example, should be handled at European level. Labour market and fiscal policy, on the other hand, are matters of national responsibility, as is the design of social security systems and social policy. The GCEE takes the view that the right political answer involves steering away from any further integration in these areas in order to effectively combat the mounting centrifugal forces within the EU.

↘ BOX 8

Analysis of the voting behaviour in the Brexit referendum

Indications as to the reasons behind the voting behaviour of British voters can be found in an analysis of the voting results in up to 398 British regions (for details on the calculations, see ↘ APPENDIX). Regions that returned a majority for Brexit **tend to be economically weaker.** ↘ CHART 35 They are characterised by lower average wages and wage growth, lower GDP per capita, lower GDP growth per capita and a lower economic competitiveness. In addition, the proportion of pro-Brexit voters tended to be particularly high in regions home to a higher proportion of people working in the manufacturing sector. Arnorsson and Zoega (2016) argue that this is linked to a marked structural shift away from the manufacturing sector, although this is not confirmed by the econometric estimates of the GCEE: regions characterised by a significant decline of the manufacturing sector since 1981 actually have a smaller proportion of pro-Brexit voters. ↘ APPENDIX

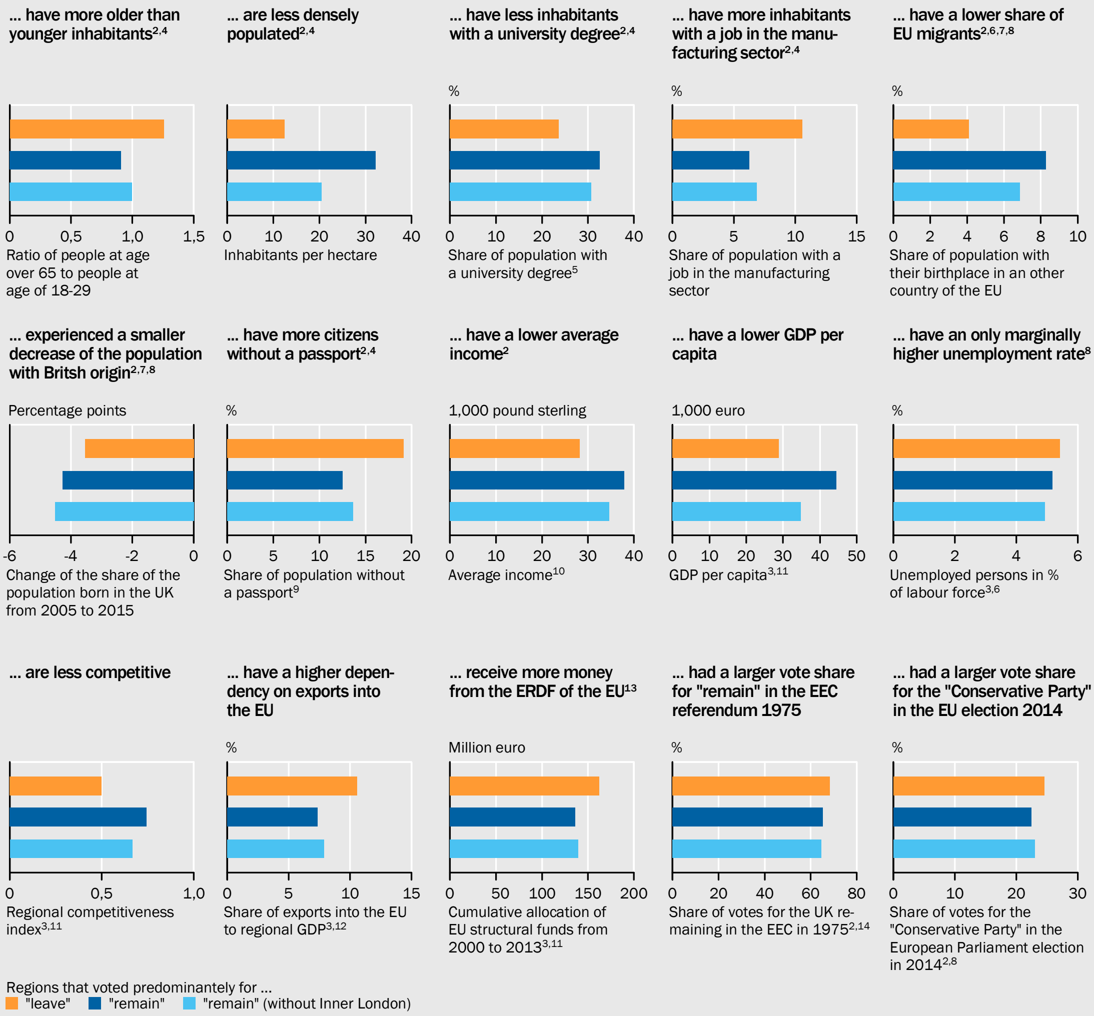
Regions in which pro-Brexit voters were in the majority are also characterised by a **lower qualification level** and tend to be more rural areas. The lower qualification level could suggest that the Brexit proponents might see themselves faced with mounting competition from less qualified migrants, which is why they could be particularly critical of the idea of free movement of persons within the EU. The regions with a majority of "leave" voters are home to a smaller proportion of nationals from other EU countries. In the period from 2005 to 2015, the decline in the proportion of the native population in these regions was more or less the same as, and the unemployment rate actually slightly higher than, those regions that voted to remain in the EU. This suggests that competition with low-qualified immigrants does not, in itself, offer a sufficient explanation.

Another striking factor is that it were precisely those regions which are, on average, more reliant on the EU and receive more **from the EU's structural and regional development funds** that voted for Brexit. The fact that these of all regions voted leave suggests that the EU has failed to communicate the advantages it offers to the population. The financial support is, however, more a symptom of the problems than an explanatory factor in its own right.

↘ CHART 35

Voting behaviour in the 2016 EU referendum in the United Kingdom[1]

Regions that voted for "leave" in comparison to regions that voted for "remain", ...



1 – The bars depict averages over the British regions (without Gibraltar) weighted by the population number from the Census 2011. Split of the regions according to the majority voting for "leave" or "remain". 2 – Data for districts or unitary authorities: in total 398, 128 "remain" 270 "leave". 3 – Data for NUTS2-regions: in total 40, 13 "remain", 27 "leave". 4 – From the Census 2011. 5 - Level 4 or higher qualification ("Degree, Postgraduate qualifications, Masters, PhD, SVQ level 5 or equivalent, Professional qualifications"). 6 – For the year 2015. 7 – Annual Population Survey. 8 – Without Northern Ireland. 9 – Without Scotland. 10 – Survey of Personal Incomes 2013–14. 11 – For the year 2014. 12 – For the year 2010 from Springford et al. (2016), based on the World Input-Output Database tables with interregional extensions. 13 – European Regional Development Fund. 14 – Results from 1975 from Butler and Kitzinger (1976).

Sources: Electoral Office for Northern Ireland, European Commission (Info-Regio), Eurostat, Northern Ireland Statistic & Research Agency (NISRA), Office of National Statistics (ONS), Springford et al. (2016), UK Electoral Commission, own calculations

The people living in the regions that returned a majority for Brexit have other **demographic and social characteristics** in common, such as a higher proportion of older people and pensioners. The population there would also appear to travel a lot less, with the share of inhabitants without a passport almost twice as high.

All of these observations only allow very cautious conclusions to be drawn as to voter **motivations**. However, the results suggest that higher numbers of Brexit voters can be found in economically weaker areas that have fallen further behind in recent years. They are also faced with the prospect of - what they at least perceive to be - tougher competition due to their poorer qualification and the increased influx of foreign workers. For some voters, the United Kingdom's exit from the EU is likely to hold the hope of a return to what are believed to be the "good old days" - that the EU has been standing in the way of.

At the same time, it is important to remember that finger pointing and the misinterpretation of economic developments can only account for part of the outcome of the referendum. In the post-vote Lord Ashcroft poll (2016), 49 % of voters said that their main motivation was a desire to **win back sovereignty**, and 33 % said that they were motivated by a wish to **limit migration.** Additionally, Hobolt and Wratil (2016) show that a general sense of distrust towards Prime Minister David Cameron and his government played a significant role in voter motivations. Better information on the advantages that the EU offers would not have been enough in itself to dispel these motivations.

II. ECONOMIC CONSEQUENCES OF BREXIT

292. The European Union is the **biggest single market in the world**. Its central characteristic is formed by the four fundamental freedoms, which enable the free and unrestricted movement of goods, services and capital and allow EU citizens to freely choose where they want to live and work. Over the past few decades, this has created close economic links between the member states, paving the way to growth and prosperity in the process (Baldwin, 1989, 1992; Landau, 1995; Henrekson et al., 1997; Feld, 2006).

1st United Kingdom's links with the EU and Germany

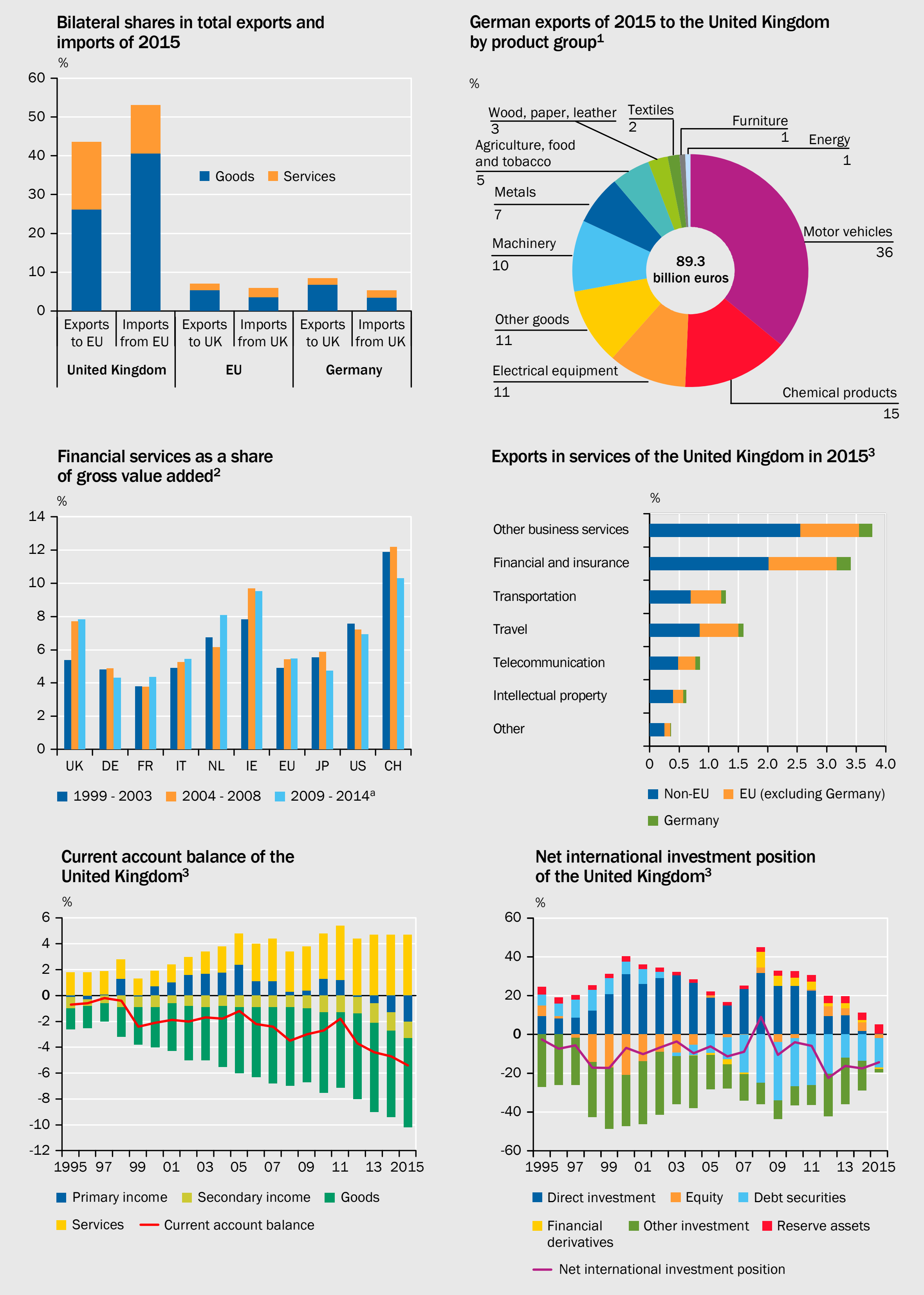
293. The United Kingdom has **close trade links** with the other EU states. Although the EU's significance has dwindled in recent years compared to the UK's partners from outside of Europe, 50 % of British imports still come from other EU countries and almost 44 % of British exports go to the rest of the EU. ↘ CHART 36 TOP LEFT The other way round, the percentages are much lower due to the differences in size. Nevertheless, around 7 % of exports from other EU countries head to the United Kingdom, and 6 % of imports of other EU countries originate in the United Kingdom.

294. From **Germany's perspective,** the UK ranks fifth among its main trading partners. In 2015, the trading volume amounted to around € 130 billion (approximately 4 % of German GDP) and the trade surplus amounted to over € 50 billion. This means that around one-fifth of Germany's total trade surplus of almost €250 billion results from the exchange of goods and services with the United Kingdom. German goods exports, particularly vehicle, chemical and machinery, play a particularly significant role in this respect. ↘ CHART 36 TOP RIGHT

295. While Germany's export economy has traditionally focused on manufacturing products, the international division of labour has resulted in the UK specialising in service exports. The percentage of the United Kingdom's total gross value added attributable to the **financial sector**, for example, has increased to around 8 % in recent years, which is almost 40 % higher than the EU average. ↘ CHART 36 CENTRE LEFT This process has come hand-in-hand with a significant concentration on individual financial services. In 2013, for example, around one

↘ CHART 36

Economic linkages between the United Kingdom, the EU and Germany



1 – Differences due to rounding. 2 – UK-United Kingdom, DE-Germany, FR-France, IT-Italy NL-Netherlands IE-Ireland, JP-Japan, US-United States, CH-Switzerland. 3 – Percentage of nominal GDP. a – For France, Switzerland and United Kingdom up until 2015.

Sources: Eurostat, OECD, ONS, Federal Statistical Office of Germany, own calculations third of Europe's total wholesale financial services were rendered in the United Kingdom (PwC, 2014).

296. The UK's strong service exports are combined with a **trade surplus in services** that recently came to around 5 % of GDP. This is not, however, sufficient to cover the **trade deficit in goods**, which is why the trade balance has been consistently in the red for two decades now. The development in the primary income account balance is striking. Since 2011, its decline alone has been responsible for a deterioration in the current account balance of more than 3 % of GDP. In economic terms, this reflects the relative increase in the income paid to foreigners based on their investment activities in the United Kingdom.

The **current account** reflects this trend; the UK has been a net capital importer since the 1990s. In recent years, the current account deficit has increased significantly, recently amounting to more than 5 % of GDP. ↘ CHART 36 BOTTOM LEFT

297. Every year, an influx of foreign capital in the same amount is required to finance the British current account deficit, with a corresponding detrimental impact on the UK's international investment position. ↘ CHART 36 BOTTOM RIGHT Looking at the individual items, **portfolio investments in debt securities** play a particularly significant role. The United Kingdom has been a net debtor in this category since 2003, and is on the cusp of becoming a net debtor as far as **direct investment** is concerned. The stock of British direct investments abroad has only increased by 40 % since 2005 while at the same time, the stock of foreign direct investment in the United Kingdom has more than doubled to total over £1.3 trillion in 2015 (75 % of GDP).

298. Around half of this direct investment comes from other EU countries. However, the UK also **attracts more direct investment from non-European countries** than any other EU member state. In total, around one-third of direct investments bound for the EU are destined for the United Kingdom. The UK's status as a gateway to the European single market is likely to be one of the main reasons behind this. In terms of competition with other member states, the United Kingdom could be a particularly attractive destination thanks to the relatively low level of regulation on its goods and factor markets.

2. Short-term economic impact

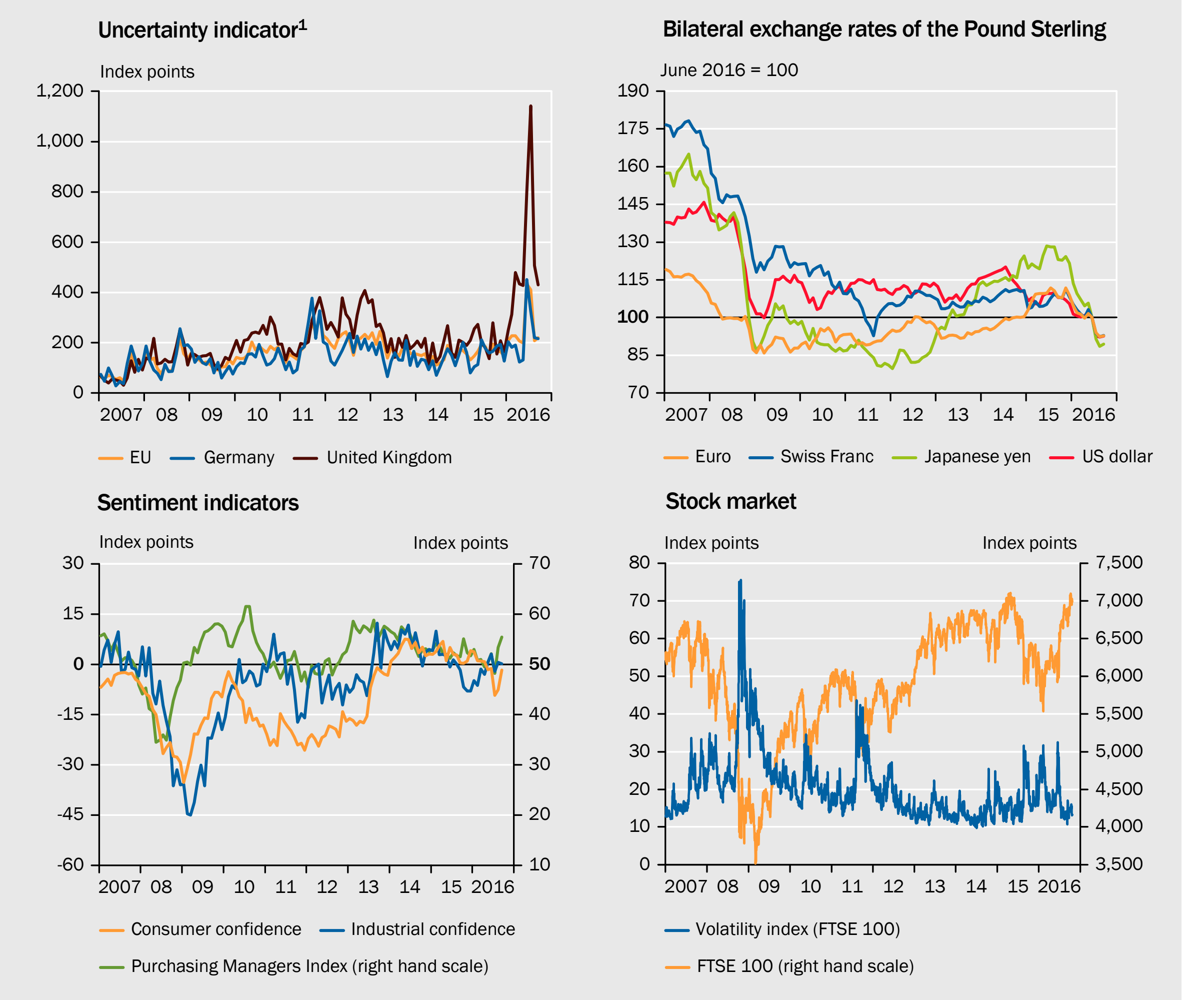
299. The United Kingdom will remain a member of the European single market until Brexit has been completed. As a result, the short-term economic implications of the Brexit vote will depend first and foremost on the extent to which the political processes fuel uncertainty and dampen sentiment among corporations and private households. After the referendum results were announced, **uncertainty indicators** initially shot up, with the developments in the United Kingdom having spillover effects on other economies. ↘ CHART 37 TOP LEFT AND BOTTOM RIGHT At the same time, **sentiment indicators** for the UK dipped. ↘ CHART 37 BOTTOM LEFT As a result, the corporate sector is likely to be more hesitant to invest and recruit new

staff in the second half of 2016. Foreign investors are also likely to cut their direct investments and consumers to postpone planned purchases.

300. Monetary and fiscal policy measures have been taken to counteract the risk of an economic slump. For example, the new government has already hinted that it plans to **depart from the current consolidation path**, announcing that specific plans will be unveiled in the "Autumn Statement" made by the British Chancellor of the Exchequer Philip Hammond on 23 November 2016 (Hammond, 2016). The **Bank of England** (BoE) also introduced **new easing measures** designed to boost the economy in August 2016 (Bank of England, 2016). These include a policy rate cut to 0.25 % and a new purchase programme for government bonds worth £60 billion over the next six months. The BoE also announced a corporate bond purchase programme worth £10 billion that is to run over the next 18 months and reduced the counter-cyclical capital buffers from 0.5 % to 0 %.

↘ CHART 37

Selected economic indicators for the United Kingdom



1 – Uncertainty indicators by Baker, Bloom and Davies (www.policyuncertainty.com). The indicator is constructed from two components. The first quantifies newspaper coverage of policy-related economic uncertainty. The second uses disagreement among economic forecasters as a proxy for uncertainty.

Sources: Economic Policy Uncertainty, EU, FTSE, Markit Economics

301. One transmission channel for this kind of monetary policy could be via the **exchange rate**. Immediately after the referendum result was announced, investors started to withdraw from investments in British pounds on the currency markets and the **pound lost ground** against the currencies of the world's other major industrialised nations. ↘ CHART 37 TOP RIGHT The subsequent easing of monetary policy came hand-in-hand with a further drop in value. This provides a boost to the price competitiveness and sales prospects of Britain's export industry. At the same time, the relative increase in foreign prices means that imported goods are being substituted by products manufactured at home. All of these developments are helping to counteract a slump in economic output. On the other hand, the currency devaluation has pushed consumer prices up, which will have negative repercussions on real disposable income. This reverses at least part of the otherwise expansionary effect.

302. In a long-term comparison, the deterioration in the available indicators is not a dramatic development in the majority of cases. Many indicators had already shown a positive counter-movement by July and August 2016. This makes the prospect of a **drastic economic slump** in the second half of the year **unlikely**. The short-term effects are expected to be fairly moderate. The GCEE has made a downward adjustment to its GDP forecast for the United Kingdom in 2016 and 2017, by 0.1 and 0.4 percentage points to 1.9 % and 1.4 % respectively. ↘ ITEM 156

303. The price and demand shifts in the United Kingdom are having spillover effects on the other EU member states via the **international trade** channel. In the short term, the depreciation of the British pound and the decrease in demand will have a negative impact on the UK's partner countries, the extent of which will vary depending on the intensity of trade relations. Given that the effects in the United Kingdom are expected to be moderate, no **serious economic repercussions** would appear to be on the horizon **for the rest of the EU** or for the **euro area** in particular. This is consistent, among other things, with the latest forecast released by the ECB, in which the outlook for recovery remains largely unperturbed by the outcome of the referendum on the whole, despite dampening effects on export growth in the euro area (ECB, 2016).

304. As for **Germany**, the impact via the trade channel is likely to be more pronounced than for the EU countries on average due to the relatively close trade relations that Germany maintains with the UK. The direct impact on exports, however, will be cushioned by several offsetting effects. Firstly, a corresponding decline in export-related imports has to be taken into account. Germany's total exports to the United Kingdom only account for around 2 % of total domestic value added (Deutsche Bundesbank, 2016). Secondly, the uncertainty surrounding the United Kingdom's membership in the single market in the future is likely to make Germany more attractive as a location in relative terms, with positive partial effects on domestic investment and employment. On the whole, current survey indicators for Germany do not point to any major short-term effects. ↘ ITEM 221

305. Any forecast of the short-term effects has to account for **considerable downside risks**. Market participants are nervous and there is still an atmosphere of heightened political uncertainty. ↘ CHART 37 TOP LEFT Only recently, Prime Minister May's announcement of her intention to trigger Article 50 TEU by March 2017 promptly gave rise to concerns of a hard Brexit with grave consequences, resulting in drastic capital outflows within only a few days and a further depreciation of the British pound. While the situation has stabilised somewhat since then, a sudden and lasting reversal in capital flows would create the need for painful adjustment processes in light of the United Kingdom's hefty current account deficit.

3. Long-term economic impact

306. Less investment in the United Kingdom not only has a short-term impact on demand; it also influences the production capacities available in the long term and productivity levels. However, the extent of the **long-term implications** of Brexit depends primarily on how trade relations, which are still up for negotiation, look like in the future. As things currently stand, the outcome of the negotiations is unlikely to be a ready-made solution. The EU's existing trade agreements with non-EU countries span a whole range of alternatives, ↘ BOX 10 from membership in the European Economic Area (EEA) to bilateral free trade agreements and arrangements that fall back on World Trade Organisation (WTO) rules. This means that any attempt to pinpoint the long-term effects is currently associated with a corresponding degree of uncertainty.

307. It is more or less undisputed that a loss of access to the single market would have a **sustained negative impact on the United Kingdom.** For one thing, this sort of scenario would erect greater trade barriers to the EU and non-EU countries, which would have a negative impact on the British economy's integration into the international division of labour. The country would lose some of the efficiency gains achieved in production in the past and production costs would start to rise. Moreover, protracted supply-side adjustments would be required to reduce the size of the export-oriented service sector in favour of other sectors. The UK's access to the EU market is important for the major financial services sector, in particular. ↘ BOX 9

↘ BOX 9

The importance of passporting rights for the UK

The United Kingdom is home to one of the world's leading financial centres: London. London's attractiveness is built around the English language, the generous supply of skilled professionals and the flexible labour market conditions (McMahon, 2016). However, last but not least, the country's EU membership makes a key contribution to **London's appeal.** Firstly, free movement of persons within the EU makes it easier for companies to recruit skilled employees. Secondly, EU membership gives the United Kingdom passporting rights.

Passporting gives British banks and subsidiaries of non-European banks that are based in the UK the right to open branch offices within the EU and the EEA and perform cross-border banking activities

(Jackson, 2016). Whereas **branch offices** are legally dependent permanent establishments of an institution and subject to supervision from their home country, **subsidiaries** are legally independent entities that have their own banking licence and are subject to supervision by the responsible national banking supervisory authority (CEPS, 2014).

Around 5,500 companies with licences from the British supervisory authorities use passporting rights to offer financial services in the other member states, while some 8,000 companies from other EU states use passporting rights to offer financial services in the United Kingdom (Bailey, 2016). Around half of the **global financial enterprises** currently have European headquarters in London and the city is responsible for generating around one-quarter of the total income from European financial services (Hill, 2016). The potential loss of passporting rights is a major concern for financial services exports, in particular. In 2015, for example, around 44 % of British financial services exports were destined for the EU, which corresponds to around 1.4 % of British GDP.

If the UK were to be stripped of its passporting rights, financial services could be offered for other EU countries via **subsidiaries in the EU**. Some British and non-European banks have subsidiaries in other EU countries (Jackson, 2016; Schoenmaker, 2016). The responsible national regulators set the requirements that these subsidiaries have to meet. For instance, a substantial share of the banking business that the subsidiaries conduct in the EU has to be conducted locally. Consequently, it is questionable whether regulators would allow banks to continue conducting their business from London and merely let accounting run through a subsidiary in other EU countries (McMahon, 2016).

A **third country equivalence arrangement** could give the United Kingdom access to the entire single market. This type of arrangement can be used in cases where the level of financial market regulation in an institution's home country is comparable to the EU standards (Woodford, 2015; Jackson, 2016). Equivalence decisions are made unilaterally by the European Commission, however, and can be revoked at any time. A comparison of the third country regimes reveals an extremely complex structure, with different levels of restrictions imposed on access to the EU common market depending on the business area. This means that, under a third country arrangement, financial services companies based in the UK would receive restricted access to the EU market in the future. This would hit large, integrated financial institutions particularly hard (Lannoo, 2016).

On the whole, the loss of passporting rights could have **tangible consequences for London's status as a financial centre**. The scale of necessary relocations will depend, however, on the extent to which existing subsidiaries in the rest of the EU are granted passporting rights and the extent to which third country arrangements can be agreed.

308. Without still having free movement of persons, a decline in **migration** would be likely. Contrary to the statements made during the Brexit campaign, immigration has provided an important pillar to economic growth in the United Kingdom in recent years (OECD, 2016; IMF, 2016a).

309. A permanent **drop in direct investment** would be another likely effect. Several studies show a close link between the inflow of foreign direct investment and access to the single market (Fournier et al., 2015; Bruno et al., 2016). Given that net capital imports have provided positive impetus for the United Kingdom's capital stock and productivity over the past few years, a drop in direct investment would cast a shadow over the country's growth outlook for the long term. The only factor offsetting all of these negative long-term effects would be the opportunity to offer additional tax incentives and to go further in deregulating the goods and factor markets. In light of the deregulation that has already

occurred in the United Kingdom, the resulting scope for efficiency gains would likely be limited.

310. **Quantifying all of these partial effects** is subject to a high degree of uncertainty. Nevertheless, numerous studies have used various models in an attempt to estimate the long-term impact on the UK's GDP. These studies tend to address the uncertainty surrounding the structure of future trade relations by calculating different scenarios. This, coupled with the variety of other assumptions, produces a broad range of conceivable effects in the majority of these studies. ↘ TABLE 17

311. The models used in the studies to forecast the long-term impact can be split into roughly two categories. The first category includes those studies that use **static general equilibrium models**. These are detailed models for trade covering a large number of countries and industries. The United Kingdom's exit from the

↘ TABLE 17

Estimates of the long term effects of a Brexit (2030 and later)[1]

Study	Trade agreement				Included channels					
	EEA[2]	FTA[3]	WTO[4]	Other	Trade	FDI	(De-)Regulation	Contributions to EU	Migration	Other[5]
Static trade models[6]										
Bertelsmann Stiftung[7]	−0,6		−1.5 bis −2.8	−1.6 bis −3.0[a]	•					
CEP/LSE/Dhingra et al. (2016)	−1,3	−1,3	−2,6	−1.0 bis −2.3[b]	•			•		
Ottaviano et al. (2014)		−1,1	−3,1		•			•		
Dynamic macroeconomic models										
HM Treasury (2016)	−3.4 bis −4.3	−4.6 bis −7.8	−5.4 bis −9.5		•	•		•		•
IMF (2016b)	−1,5		−4,5		•	•				•
NIESR[8]	−1.5 bis −2.1	−1.9 bis −2.3	−2.7 bis −3.7	−7.8[c]	•	•		•		
OECD (2016)				−2.7 bis −7.7[d]	•	•	•	•	•	•
Open Europe[9]		−0.8 bis 0.6	−2,2	1.55[e]	•	•	•	•		
Oxford Economics (2016)[10]				−0.1 bis −3.9[f]	•	•	•	•	•	•
PwC (2016)		−1,2	−3,5		•	•	•	•	•	•
Other analysis										
Mansfield (2014)[11]	0,1		−2,6	1.1[g]	•	•	•	•		•
Minford (2016)[12]				4.0[h]	•					

1 – Percentage deviation from the GDP level in the baseline scenario. For Bertelsmann Stiftung (2015) and Dhingra et al. (2016): GDP per capita. 2 – EEA: Membership in the European Economic Area. 3 – FTA: Free trade agreement comparable with the agreements between the EU and Switzerland. 4 – WTO: fallback on the rules of the World Trade Organization. 5 – Different for the different studies: e.g. additional productivity effects, uncertainty or financial conditions. 6 – Results of the static analysis. 7 – Aichele and Felbermayr (2015). 8 – Ebell and Warren (2016). 9 – Booth et al. (2015). 10 – Information according to the executive summary. 11 – Scenarios using different estimates for the individual effects. 12 – Static Macro-model with four regions each with four production sectors. It is assumed that after abolishing all trade barriers consumers and producers face world market prices for goods. a – When also the preferential access to EU-trading partners is lost. b – 0.3 percentage points less costs if all tariffs are abolished unilaterally. c – Given an additional negative productivity shock. d – Optimistic and pessimistic assumptions for the strength of the effects. e – Strong additional deregulation. f – Best- and worst-case-scenarios. g – Best-case-scenario with „generous" exit-agreement, additional trade agreements with third countries and deregulation. h – Unilateral abolishing of all trade barriers by the United Kingdom.

EU would be associated with higher trading costs due to the increase in tariff and non-tariff barriers to trade. The authors of these studies estimate the extent of this cost increase for the various scenarios and based on the model endogenously arrive at the overall effect of trade shifts on GDP. The varying extent of the effects depends primarily on the chosen scenarios and assumed increase in trading costs.

Finally, in order to arrive at a net effect, some of the studies compare the estimated trade effect with an estimated value for the savings the UK will make in the future as a result of it no longer having to make net contribution payments to the EU. One of the disadvantages of these models lies in the fact that they do not reflect the temporal transition to the new equilibrium.

312. In order to model this, the second category of studies uses **dynamic macroeconomic models**. Based on empirical analyses, the results of academic literature or other estimates, these studies start by determining the effects of Brexit via various channels separately, such as trade, foreign direct investment, migration, uncertainty and regulation. These effects are then applied to macroeconomic models. Examples of these include large-scale structural macroeconometric models like the commercially available NiGEM model and large-scale DSGE models such as the model by Vitek (2015) used by the IMF (2016b).

313. The range of the effects estimated using all of these models is relatively broad, with the long-term impact on GDP varying between -9.5 % and 4 %. This is mainly because the studies include different channels and assume different scenarios, for example regarding the future trade relations with the EU. By far the majority of the studies, however, conclude that the **long-term impact** of Brexit **on the United Kingdom would be clearly negative**. The long-term effects on Germany and the other remaining EU member states would likely be much less pronounced, because the decline in demand from the UK would be spread over a large number of countries and because the remaining effects would be cushioned by opposing developments.

↘ BOX 10

Examples of existing trade agreements between the EU and third countries

Brexit would result in the renegotiation of trade relations between the EU and the United Kingdom. A glance at the existing relationships between the EU and third countries reveals a range of possibilities. Various options, from membership in the European Economic Area (EEA) to bilateral free trade agreements, a customs union and WTO trade rules, are possible, each associated with different mutually guaranteed rights and responsibilities. ↘ TABLE 18

Membership in the EEA ensures the greatest possible access to the European single market and is the option closest to trade relations as an EU member state. **Iceland, Liechtenstein and Norway** are currently members of the EEA, which means that they belong to the European single market. In order to achieve this membership, countries have to honor the four fundamental freedoms, i.e., the free movement of goods, services, capital and persons within the single market. Acts and legislative amendments affecting the European single market have to be transposed into national law. However, binding provisions relating to fisheries and agricultural policy, the customs union, trade policy, foreign and security policy, justice and home affairs, as well as economic and monetary union, do not apply. The EEA countries have no right to a seat and no right to vote in the European Parliament or the Council of the European Union. The only way to influence legislation is by participating in expert groups and committees and by submitting non-binding EEA EFTA comments. Furthermore, members make payments to the EU. The net payments made by Norway and Iceland in 2015 accounted for 0.17 % and 0.12 % of GDP respectively. By way of comparison, the United Kingdom made a net contribution to the EU corresponding to 0.42 % of its GDP, but was able to exert influence over EU legislation.

Switzerland has more limited access to the European single market via comprehensive **bilateral agreements**. Since the Swiss population rejected EEA membership in a referendum held in 1992, the “Bilateral Agreements I” were signed in 1999, covering the free movement of people, technical barriers to trade, public procurement markets, agriculture, overland transport, civil aviation and research. These were followed by the “Bilateral Agreements II” in 2004, covering free movement of persons within the Schengen area, asylum and migration (Dublin Regulation), the taxation of savings income, combating fraud, processed agricultural products, the environment, statistics, MEDIA (access to EU promotional programmes for Swiss filmmakers), pensions and education. The more than 120 sector-specific bilateral agreements, which took **a total of more than seven years to negotiate**, largely allow for the same provisions as the EEA Agreement as far as the four freedoms are concerned. Unlike the EEA Agreement, however, the bilateral agreements are static, which is why a framework institutional agreement is being negotiated to resolve adjustment-related problems.

After Swiss voters backed the popular initiative “against mass immigration” in a February 2014 referendum, however, these negotiations have stagnated, because the initiative has a bearing on fundamental principles of the single market, particularly the free movement of people. Furthermore, a “guillotine clause” applies to the “Bilateral Agreements I”, which means that if one of the agreements in the overall package is not extended or is terminated, this will result in the termination of the entire “Bilateral Agreements I”. In order to implement the mass immigration initiative, the Swiss National Council resolved the concept of “priority for domestic labor force/freedom of movement light” in September 2016. This means that in times of considerable immigration, the Swiss Federal Council can require vacant positions to be reported to the regional employment centres (RAV) before they are advertised in a public announcement, giving Swiss workers priority in the placement for these positions during this period. There are no plans, however, to force companies to recruit domestic workers.

The two chambers of the Swiss parliament, the National Council and the Council of States are currently debating whether this proposal implements the **mass immigration initiative** to an adequate extent. The legal services of the European Commission and the Council of Ministers have warned against discrimination based on origin, place of residence or nationality, but believe that the proposal could be shaped in a way that makes it consistent with EU law, meaning that the move would not constitute a breach of the Agreement on the Free Movement of Persons. The Swiss federal administration and Schweizer Post have been applying similar provisions already since the bilateral agreements were concluded, without any objections having been raised by the EU. This suggests that a solution is within reach.

The Swiss model of trade relations with the EU also entails payment obligations, albeit in an amount corresponding to a smaller proportion of GDP than in Norway’s case. While decision-making and legislative powers are not ceded to a supranational level, acts or legislative amendments affecting the bilateral agreements have to be implemented. Further legal harmonisation also comes about as part of the **autonomous implementation** mechanism. This is not, however, due to any binding effect via the bilateral agreements, but is based on voluntary and autonomous legislative alignment. The Commission wants to use the negotiations on the “priority for domestic labor force/freedom of movement light” initiative to conclude a framework institutional agreement that will result in more dynamic adjustments to single market regulations.

↘ TABLE 18

Key elements of selected economic relationships

		EU	EEA[2]	Switzerland	Canada[3]	Turkey[4]	WTO[5]
Freedom	goods	✓	✓	✓	(✓)	(✓)	(✓)
	services	✓	✓	✓	(✓)		(✓)
	capital	✓	✓	✓			
	persons	✓	✓	✓			
Duties	payments	✓	✓	✓			
	legal harmonisation	✓	(✓)	(✓)			
Rights	political participation	✓	(✓)				

1 – Check marks in brackets indicate limited validity. 2 – European Economic Area: Iceland, Liechtenstein, Norway. 3 – Comprehensive Economic and Trade Agreement (CETA). 4 – Customs union. 5 – Rules for the member states of the World Trade Organization.

Trade relations with **Canada** are to be intensified as part of the **Comprehensive Economic and Trade Agreement (CETA)**. The agreement provides for the reciprocal opening up of the markets for goods, services and investment. Customs tariffs between Canada and the EU are to be largely abolished and measures taken to allow mutual participation in public procurement procedures. Concerning investment, there are plans to simplify and accelerate the process for resolving investment disputes. The negotiations on the free trade agreement were launched in 2009 and concluded in 2014, although the agreement has still to be signed by the Council of the European Union and approved by the European Parliament. The EU has also granted the national parliaments a right of co-determination. After the Federal Constitutional Court in Germany rejected a preliminary injunction request, nothing stands in the way of an approval of CETA.

The EU also has free trade agreements with other countries including **Mexico, Chile and the Republic of Korea**. The Economic Partnership, Political Coordination and Cooperation Agreement (the “Global Agreement”) was concluded with Mexico in 1997. A free trade agreement was developed on this basis that entered into force in 2000. The part related to goods was immediately applied, and trade in services followed in 2001. The EU and Mexico have been negotiating moves to modernise and expand the agreement since May 2016. The EU and Chile concluded an Association Agreement in 2002, which covers political dialogue, cooperation to promote sustainable economic, social and environmental development and a free trade zone. The free trade zone was set up for goods, services and public procurement. The EU entered into a strategic partnership with the Republic of Korea in 2010 which has included a free trade agreement since July 2011. It reduces customs tariffs for agricultural and industrial goods, lifts non-tariff barriers to trade and facilitates market access for services and investments.

Finally, the EU also has Stabilisation and Association Agreements with the Western Balkan countries, the Euro-Mediterranean Association Agreements, the Association Agreement with Central America, and the trade agreement with the South American Andean Community, all of which set out bilateral provisions for political cooperation and free trade agreements.

Trade relations between the EU and **Turkey** have been organised as part of a **customs union** since 1996. This allows for the free movement of industrial goods, while the EU's external tariff applies and trade policy measures are being harmonised. In the United Kingdom’s case, a customs union - extended to cover further sectors - could prevent the reintroduction of customs tariffs in bilateral trade with the EU and would presumably also prevent London from having to individually renegotiate the numerous EU trade agreements. The UK would, however, be bound by EU foreign trade policy without having a say in it. In particular, trade in services, which is so significant to the UK economy, is not part of the customs union with Turkey.

The **most limited access to the European single market** is provided by membership of both the United Kingdom and the EU in the World Trade Organisation (**WTO**), which was set up in 1995. The rules negotiated by the WTO's members serve to lift barriers to trade in order to promote international trade. The WTO rules deal primarily with the dismantling of customs tariffs and equal treatment for trading partners with regard to trade in goods and services, as well as rights to intellectual property. Trade relations based on the WTO rules do not result in any payment obligations and no decision-making or legislative powers are ceded to a supranational level. However, the WTO rules do not go as far in lifting non-tariff barriers to trade as the other models presented here. Non-tariff barriers to trade arise, for example, in connection with the regulation of licenses, product standards and technical provisions and play a key role in international trade.

The United Kingdom is currently a member of the WTO via its EU membership. A scenario resulting in a country exiting a union while maintaining its WTO membership would set a precedent, meaning that it is not clear how much time would be required before the United Kingdom could start trading with the EU based on the WTO rules.

III. INSTITUTIONAL CONSEQUENCES OF BREXIT

314. Brexit would have serious institutional consequences. The **exit of one of the three largest member states** would shift the balance of power within the EU. Already today the United Kingdom does not participate in all EU decision-making processes anymore. This could, however, allow for progress in policy areas in which the UK has blocked an agreement in the past. Finally, Brexit would have a direct impact on the EU budget.

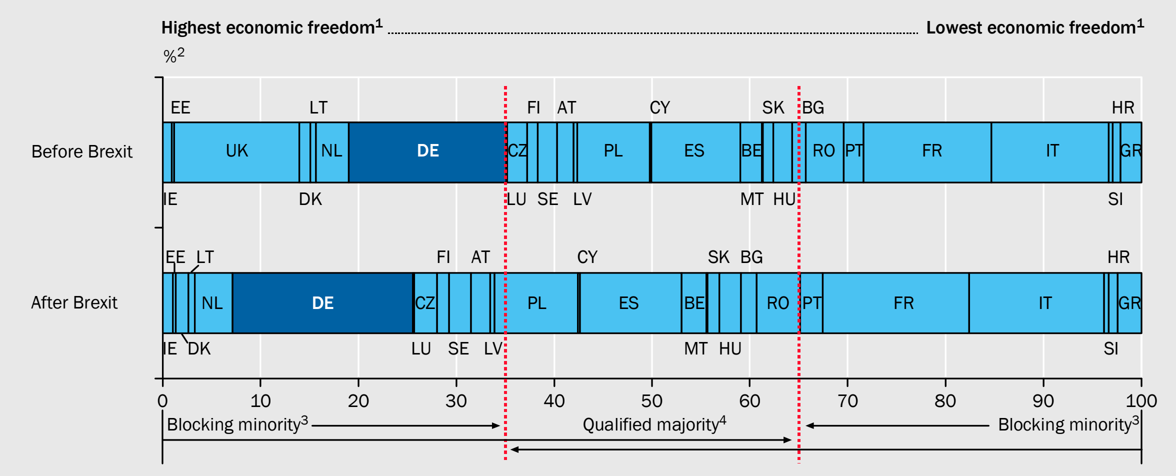
1st Shift in the balance of power within EU bodies

315. The exit of a large member state would be significant when it comes to voting at EU level. Around 80 % of all EU legal provisions are passed using the ordinary legislative procedure (Article 294 TFEU). Since 1 November 2014, a **qualified majority** has been required in the Council of the EU to approve a proposal made by the Commission or the EU's High Representative. A qualified majority refers to a situation in which at least 55 % of the member states representing at least 65 % of the total EU population vote in favour of a proposal. The **unanimous** approval of the Council is only required in a handful of politically sensitive areas, such as security and defence policy, the EU's financial framework or the harmonisation of laws relating to taxes and social security.

316. If the EU member states are ranked based on the Economic Freedom Index of the Heritage Foundation, which measures economic freedom and, as a result, indirectly shows the degree of liberal attitudes of a country, then Germany has played a key role prior to Brexit: the six most liberal countries plus Germany had a **blocking minority**. ↘ CHART 38 If all countries were to vote in line with their position in the ranking, then Germany would have the pivotal vote when it comes to accepting or rejecting a proposal. After Brexit, this key role would be handed over to other countries, for example Poland.

↘ CHART 38

Blocking minority and majority in the Council of the European Union, countries ranked according to Economic Freedom Index



1 – Ranking of the countries in descending order according to their 2016 Economic Freedom Index score (Heritage Foundation). IE-Ireland, EE-Estonia, UK-United Kingdom, DK-Denmark, LT-Lithuania, NL-Netherlands, DE-Germany, LU-Luxembourg, CZ-Czech Republic, FI-Finland, SE-Sweden, AT-Austria, LV-Latvia, PL-Poland, CY-Cyprus, ES-Spain, BE-Belgium, MT-Malta, SK-Slovakia, HU-Hungary, BG-Bulgaria, RO-Romania, PT-Portugal, FR-France, IT-Italy, SI-Slovenia, HR-Croatia, GR-Greece. 2 – Share of the total EU population. Population numbers for the year 2015 (population at their usual residence). 3 – In the ordinary legislative procedure of the EU: blocking minority with 35 % of the total population and a minimum of four member states. 4 – In the ordinary legislative procedure of the EU: qualified majority with 65% of the total population and 55 % of member states.

Sources: Eurostat, Heritage Foundation

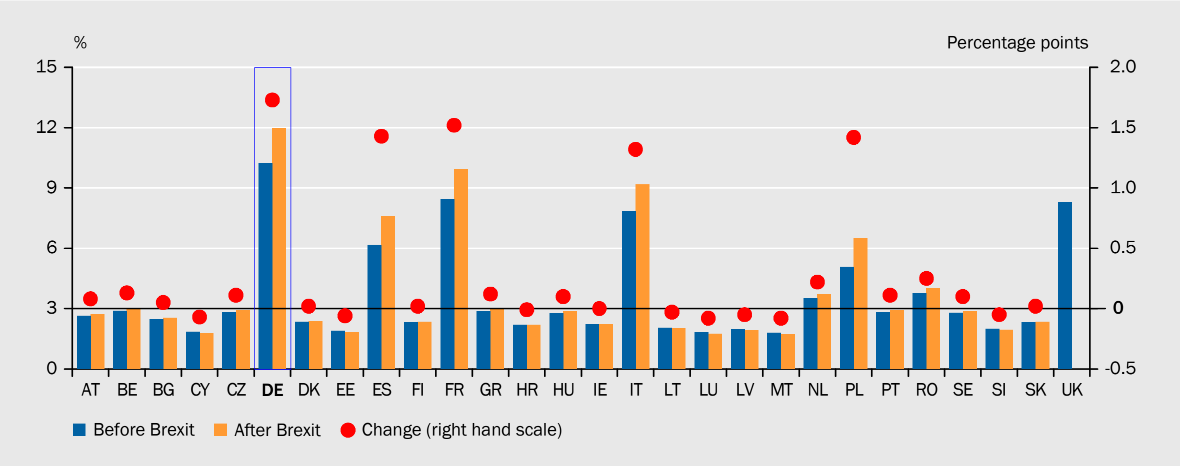
317. Estimates of member state preferences based on their historical voting behaviour within the Council of the EU (Badinger et al., 2014) show, much like the Economic Freedom Index, that Brexit would result in the EU losing a member state that has traditionally taken one of the most liberal stances. To date, **Germany** has often been able to position itself between the coalitions around France and UK, acting as an **intermediary**. In a scenario without the UK, Germany would have to take a **clearer market-friendly stance**.

318. Power indices can be calculated to show a country's voting power where the voting positions are not fixed. The Banzhaf (1965) index is one of the most commonly used power indices. It measures a country's power expressed as the share of the possible voting combinations of all countries, where a particular country is pivotal to the outcome of the vote. The calculation of the index for the Council of the European Union shows that the large member states, Germany, France, Italy, Spain and Poland would benefit the most from Brexit. ↘ CHART 39

The need for a qualified majority, i.e., the approval of 55 % of the member states representing 65 % of the population, means that small countries have much greater voting power than their share of the population would suggest. Brexit would, however, reduce the number of member states required for a majority from 16 to 15. Together with a proportional increase in the shares of the population, this would favour the larger member states. Voting procedures in the EU would also become more efficient after Brexit, meaning that proposals would be more likely to be approved. The UK's exit would also result in greater proportionality, meaning that the distribution of voting power based on the qualified majority procedure would be brought closer into line with the distribution of the population.

↘ CHART 39

Power indices for the EU member states before and after Brexit[1]



1 – Normalized Banzhaf index; voting procedures of the Council of the European Union with qualified majority; population numbers for the year 2015 (population at their usual residence). AT-Austria, BE-Belgium, BG-Bulgaria, CY-Cyprus, CZ-Czech Republic, DE-Germany, DK-Denmark, EE-Estonia, ES-Spain, FI-Finland, FR-France, GR-Greece, HR-Croatia, HU-Hungary, IE-Ireland, IT-Italy, LT-Lithuania, LU-Luxembourg, LV-Latvia, MT-Malta, NL-Netherlands, PL-Poland, PT-Portugal, RO-Romania, SE-Sweden, SI-Slovenia, SK-Slovakia, UK-United Kingdom

Sources: European Commission, own calculations

319. In addition, Brexit would **shift the balance of power in favour** of the **EMU** member states. While 67 % of the EU population currently lives within the euro area, this figure would rise to 76 % after Brexit. The share of the population attributable to the Mediterranean states ("EU Med": Cyprus, France, Greece, Italy, Malta, Portugal and Spain) would change from 39 % to 44 %, and the share attributable to the Visegrád Group (Czech Republic, Hungary, Poland and Slovakia) would change from 13 % to 14 %.

2nd Possible change of course in EU policy areas

320. Although the majority of votes in the Council of the EU are unanimous, the UK is the country that has abstained or voted against the majority the most often. In the period between 2009 and 2015, the UK was a member of the **losing coalition** in 12.3 % of votes within the Council of the EU (Hix et al., 2016). The situation in the European Parliament is similar, with British MEPs being by far the most likely to vote against the majority there (Hix et al., 2016). It therefore appears that the UK's political vision is one that differs from that of the other EU member states particularly often.

321. Past voting results do not, however, allow for the conclusion to be drawn that the UK might exert little influence over EU legislation. Assuming that the member states in the Council of the European Union and the MEPs in the European Parliament can be ranked based on their preferences with respect to a certain proposal and vote accordingly, **minority votes play a key role**. It can be assumed that only proposals that have a chance of being accepted get as far as a vote. This means that a proposal has to be sufficiently in tune with the preferences of a group of countries that can constitute a majority. Consequently, proposals that lie at the extremes of the spectrum of preferences are never put to a vote in the first place.

It is true that, if a country with a large share of the voting rights, like the UK, is fairly close to one of these extremes, then it is outvoted particularly often due to its preferences. The fact that it has assumed a clearly dissenting stance, however, ensures that the proposal will already have been corrected to reflect its preferences to some extent, meaning that it reflects a more extreme position than the political spectrum of the remaining member states would otherwise suggest. This shows that, even if it votes against the majority more often, the UK exerts a considerable influence over EU legislation.

322. The United Kingdom has been able to **block** certain projects, partly because its consent was required for a unanimous decision. This blockade would not continue to exist after a Brexit. One current example is defence policy, an area in which the UK has always rejected the idea of closer cooperation within the EU. At the very first unofficial EU meeting without British participation in Bratislava in September 2016, closer cooperation (as part of a permanent structured cooperation pursuant to Article 42 (6) and Article 46 TEU) in defence matters was already on the agenda. Other policy areas in which the United Kingdom has taken a dissenting position exemplarily include:

- **Financial transaction tax**: The UK leads the member state opposition to an EU-wide financial transaction tax and brought action before the European Court of Justice to block the project in 2013. Ten member states (including Germany) are currently involved in negotiations on the introduction of this tax which, as approved by the Council of the EU in 2013, would be introduced by way of enhanced cooperation between the participating EU member states. ↘ ITEM 47
- **Capital Markets Union**: The United Kingdom is advocating a decentralised structure of Capital Markets Union and is opposed to the idea of a central supervisory authority or the harmonisation of regulation and measures in areas such as insolvency, tax and corporate law, and accounting principles. The European Commission and France, on the other hand, support a centralised solution with a strong regulator, similar to the role played by the ECB within the banking union.
- **Free trade:** The UK is the biggest supporter of the extension of EU free trade to other countries. It was in favour of the EU's expansion and advocates new free trade agreements, for example with China. While this position is largely consistent with that taken by the German Federal Government, other member states, such as France, are more reluctant.
- **State aid**: The United Kingdom has continually pushed for deregulation and a clampdown on state aid and subsidies. Other member states, such as France, would want to have more national discretion when it comes to providing state aid.
- **Fiscal Compact:** The British opposition stood in the way of moves to step up the Maastricht criteria, in particular the financial sanctions and the strengthening of the national fiscal frameworks, being transposed into EU law. Instead, a separate intergovernmental agreement (the Fiscal Compact) was concluded among the 25 participating states.

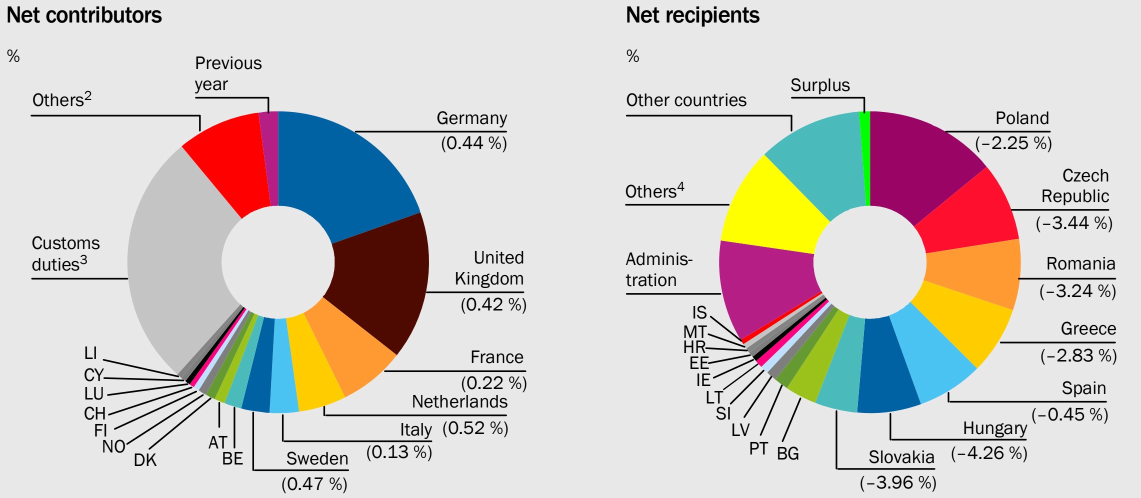
– **Climate policy**: The UK is against specific targets for the expansion of renewable energies or measures to increase energy efficiency. Instead, it is advocating for more stringent targets for reducing emissions as part of the EU Emissions Trading System (ETS) and the continued generation of electricity using nuclear power.

323. These examples show that the United Kingdom's exit would remove a major dissenting voice in several areas of EU policy. This could allow some decisions to be made differently at EU level. It is also clear, however, that the United Kingdom was not the main obstacle to a group of member states that wanted **greater integration**. The Fiscal Compact, the financial transaction tax and defence policy, are examples that show that greater integration is possible in principle for a group of member states and without any treaty changes. Rather, disagreements between the member states and opposition from the general public are likely to pose greater obstacles to more integration.

3. EU budget and other links

324. At the moment, the United Kingdom is the **second-largest net contributor** to the EU, after Germany. ↘ CHART 40 The country contributes a net total of 0.42 % of its GDP to the EU budget. This already includes a special discount, granted since 1985, corresponding to around 66 % of its net payments. If the EU budget remains otherwise unchanged after Brexit, the other member states would have to contribute 7.9 % more (share of the UK's net contribution in relation to total EU spending) in order to replace the United Kingdom's net contribution.

↘ CHART 40
Revenues and expenditures in the EU budget 2015[1]



1 – The net contribution for each individual country is the difference between the overall contributions of a country to the EU (value added tax based and gross national income based) and payments from the EU to a respective country (excluding administration). United Kingdom rebate taken into account; contributions from and to Switzerland, Norway, Liechtenstein and Iceland taken from Darvas (2016). Values in parentheses: In relation to the nominal GDP of the respective country. AT-Austria, BE-Belgium, BG-Bulgaria, CH-Switzerland, CY-Cyprus, DK-Denmark, EE-Estonia, FI-Finland, HR-Croatia, IE-Ireland, IS-Iceland, LH-Liechtenstein, LT-Lithuania, LU-Luxembourg, LV-Latvia, MT-Malta, NO-Norway, PT-Portugal, SI-Slovenia. 2 – Among others: taxes on EU salaries, contributions of other non-EU countries, penalty payments of corporations.
3 – All tariffs on imports into the EU are levied by the individual member states. In return member states keep one quarter of the tax revenue as collection costs and pass three quarters on to the EU-Budget. 4 – Earmarked and other expenditures.

Sources: Darvas (2016), European Commission

325. A follow-up agreement could, however, also require the UK to **contribute** to the EU budget. Switzerland, Liechtenstein and Norway, for example, also contribute between 0.01 % and 0.17 % of their GDP to the EU budget in net terms (Darvas, 2016). ↘ CHART 40 Furthermore, the reintroduction of customs tariffs between the United Kingdom and the EU would increase the EU's **customs revenue** due to the large volume of trade. Based on the €184 billion in current volume of EU goods imports from the UK, an average duty of 2 %, for instance, would equate to customs revenue of around one-third of the current net contribution

326. Brexit would also have to involve negotiating the financial obligations resulting from **payments** and **financial commitments** of the EU, not least with regard to pension obligations for current and former British EU civil servants. Other matters that would require clarification include the continuation of the United Kingdom's **capital contribution** to institutions like the European Investment Bank (EIB) and the ECB. The question as to whether European authorities like the European Banking Authority (EBA) and the European Medicines Agency (EMA) would remain in the United Kingdom would also need to be considered.

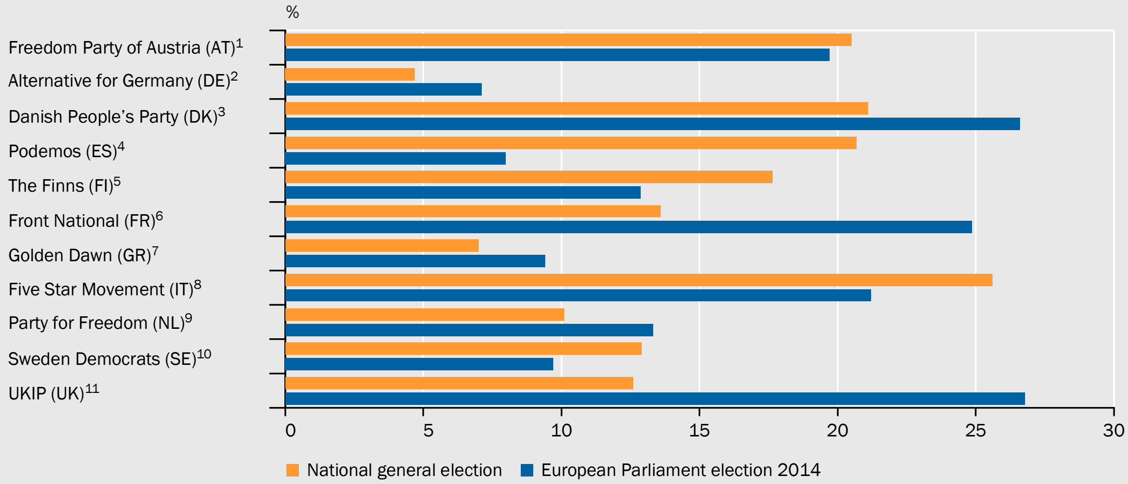
IV. PUTTING THE EU TO THE TEST

327. As in the UK, **eurosceptic parties** have obtained a considerable share of the vote in many other member states ↘ CHART 41 Surveys have also revealed a view held by citizens in some member states that their country has not benefited from the EU: According to the Eurobarometer (2011), the proportion of citizens that hold this view is particularly high in Greece (50 %), Hungary (49 %), Lithuania (47 %), Cyprus (47 %) and Austria (46 %) in a ranking led by the United Kingdom (54 %).

In order to identify an appropriate political reaction to this trend, it is important to understand the **arguments and possible motivations of Brexit supporters**. On the one hand, an analysis of their economic and social situation provides key clues in this regard. ↘ BOX 8 On the other hand, the points of criticism that formed the backbone of the "leave" campaign in the Brexit referendum also have to be worked through. Many of the key critiques are very similar to those being raised in EU-sceptic campaigns in other member states.

328. The GCEE takes the view that the Brexit referendum has greatly intensified the need for such reforms that increase the economic capabilities of the EU. The following section focuses on **three key reform areas** which the GCEE believes require particular attention and which partly address the criticism raised by the "leave" campaign. These include greater respect for the principle of subsidiarity, freedom of movement of people and EU finances.

↘ CHART 41
Recent election results of EU sceptic political parties



1 – AT-Austria, general election 2013. 2 – DE-Germany, general election 2013. 3 – DK-Denmark, „Dansk Folkeparti", general election 2015. 4 – ES-Spain, general election 2015. 5 – FI-Finland, „Perussuomalaiset", general election 2015. 6 – FR-France, general election 2012. 7 – GR-Greece, „Chrysi Avgi", general election 2015. 8 – IT-Italy, „Movimento 5 Stelle", general election 2013. 9 – NL-Netherlands, „Partij voor de Vrijheid", general election 2012. 10 – SE-Sweden, „Sverigedemokraterna", general election 2014. 11 – UK-United Kingdom, „United Kingdom Independence Party", general election 2015.

Sources: various national sources

1. Strengthening subsidiarity

329. The leave campaign wanted to win back full **sovereignty** in legislative matters. It wanted the United Kingdom to be able to make decisions independently of the EU and its institutions (Vote Leave, 2016). This, it claimed, would make the legislative process more democratic again and would free it from its ties to the European Court of Justice and the European Parliament.

330. First and foremost, this point of criticism raises the question as to how competencies should be distributed between the EU and the member states in order to achieve an optimal balance between supranational and national competence. The distribution of powers within the EU is based on the **principle of subsidiarity**. Pursuant to Article 5 (3) TFEU, the EU can only take action in the areas in which it does not have exclusive competence insofar and to the extent that the member states cannot sufficiently achieve certain political objectives and these can be better achieved at Union level.

The philosophical principle of subsidiarity, which is related to the Catholic social doctrine, goes further than this constitutional policy interpretation by attempting to distinguish private from public activities (Feld and Kirchgässner, 1996). Neither interpretation, however, clarifies how decisions are to be made on a **transfer of powers** in particular whether a higher state level can claim power simply because it alleges that the lower level is not adequately performing its political duties, or whether the lower level has to actively transfer this power. In the first case, the higher state level plays the leading role (top-down approach) while in the second, the lower state level retains control over the procedure (bottom-up approach).

331. The economic interpretation in the **decentralisation theorem** (Oates, 1972) is based on strengthening lower state levels. According to the theorem, decentralised provision of public services and financing for these services is efficient under certain circumstances. One of these conditions is spatial congruence between the beneficiaries of the public services and those bearing the costs, as well as their decision makers (principle of fiscal equivalence). Such congruence cannot be achieved if cross-border external effects occur, as is often the case in environmental matters, for example. The **contagion effects** observed during the financial crisis are also an example for such externalities.

332. Other reasons for the transfer of power to higher government levels include cost reductions via **economies of scale**, **avoiding regulation** in cross-national competition and the wish to provide **insurance** against asymmetrical macroeconomic shocks (Feld, 2007a):

– Cost reductions via economies of scale can be achieved if public services can be used by additional individuals without any negative impact on the quality of use for existing consumers (**non-rival consumption**). This applies, for example, to national defence.

– Regulations, such as those aimed at consumer protection, serve to reduce inefficiencies based on the **asymmetrical distribution of information** between consumers and producers. In regulatory competition, producers can choose a location that has more lenient regulations, triggering a downward deregulation spiral (Sinn, 2003; Feld, 2007b).

– Higher state levels also allow for a form of protection against asymmetrical shocks at the lower level via **commonly financed fiscal transfers** (Feld and Osterloh, 2013).

333. These arguments in favour of centralisation are not without controversy. Protection against asymmetrical shocks at supranational level, for example, is not essential if there are other balancing mechanisms in place, e.g. via the factor or credit markets. In particular, however, the advantage of decentralised service provision and financing, i.e., **the accommodation of different political preferences**, has to be taken into account (Tiebout, 1956; Spolaore, 2016). This also allows more control to be exerted over political decision-makers and reduces problems related to moral hazard. There are conflicts of interest and problems associated with weighing up conflicting positions, which have to be resolved using suitable procedural rules for the distribution of competences (Feld, 2007a).

334. These considerations provide an indication of which areas of policy should be set up at the European level and which should remain in the remit of the member states (Tabellini, 2003; Alesina et al., 2005; Feld, 2005a). It is, however, important to **take a differentiated approach to assessing** these areas. In the area of public security, for example, police services do not have to be fully centralised, because ultimately, terrorism and organised crime in particular, have an international focus, meaning that they have to be combated at international level.

The same applies to environmental policy. Straightforward cross-border problems can be solved by agreements reached between the countries involved without the EU having to take action. The same cannot be said, on the other hand, for **climate protection**. Substantial economies of scale support the idea of an EU involvement in defence matters. However, it is important to remember that there is already an international organisation for Europe's defence that extends far beyond Europe's borders – NATO.

335. The EU treaties, particularly the TFEU (Lisbon Treaty), which came into force in 2009, set out the areas in which the EU has largely exclusive powers, for example agricultural policy and foreign trade. In other policy areas, **competence** is shared between the EU and the member states, for example in matters relating to occupational health and safety, and environmental protection. Competence in matters such as economic, fiscal and employment policy, in particular, rests with the member states, although coordination is possible.

336. The GCEE is of the view that the **stringent interpretation and systematic application of the principle of subsidiarity** is the right way of ensuring economic efficiency and democratic legitimacy. Areas in which the EU should have a certain degree of power include:

- **Foreign policy and defence**. Particularly in matters relating to foreign and defence policy, considerable economies of scale make joint action advantageous. In foreign policy matters, the collective weight of all member states represents more power than the individual weights of the member states combined. In defence matters, the bundling of military resources would likely translate into efficiency gains. The transfer of power should not, however, result in competition with NATO. Enhanced defence cooperation was already discussed at the unofficial EU meeting in Bratislava in September 2016.
- **Migration and asylum**. Free movement of persons, particularly within the Schengen area, limits the options available for implementing national migration and asylum policies. The migration of refugees, to cite a recent example, is testimony to how national policy regarding refugee border crossings can impact other states. Securing Europe's external borders against illegal entry is an area in which migration policy and defence policy overlap, and is therefore an ideal candidate for EU level action. Strengthening the role of the European Agency for the Management of Operational Cooperation at the External Borders (Frontex), which was established in 2005, and moves to strengthen the powers assigned to the agency, is one of the areas in which the EU is moving in the right direction.
- **Public security and law enforcement**. International terrorism and organised crime transcend national borders. This is especially true in the Schengen area. The completion of the single market not only allows for gains to be derived from the international division of labour in respect of legal private-sector activities. Criminal organisations also exploit the advantages created by the single market for their illegal activities. This indicates that the EU should have more competencies with regards to public security, which means, first and foremost, strengthening the European police authority, Europol.

- **Single market, competition policy and foreign trade policy**. The common single market allows the European economy as a whole to exploit economies of scale and utilise advantages from the international division of labour. There should be no tariff and non-tariff barriers to trade within the common market. In this respect, responsibility for foreign trade policy, including the collection of customs tariffs at the EU's external borders, is a logical consequence of its single market competence. The exploitation of economies of scale by the corporate sector should not, however, result in companies obtaining dominant positions or in any other measures that hinder competition. European competition policy is a logical complement to single market competence. However, comprehensive harmonisation and standardisation of entire legal areas cannot be justified by the single market competence. There is a risk of single market competence mutating into a general power if every norm that applies in a member state can be classed as a market barrier (Grimm, 2016, p. 44). In addition, common regulations should not impose too many restrictions on competition between different locations.

- **Financial market supervision**. The GCEE argues that organising the supervision of banks, insurance companies and financial markets at European level is the right approach. The need for a European banking supervisory authority arises, firstly, from the cross-border activities of banks within the single market. Secondly, there is a danger, within a currency union, of risks from the banking sector being shifted to the central bank (2012 Annual Report items 299ff.). The supervision system should cover the whole of the EU (2012 Annual Report item 307). Similarly, the GCEE speaks out for a macroprudential integrated financial supervision at EU level (2014 Annual Report item 381). Although this system should not replace national macroprudential supervision, it should come into play when cross-border contagion effects for the European financial system are not given sufficient consideration (2014 Annual Report item 369). In the medium term, the GCEE is calling for a common system of **integrated micro and macroprudential financial supervision outside of the ECB**, at EU level (2014 Annual Report item 381). The financial transaction tax, on the other hand, should be viewed critically in light of its detrimental impact on liquidity and pricing on the financial markets. ↘ ITEM 47

- **Capital Markets Union**. Greater integration of the European capital markets is desirable because it would create risk-sharing potential, and thus also the potential for welfare gains (2015 Annual Report items 435ff.). The European Capital Markets Union is likely to boost capital market financing in Europe by increasing the size and depth of the market. This could likely play a major role, for instance, in start-up financing (2015 Annual Report items 684ff.) and the creation of markets for non-performing loans ↘ ITEM 522. In order to achieve further integration, standardisation and harmonisation would be prudent in some areas, for example the securitisation of corporate loans and the legal basis of furnishing collateral. However, it is always important to weigh up the advantages of greater standardisation and harmonisation against the disadvantages of less accurately fitting solutions.

– **Climate policy**. As emissions have a global effect on the Earth's climate, any approach to climate policy should be as global as possible. An EU-wide climate policy could already prove more efficient in achieving targets, for example for CO2 emissions, than national policies because the costs of avoiding emissions vary from region to region. National subsidies for renewable energy, for example, are inefficient or even counter-productive compared with a Europe-wide emissions trading system. ↘ ITEMS 906 FF.

337. By contrast, there are policy areas in which better solutions can be reached at **national level** due to very heterogeneous preferences of the population, and which should largely remain within the remit of the member states. These include:

– **Fiscal policy**. Member states and their subordinated authorities must have the opportunity to exert sovereign control over their revenue and spending policies. This ensures competition between different locations, in particular fiscal competition. Appropriate regulations can be put in place to limit the external effects of excessive debt within the European Monetary Union, as the GCEE set out in its Maastricht 2.0 concept (2012 Annual Report items 173ff., 2013 Annual Report items 269ff., 2014 Annual Report items 60ff.), as well as in its proposals for the removal of privileges for government bonds (2015 Annual Report items 57ff.) and for an insolvency mechanism for sovereigns. ↘ BOX 2 These are justified from a stability perspective because otherwise - as the debt crisis in the euro area showed - the principle of alignment of liability and control is jeopardised. Other moves to restrict budgetary and tax autonomy, such as harmonising the assessment base for corporate taxes, give rise to more difficult conflicts (2014 Annual Report items 590ff.).

– **Labour market and social policy**. The structure of the labour markets and social welfare systems varies considerably between member states, reflecting different regional preferences. It would be virtually impossible to have standardised minimum wages, unemployment insurance or protection against dismissal, for example, and still reflect the variety of preferences within the EU. Rigid labour market structures would invite moral hazard behaviour among member states in a structure with a common EU-wide unemployment insurance system. The higher unemployment connected with labour market rigidities would trigger higher payments from the European level. So, since liability and control are not well aligned, an EU-wide unemployment insurance system does not make sense unless a large number of social security regulations are harmonised (2015 Annual Report item 61).

338. A comparison of the EU's existing powers and its actual legislative activity against these indications as to how competencies ought to be distributed between the EU and its member states already for quite some time reveals significant discrepancies (Alesina et al., 2005). This is also due, not least, to the tendency of the European Commission to continuously **take possession of more competencies**. Although the member states determine treaty amendments and, as a result, EU powers in primary law, the European Commission interprets this primary law, with the help of its right of initiative, in secondary and tertiary law acts (directives, regulations, decisions, comitology decisions). Junge et al.

(2015) provide evidence of an increase in the Commission's activities, based on an evaluation of all secondary and tertiary EU legal acts, in the period from 1983 to 2009. This applies, in particular, in times with legislative standstill between the EU institutions, for example due to blockades by individual member states.

The ECJ tends not to stand in the way of this trend towards centralization. Rather, with the help of its room for interpretation and guided by the principle of an "ever closer union", it tends to contribute to the stronger centralization of policy areas (Hilpert and König, 2016). The President of the ECJ, Koen Lenaerts, attributes the considerable room for interpretation to the unspecific wording that is often used in European legal acts, something that reflects difficult political compromises (Wall Street Journal, 2015).

Whatever its cause, this development gives cause for concern and points towards insufficient subsidiarity control. Against this backdrop, the frustration felt in some member states is not surprising (Eurobarometer, 2015).

339. There are several mechanisms in place to **protect the principle of subsidiarity** within the EU, such as the ability of a majority of the national parliaments to block legislation, an early-warning system using "yellow cards" or "orange cards" and the opportunity to bring a case before the ECJ. Very little use has been made of these options to date (in total twice a "yellow card" until 2015; European Commission, 2013, 2014, 2015). In indirect terms, the national parliaments still have control functions because they implement secondary EU law with sovereign authority as part of their legislative powers. This applies even if the implementation breaches the EU's requirements, resulting in infringement proceedings, the outcome of which is uncertain. Ultimately, however, the principle of subsidiarity cannot restrict the EU's power gains to any significant extent. This is likely due to its lack of justiciable content (Grimm, 2016, p. 23).

340. Overall, **subsidiarity controls are too weak**. In cases in which legal action is brought before the ECJ, stringent subsidiarity control is not guaranteed. The only factor limiting the EU's power lies in the decisions made by national constitutional courts, not least by the Federal Constitutional Court in Germany. However, this process is likely to be rife with conflict in the long term. The EU architecture should be strengthened further in this respect in order to do a better job of upholding the principle of subsidiarity and, in the process, ensuring a certain degree of proximity to the citizens. One proposal made by the European Constitutional Group (1993, 2003) involves the establishment of a **subsidiarity court** operating with judges from the supreme courts of the member states on a rotating basis (Sinn, 2016).

2nd Free movement of persons with delayed integration into social welfare systems

341. If public goods are made available by lower state levels to a varying extent and quality, then citizens have to be able to choose, depending on their own preferences, to live in the place where the supply of public goods best suits their pref-

erences (Tiebout, 1956). This means that the **principle of subsidiarity goes hand-in-hand with free movement of people**. The "leave" campaign, on the other hand, painted a picture of the EU representing an uncontrolled **influx of EU migrants** into the United Kingdom. This, the campaign argued, was why it was time for the country to take back control of its own borders.

In 2015, the UK was home to 8.6 million immigrants according to the UN Global Migration Database. Three million of them were born in the rest of the EU, with 1.3 million of these EU migrants hailing from countries that have joined the EU since 2004. This puts the **proportion of immigrants** in the United Kingdom below the EU-15 average. ↘ CHART 42

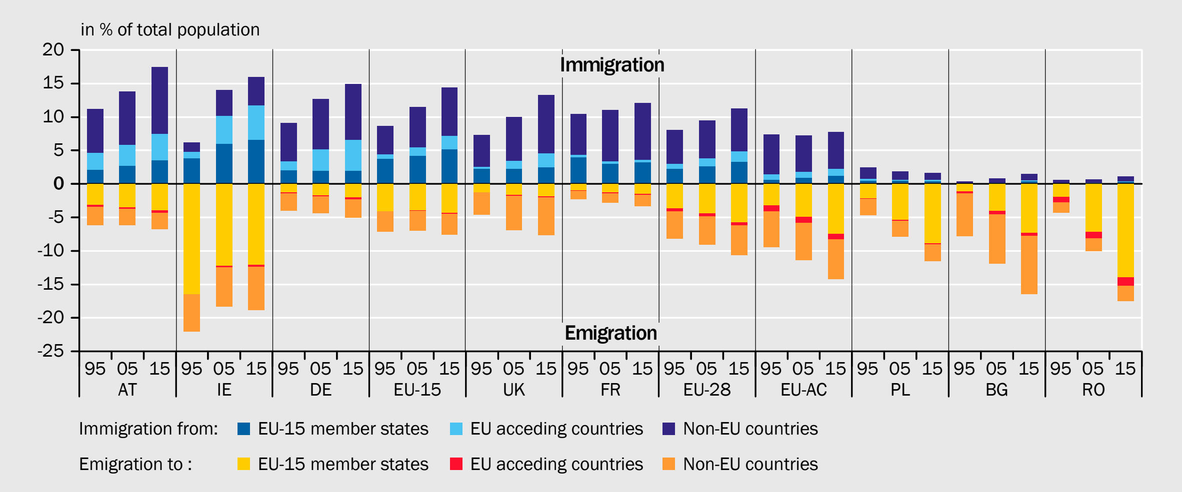
342. Free movement of persons, which encompasses free movement for workers and freedom of establishment, has been one of the four fundamental EU freedoms since 1993. As well as increasing personal opportunities for EU citizens and helping to maintain peace, there are key macroeconomic advantages to free movement of people; freedom of movement allows employees to work in the location within the EU in which they generate the highest marginal product. Free movement of persons also helps **compensate for asymmetrical factor endowments**, meaning, for example, that workers with certain skills from one part of the EU with a surplus of these skills can move to another part of the EU where these skills are in shorter supply.

In the euro area, freedom of movement also acts as an essential **compensatory mechanism for asymmetric shocks**, as exchange rate adjustments between the EMU member states are not possible.

343. Among the general public, however, an increase in the number of immigrants is often associated with declining wages, rising unemployment, higher fiscal costs and the impairment of public goods. The popular criticism levelled against the effects of migration by the "leave" campaign does not, however, stand up to an **empirical analysis**:

↘ CHART 42

Immigration and emigration in selected member states of the European Union by country of origin (stock)[1]



1 – AT-Austria, IE-Ireland, DE-Germany, EU-15-European Union (until 2003), UK-United Kingdom, FR-France, EU-28-European Union (since 2012), EU-AC-acceding countries to the European Union (since 2004), PL-Poland, BG-Bulgaria, RO-Romania.

Source: UN

- The **impact on wages and unemployment** depends, to a large degree, on whether the immigrants' skills substitute or complement the skills of the domestic population. According to the Office for National Statistics (ONS), 30 % of immigrants came to the United Kingdom with a definitive job in place and 21 % to seek work, in the first quarter of 2016. 27 % of immigrants came to the UK to pursue training or to study. Nickell and Salaheen (2015) have identified a minor negative effect of immigration into the United Kingdom on wages in the lower-skilled service sector. Wadsworth et al. (2016) do not identify any statistical link between immigration and employment in the United Kingdom. The finding of an insignificant or minor displacement effect is consistent with numerous other empirical studies, although the effects on a flexible labour market like the UK's tends to be even less pronounced than the impact on a more regulated labour market. ↘ ITEM 768
- On average, the EU immigrants are better qualified, younger and more likely to be employed than the UK-born population (Rienzo, 2016). Consequently they make a positive contribution to the **public budgets**. Dustmann and Frattini (2014) calculate that EU migrants made a net contribution of £15 billion in the period from 2001 to 2011, with £5 billion attributable to migrants from the ten eastern European countries that joined the EU after 2004. By contrast, the net contribution made by the domestic population during the same period amounted to -£617 billion.
- There is almost no empirical evidence of immigrants having **impaired public goods**, such as healthcare or social benefits, or public security. Giuntella et al. (2015) could not identify any impact of immigration on waiting times in the British healthcare system, the National Health Service. On the contrary, the UK's healthcare system is already heavily reliant on immigrants; according to the Health and Social Care Information Centre, one quarter of doctors are not British nationals. There are few studies addressing the link between immigration and crime. Bell et al. (2013) and Jaitman and Machin (2013) show that the large wave of immigration that started in 2004 did not have any significant impact on crime rates within the United Kingdom.

344. Free movement of people within the EU is a central topic in the exit negotiations with the United Kingdom. The country had already negotiated a modification to the freedom of movement rules prior to the referendum. These have not yet been implemented by the EU, however, as they were tied to a "remain" vote in the EU referendum in the United Kingdom. These new arrangements would provide for **measures to limit labour flows** if they reached a scale that had a negative impact on the countries of origin and destination countries (European Council, 2016).

An exceptionally large influx of workers from other member states would trigger a warning and protection mechanism. The Council could then authorise a member state to limit access for new workers from the EU to employment-related benefits that are not financed via contributions for a period of up to four years in total from the time they start work. This is designed to preserve the functioning of the social welfare systems, the labour market and the smooth operation of a member state's public services. Benefits for children, such as child benefits, can also be tied to a child's place of residence.

345. The extent of **migration into social welfare systems**, i.e., migration for the purposes of exploiting higher social welfare standards, has proven negligible to date (De Giorgi and Pellizzari, 2009; Riphahn et al., 2010; Kahanec, 2012; Giulietti et al., 2013; Medgyesi and Pölöskei, 2013; Skupnik, 2014). So far, allowing full freedom of movement for EU countries with relatively low prosperity and social welfare levels such as Romania and Bulgaria has done little to change this. The results for more homogeneous and, as a result, more migration-friendly economic areas like the United States, on the other hand, show a mixed picture (Borjas, 1999; Levine and Zimmerman, 1999; McKinnish, 2007; Kennan and Walker, 2010).

346. Consequently, the analysis provides little evidence for justifying restrictions on the free movement of persons. As a result, the right of all EU citizens to social welfare benefits in the location of their choosing, which is founded on the **principle of equal treatment,** is not a problem at present. This would change if migration were to end up putting so much pressure on the social welfare systems that it would undermine the exclusive competence of the member states in social welfare matters (SVR Migration, 2013). This would create an imbalance between financing, regulation and the uptake of social benefits in the EU.

347. To prevent this, member states could provide for the **delayed integration** of EU migrants **into their social welfare systems** (Scientific Advisory Board to the German Ministry of Finance, 2001), meaning that they are only awarded a full entitlement to social welfare benefits after obtaining permanent residency status. During this time, people in work, or those who can prove that they are actively seeking work, and their family members would be entitled to social benefits in the member state in which they were previously permanent residents. This type of arrangement would go further than the restrictions negotiated in February 2016 at the United Kingdom's request (European Council, 2016).

348. Current proposals for EU reforms either seek to transfer further competencies to European level or call for as many concessions to be made to the UK as possible in order to keep it in the single market. ↘ BOX 11 The GCEE does not currently see any basis for **further-reaching integration steps** in the areas of fiscal, labour market and social policy ↘ ITEM 362 (2013 Annual Report items 324ff.; 2015 Special Report items 94ff.; Feld et al., 2016). These could only be achieved, if at all, if the EU becomes a federal state. Given the prevailing scepticism surrounding European integration in many member states, premature integration steps in this direction would threaten to tear the EU apart.

At the same time, it is important to warn against making too many concessions to the United Kingdom, for example as part of a continental partnership (Pisani-Ferry et al., 2016). The United Kingdom should not be allowed to keep full access to the single market without ensuring full freedom of movement of people at the same time. **Free movement of persons** is a prerequisite for the **establishment of a common European labour market.** It thus performs a key function in the single market, but in particular for European monetary union.

Taking an accommodative stance towards the United Kingdom would not least encourage others to follow in its footsteps and could pose a threat to the integration achieved with the European economic and monetary union.

349. The idea of a "breathing currency union" should be viewed with a similarly critical eye (Sinn, 2016). The institutionalised option of exit from, and entry into, monetary union would remove all credibility from the promise of irreversibility. From the perspective of the financial markets, the monetary union would mutate into a fixed exchange rate system that would be worth speculating against. The **"breathing currency union"** would **no longer be a currency union** at all. It would be more honest to call for its abolishment. The GCEE, however, rejects this idea given the associated economic costs for the member states involved. This does not mean that a member state can remain within the monetary union if it continually breaches its rules and agreements. In cases like these, it must be possible for countries to exit the monetary union as a last resort (2015 Special Report item 93).

↘ BOX 11

Current proposals for reforms of the EU

The Brexit decision and the imminent 60th anniversary of the Treaties of Rome have prompted a discussion on the further development of the EU. These suggestions complement the proposals for reforms of the monetary union that were put forward as a result of the euro crisis and, in some respects, also cover the EU as a whole.

Ayrault and Steinmeier (2016) propose a union for a joint security and defence policy, as well as a joint European asylum and immigration policy. Norms and procedures for asylum seekers should be harmonised, such as by setting up a European asylum agency. The introduction of a European immigration law should be assessed as a way of dealing with increased labour migration from outside of the EU. As for the monetary union, the authors propose, among other things, the appointment of a permanent president of the Eurogroup and the gradual establishment of a fiscal capacity as progress is made with common fiscal and economic policy decisions.

Pisani-Ferry et al. (2016) concentrate on the future relationship between the EU and the United Kingdom as part of a **continental partnership**, although this implies a new way of looking at the EU in itself. The authors emphasise the functional definition of the single market as a customs union with uniform rules or minimum standards and joint competition policies, as well as a contribution to common public goods. This definition attaches less significance to the four freedoms of free movement of goods, services, capital and people. The authors argue that certain elements - such as freedom of movement for workers - can be restricted without impairing the single market. These restrictions would form the basis for an agreement between the EU and the UK. Other elements of the proposal relate to the involvement of the partners in EU legislative matters and contributions to the EU budget. The authors consider expanding the partnership model to include Turkey, but do not discuss the possibility that other member states might be tempted to follow in the United Kingdom's footsteps.

Other contributions focus on reforming the European monetary union and contain some elements that involve non-euro area countries as well. The **Five Presidents' Report** (Juncker et al., 2015) provides for measures to deepen monetary union in two stages, ultimately leading to a political union. The first stage involves promoting competitiveness and structural convergence, as well as creating a full banking and capital markets union and putting a responsible fiscal policy in place by reforming the European Semester and establishing a European fiscal board. The second stage involves setting targets for convergence progress which, if achieved, results in participation in a fiscal union for the purposes of macroeconomic stabilisation, i.e., a euro area treasury. The European Commission's white paper, which is expected to be released in the spring of 2017, will assess the progress made in stage one and propose measures for transition to stage two.

Enderlein et al. (2016) propose an intergovernmental approach that includes three elements. First of all, they propose that the EMU be made more resilient to crises. This would involve equipping the ESM with a fast reaction mechanism (a fund that would be jointly pre-financed or earmarked by the member states, in the amount of €200 billion to finance an initial crisis reaction, e.g. the purchase of government bonds on the secondary market), expanding the banking union to include risk-sharing among national deposit guarantee schemes and revising the fiscal rules. Next, structural reforms should be made, together with public and private investment, to foster growth and achieve increasing convergence in the medium term. Finally, the monetary union should be expanded by a political union via a change of the treaties.

Sinn (2016) suggests that the EMU be converted into a "**breathing currency union**" with clear regulations governing entry and exit. This, Sinn argues, could give member states the opportunity to exploit the depreciation of their currencies that would come with an exit to become competitive again before re-entering the EMU at a later date. Sinn also calls for insolvency regulations for sovereigns and a number of changes relating to the ECB. For the EU, the introduction of a subsidiarity court, the establishment of Europe-wide networks (e.g. for electricity, gas, Internet and telephony), the creation of a common army, joint border protection and security policy and new common asylum and migration regulations are requested. Sinn (2016) also proposes that the home country principle should apply to migrants within the EU. This means that EU citizens migrating within the EU would only receive the social welfare benefits provided by their country of birth, unless they had already made sufficient contributions by taxes or fees to the social welfare systems of their host country. With regard to a potential Brexit, Sinn argues that countries like the UK, Turkey and Ukraine should be given the option of becoming "associate EU members". They would then share three of the EU's freedoms, namely free movement of goods, services and capital, with the EU member states, but would not apply free movement of people.

350. These assessments by the GCEE show that freedom of movement of people is largely to be understood as the freedom of movement for workers. Migration to social welfare systems, on the other hand, is not desirable. From this angle, delayed integration into the social welfare systems does not call the principle of free movement of persons into question. The United Kingdom could, for example, look to Switzerland, where the concept of "**priority for domestic labor force/freedom of movement light**" was resolved in September 2016 to implement the mass immigration initiative, as a way of addressing concerns among the British population about uncontrolled immigration. In times of mass immigration, the Swiss government provides for the reporting of vacant positions to the regional employment centres (RAV) in advance, i.e., before they are advertised in a public announcement. Companies would not, however, be forced to employ the Swiss domestic workers referred to them by the RAV. ↘ BOX 10 This is unlikely to constitute a breach of the principle of free movement of persons.

3. Reorganising EU finances

351. A third major criticism of the "leave" campaign related to the inefficient use of funds by the EU. The campaign argued that Britain's contribution to the EU budget could be better spent at home.

352. The financial contributions made by the EU member states are destined for the EU budget. The budget is used to finance the EU's activities and concentrates, in line with its historical development, on **agricultural, structural and cohesion policy**. The United Kingdom is one of the countries that has argued the most vehemently against further increases of the EU budget, and in favour of spending being diverted away from administration and agriculture and towards innovation, growth, research and development. In 2015, 40 % of the EU budget went to the "Sustainable growth: natural resources" area, which includes agriculture spending, and 6 % to administration. A further 35 % of the budget was spent on "economic, social and territorial cohesion", while only 12 % was spent on "competitiveness for growth and employment", which includes innovation and research programmes.

353. This **prioritisation** has been **outdated** already for a long time (Feld, 2005b). Firstly, food supplies in the EU are secure and affordable. The extensive system of agricultural subsidies favours excess production and puts large agricultural businesses and landowners at a particular advantage (European court of auditors, 2016). Secondly, the current structural and cohesion policy is not effective, particularly since the funds flow to economically weaker and stronger regions at the same time. In addition, there is empirical evidence of declining marginal benefits of the structural funds (Becker et al., 2012). Furthermore, it is not clear whether the structural funds have a positive impact on growth and convergence in the regions that receive them (Mohl and Hagen, 2010). Nor can a negative impact on the surrounding regions be ruled out (Breidenbach et al., 2016).

354. By contrast, there are **new challenges** that could be tackled more easily with access to adequate financing, such as spending in connection with the migration of refugees or the joint security policy. ↘ ITEM 336 Measures should be taken to make the allocation of EU budget funds more flexible in order to allow current challenges to be better addressed. At present, a seven-year budget serves as a framework for the allocation of funds to various policy areas. More flexible allocation was already intended for the upcoming negotiations for the next multiannual budget for the period from 2021 to 2027. The EU does not need its own tax to address these challenges (Scientific Advisory Board to the German Ministry of Finance, 2016).

355. A welcome development would be moves to bring the **EU's structural funds closer into line with the country-specific recommendations made by the European Commission**. The European Semester is already aiming to create closer links between the EU's country-specific recommendations and EU structural support. Particularly within the framework of deficit or imbalances procedures, conditionality can be imposed that ties the release of funds to the implementation of agreed reforms. This could strengthen the currently some-

what limited options open to the European Commission for imposing sanctions on member states that receive structural funds.

V. CONCLUSION: STRENGTHENING THE EURO-PEAN PROJECT THROUGH MORE SUBSIDIARITY

356. At the moment, not much is known about the United Kingdom's **negotiation objectives or strategy**. The negotiations on the relationship between the United Kingdom and the EU are likely to involve a drawn-out process with an uncertain outcome. There is also a great deal of uncertainty surrounding the **macroeconomic effects** of Brexit. In the short term, however, it would appear that the vote will only have a moderate impact. In the long term, the economic impact of Brexit will depend, to a decisive degree, on the outcome of the exit negotiations.

357. The first step should be to minimise uncertainty and potential damage for the EU and the United Kingdom. The individual agreement with the EU that the British government favours at the moment must not, however, lead to "cherry-picking". The **negotiations on a follow-up agreement** must focus on ensuring consistency with existing relationships with third countries, such as Switzerland or Norway, and taking the risk of inspiring copycats in other EU member states into account.

358. Although euroscepticism has always been larger in the UK than in other parts of the EU, the increased trend towards eurosceptic voices in some member states is cause for concern. The EU has to accept responsibility for failing to communicate more clearly the **advantages of the EU**, which pursues peace and prosperity as its utmost objectives. The fact that EU institutions are often a convenient scapegoat for national governments offers as little solace as the theory that the Brexit referendum could have been a form of protest lodged by British voters against their own government.

359. As a result, it is important to learn the right **lessons from the referendum** in the United Kingdom. The GCEE calls for more respect for the **principle of subsidiarity** in order to strengthen sovereignty and democracy. Moreover, there is a pressing need to reorganise the EU's finances. Whereas high agricultural subsidies result in significant market distortions, the structural funds should be brought more closely into line with the country-specific recommendations made by the European Commission so that they can be used more efficiently.

360. Restricting the freedom of movement of people would pose a real obstacle to the establishment of a common European labor market, and thereby weaken the single market within the EU, but particularly within the European monetary union. At most, modifications could be made in line with the "priority for domestic labor force/freedom of movement light" model planned in Switzerland to give

domestic workers a time lead over migrants when it comes to job placement. In order to prevent misaligned incentives, **delayed integration into social welfare systems** is a possible option. Free movement of persons is about migration to labour markets, not migration into social welfare systems.

361. Regardless of the eurosceptic voices within the EU, proposals for increased integration have been revived in the context of a possible Brexit. ↘ BOX 11 The GCEE warns against **premature integration steps** (Special Report 2015 items 94ff.):

– the creation of a **common fiscal capacity** is neither necessary nor expedient (2013 Annual Report 2013 items 324ff.), as there is no political will for European fiscal policy and the idea runs the risk of creating permanent one-sided transfers between the countries. The capital and credit markets, on the other hand, can make a key contribution to shock absorption (Feld and Osterloh, 2013).

– A **European unemployment insurance system** is not an expedient option either due to the considerable differences in the existing labour market regulations within the EU. Social and labour market policy falls within the remit of the member states, so a common unemployment insurance system would create considerable incentive problems.

– The GCEE takes a critical view of the idea of the **harmonisation of economic policy**, for example as part of macroeconomic imbalances procedures or in proposals for the international coordination of wage-setting. Firstly, it is important to ask, from an economic perspective, whether harmonisation would hinder competition and, as a result, efficiency. Secondly, the options available to the member states for controlling their economies are limited and harmonisation would, at the same time, result in greater intervention of economic policy.

362. The GCEE believes that there is a need for **further integration** in the following areas, in particular:

– Greater EU powers in the fields of **internal security** and the **protection of external borders** would mark significant progress in efforts to combat organised crime and terrorism. At the same time, Europe could implement a common migration and asylum policy. This would require moves to strengthen Europol and Frontex, but would have to involve more than simply allocating more funds to these two institutions. Rather, they would have to be given more competencies to act autonomously. Moves to bring career paths at Europol and Frontex closer into line with those of the national authorities that the institutions recruit from would also be helpful. This would increase the mobility between these institutions.

– The GCEE is in favour of greater integration for Europe's capital markets to create a **capital markets union** to allow for welfare increasing risk diversification. This will require further standardisation and harmonisation, such as the securitisation of corporate loans and the legal basis of furnishing collateral.

– An EU-wide **climate policy** could be more efficient in achieving climate policy targets such as for carbon emissions, than national policies because the costs of avoiding emissions vary from region to region. This could be achieved by strengthening the Europe-wide Emissions Trading System.

A differing opinion

363. One member of the Council, Peter Bofinger, does not agree with the view taken by the majority of Council members that strengthening the European Union (EU) should focus on strengthening the principle of subsidiarity.

364. The majority believes that the "right lesson" to learn from the referendum in the United Kingdom involves first and foremost focusing more on the **principle of subsidiarity** to allow the EU to concentrate more efficiently on its key tasks. They say that the EU must also be able to communicate its advantages more clearly.

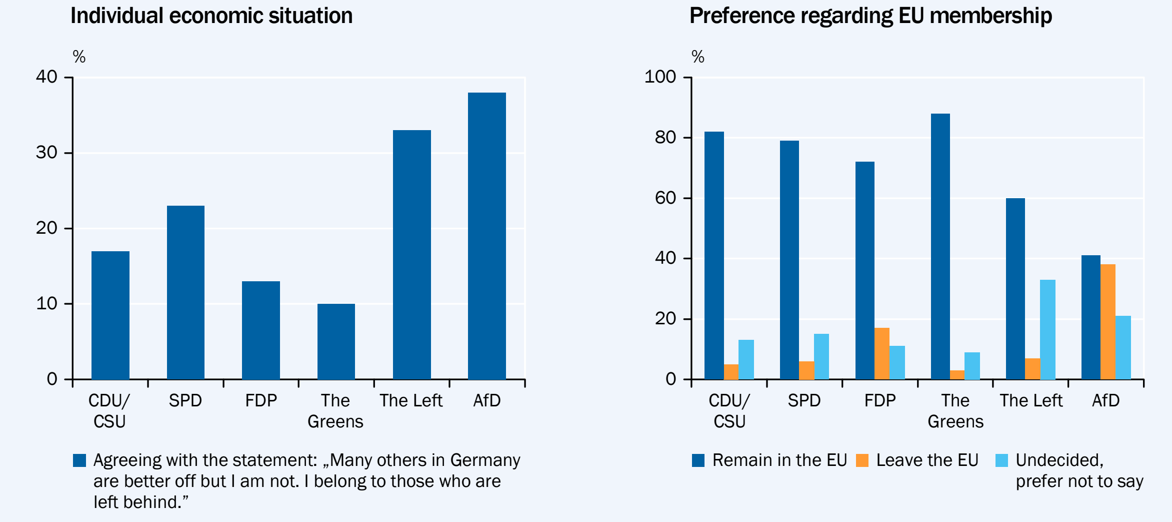
365. It is worth asking whether the dissatisfaction of many citizens with the EU really does lie in an exaggerated trend towards creeping competence in the EU and in subsidiarity controls that are too weak. Surveys such as the Eurobarometer (2016) show that **immigration** is currently cited by 48 % of citizens as the most pressing **problem facing the European Union**. One-third of Europeans believe that the biggest problem facing their **own country** is **unemployment**. Although this problem has become less of an issue in recent years, the survey results reflect the fact that the EU unemployment rate remains high and has only decreased by just under 2 percentage points since its high of 2013. High unemployment is likely to be one of the main reasons behind the concerns over migration.

366. In **Germany**, it has been shown that most of the supporters of the Alternative for Germany (AfD) party believe that EU membership is a bad thing for Germany. At the same time, this group considers itself particularly detached from the development of society's prosperity (Köcher, 2016). ↘ CHART 43 The negative correlation between the income situation and the assessment of economic integration is also evident from the analyses of voting behaviour in the Brexit referendum (Zoega 2016, ↘ BOX 8). A study conducted by Ioannou et al. (2015) finds that, in the EU, higher unemployment in citizens' own countries and a higher stock of public debt in other countries is negatively associated with trust in the EU.

367. Given the significance of unemployment and per capita income to attitudes towards the EU, it makes little sense to simply strengthen subsidiarity in reaction to the Brexit vote. Rather, the aim should be to do everything possible to promote growth and reduce unemployment as significantly as possible.

Anyone who shares the majority's view that structural reforms resulting in **lower wages** a particularly suitable way of achieving this has to be aware that this strategy is a **zero sum game** within the euro area. This means that the only thing it could achieve would be an improvement in price competitiveness vis-à-

↘ CHART 43
Survey regarding the sentiment about the individual economic situation and preferences regarding the EU membership by political party[1]



1 – CDU/CSU-Christian Democratic Union/Christian Social Union (Bavaria only), SPD-Social Democratic Party, FDP-Free Democratic Party, AfD-Alternative for Germany.

Source: Institut für Demoskopie Allensbach

vis third countries. Given the considerable level of uncertainty surrounding the factors determining the euro exchange rate, however, it remains to be seen whether this can actually be achieved.

368. As a result, strengthening the euro area economy by implementing a broad-based **programme to promote future viability** would be a good solution. This should include not only infrastructure investments, but also additional spending on education, research and development. In order to have an impact across the board, the programme should have an annual volume corresponding to 1 % of GDP and run over a period of five years.

369. The easiest way to finance the programme would be to give the member states corresponding additional leeway with the provisions of the Stability and Growth Pact, in line with the "**golden rule**" of fiscal policy. This would not necessarily result in an increase in **debt ratios**. The empirical literature (Batini et al., 2014) shows that multipliers are relatively high in periods characterised by a negative output gap. They are even higher if the economy is in a phase at the **zero lower bound**; in this scenario, values as high as 2.3 to 4 are estimated for government spending (Batini et al., 2014). Dell'Erba et al. (2014) also show that in persistent recessions, the multipliers are much higher than the usual values.

370. In such cases, an **expansionary policy that lowers the debt ratio** can be achieved using relatively conservative parameters. Assuming a multiplier for additional government spending of 2 and also a ratio of tax revenue to gross domestic product of 0.3, then an increase in government spending by €1

– would increase gross domestic product by €2,
– would increase debt by €0.40, because the additional spending would be offset by additional revenue of €0.60 (30 % of the €2 generated in addition).

A hypothetical initial debt ratio of 100 % would then drop to 98.4 %.

371. The possibility that additional government spending could reduce the debt ratio was recently presented by the President of the Council of Economic Advisors, Jason Furman (2016) as an element of a **"new view" of fiscal policy**. He argues that, in a situation in which monetary policy is reaching its limits, fiscal policy can be a particularly effective complement. It also has the potential to "crowd in" private investment through stronger growth. This would result in an increase in inflationary expectations and, as a result, also in real interest rates. Finally, Furman says that fiscal policy is particularly effective if it is coordinated, because this results in positive spillover effects.

372. It is also worth asking to what extent **unlimited tax competition** within the EU is conducive to its stability. If social acceptance of globalisation in general, and of the fundamental freedoms of the EU, is to be secured in the long run, then effective redistribution from the winners to the losers is a must. Tax competition within the EU must not stand in the way of this distribution task facing the member states.

APPENDIX TO THE CHAPTER

↘ TABLE 19

Regression analysis to explain the share of "leave" votes in the EU membership referendum 2016 by regions[1]

	Districts		NUTS2 regions	
	(1)	(2)	(3)	(4)
Share of the population with an university degree [Mean: 26.7 %]	–1.01 ***	-1.06 ***		
	(0.04)	(0.04)		
Share of students in the population [Mean: 4.5 %]	–0.56 ***			
	(0.07)			
Ratio of people of age over 65 to people under 15 [Mean: 96.8 %]	0.02 ***			
	(0.01)			
Share of the population with a job in the manufacturing sector [Mean: 9.4 %]	0.22 ***	0.26 ***	1.72 ***	2.06 ***
	(0.08)	(0.09)	(0.30)	(0.29)
Change of the share of the population with a job in the manufacturing sector (1981 – 2011) [Mean: –17.2 percentage points]	0.07 *	0.16 ***	0.43 ***	0.50 ***
	(0.04)	(0.03)	(0.11)	(0.13)
Change of the weekly salary (2002 – 2014) [Mean: +29 %]	–0.04 ***	–0.06 ***		
	(0.02)	(0.02)		
Change of the share of the population born outside of the United Kingdom (2005 – 2015) [Mean: 3.3 percentage points]	0.28 ***	0.12 *	0.57 *	1.26 ***
	(0.07)	(0.07)	(0.36)	(0.43)
Share of minorities in the population [Mean: 9.7 %]	–0.05 *			
	(0.03)			
Inhabitants per hectare [Mean: 14,700 persons]		–0.96 ***		
		(0.15)		
GDP per capita [Mean: 0.04 million pound sterling]			–1.72 ***	
			(0.37)	
Average annual GDP growth (2004 – 2014) [Mean: 2.2 %.]				–3.31 ***
				(0.82)
Scotland	–0.17 ***	–0.18 ***	–0.14 ***	–0.12 ***
	(0.01)	(0.01)	(0.01)	(0.02)
Wales	–0.05 ***	–0.07 ***	–0.07 ***	–0.07 ***
	(0.01)	(0.01)	(0.02)	(0.01)
Sample size	375	375	39	39

1 – Fractional logit regression with 375 districts in the United Kingdom (columns 1 and 2) and 39 NUTS2 regions (columns 3 und 4), both without Northern Ireland. Dependent variable: share of "leave" votes. Shares refer to fraction of the total population in the respective electoral district or NUTS2 region. Means refer to the sample of regression in column 1. Constant is included in all regressions. The table shows marginal effects at the means except for country dummies (Scotland and Wales) which are shown as discrete effect (a change from 0 to 1). Robust standard errors in parentheses.

*, *** indicate significance at the 10 %- and 1 %-level, respectively.

Sources: Eurostat, ONS, UK Electoral Commission, own calculations

↘ TABLE 20

Voting behaviour in the 2016 referendum on the EU membership[1]

	Unit	"remain" regions	"remain" regions (w/o Inner London)	"leave" regions	t-statistic[2]
Share of women in the population	%	50.9	51.0	50.9	0.0
Ratio of people of age over 65 to people of age 18–29		0.91	1.00	1.26	– 4.7 ***
Share of people of age over 65 in the population	%	14.5	15.4	17.6	– 2.8 ***
Median age		37.06	37.92	40.39	– 1.3
Share of the population without a formal qualification	%	20.9	21.7	24.5	– 1.9 *
Share of the population with university degree or higher	%	32.7	30.7	23.7	4.5 ***
Share of students in the population	%	7.5	7.1	4.3	4.2 ***
Share of the population with British origin	%	84.9	88.2	91.0	– 0.9
Share of the population with the birth place in the same part of the UK	%	75.7	79.0	87.4	– 1.9 *
Share of the population with the birth place in the EU	%	8.3	6.9	4.1	6.4 ***
Share of the population with the birth place outside of the EU	%	18.2	15.1	5.7	8.1 ***
Change of the share of the population with British origin from 2005 to 2015	percentage points	– 4.3	– 4.5	– 3.6	– 1.3
Change of the share of the population with the birth place in the EU from 2005 to 2015	percentage points	2.9	2.7	2.2	1.8 *
Share of the population without a passport	%	12.5	13.6	19.1	– 4.3 ***
Ratio of part-time jobs to full-time jobs		0.34	0.35	0.38	– 1.5
Share of retirees and pensioners in the population	%	11.8	12.7	15.2	– 3.5 ***
Share of the population with industry or construction jobs	%	14.7	15.8	20.4	– 4.2 ***
Share of the population with a job in manufacturing	%	6.2	6.9	10.5	– 5.7 ***
Change of the share of the population with a job in manufacturing from 1981 to 2011	percentage points	– 16.9	– 17.2	– 19.0	1.1
Share of the population with a job in agriculture	%	0.8	0.9	1.1	– 2.0 **
Share of the population with a job in the financial or insurance industry	%	5.4	4.7	3.6	4.1 ***
Inhabitants per hectare		32.15	20.46	12.43	5.4 ***
Share of academic and management jobs	%	31.0	30.0	25.6	2.7 ***
Share of technical and assistant jobs	%	43.7	45.4	51.2	– 2.0 **
Share of the population with good or very good health	%	82.9	82.7	80.3	0.4
Share of the caucasian population	%	81.1	84.9	90.6	– 1.7 *
Share of the black British population	%	5.3	3.5	1.7	4.9 ***
Share of the Asian population	%	9.3	8.2	5.5	2.3 **
Average wage (per year)	pound sterling	32,960	30,733	25,694	3.6 ***
Average wage (per week)	pound sterling	582	559	477	2.8 ***
Change of average wage (per week) from 2005 to 2015	%	19	19	19	0.1
Median income	pound sterling	37,838	34,677	28,259	4.1 ***
Average pension	pound sterling	17,531	17,412	15,281	2.0 **
Share of the votes for the Conservative Party in the EU election 2014	%	22.9	23.5	24.3	– 0.9
Share of the votes for the Labour Party in the EU election 2014	%	31.3	28.9	24.3	2.2 **
Share of the votes for UKIP in the EU election 2014	%	18.3	19.8	33.3	– 7.3 ***
Average annual GDP growth over the last 10 years	%	2.5	2.2	2.0	1.5
GDP per capita	euro	44,444.30	34,777.40	28,808.11	2.4
Unemployment rate	%	5.2	4.9	5.4	– 0.2
Youth unemployment rate	%	14.9	14.2	14.7	0.1
Long-term unemployment rate	%	1.8	1.8	1.7	0.3
Index of regional competitiveness		0.74	0.67	0.50	1.4
Approved EU-regional funds (as a share of GDP)	%	0.26	0.30	0.40	– 0.6
Dependence on overall exports into the EU	%	7.5	8.0	10.3	– 1.8 *
Dependence on manufacturing sector exports into the EU	%	23.5	23.6	30.8	– 1.5
Dependence on service sector exports into the EU	%	4.7	4.9	6.8	– 1.9 *

1 – The columns show the averages over British regions (without Gibraltar) weighted by the total population of the Census 2011. Split of regions according to the majority voting for "leave" or "remain". Depending on the variable the regions are British districts (in total 398, 128 "remain", 270 "leave") or NUTS2 regions (in total 40, 13 "remain", 27 "leave"). 2 – t-test for significance of the difference between "remain" and "leave" regions.

*, **, *** indicate significance at the 10 %-, 5 %- and 1 %-level, respectively.

Sources: Electoral Office for Northern Ireland, European Commission (Info-Regio), Eurostat, Northern Ireland Statistic & Research Agency (NISRA), Office of National Statistics (ONS), Springford et al. (2016), UK Electoral Commission, own calculations

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