

CHALLENGE EUROPE

Yes, we should!

EU priorities for 2019-2024



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The never-ending Brexit?¹

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MAIN RECOMMENDATION ▶ Even after Brexit, the EU will have to deal with immediate day-to-day issues i.e. the EU-UK trade negotiations and with more strategic questions regarding the future relationship between the two.

WHAT TO DO:

- ▶ Ensure an orderly withdrawal, but not at any cost.
 - ▶ Develop a vision for a close and stable future relationship that both sides can live with.
 - ▶ Engage in contingency planning for the worst-case scenario, i.e. no deal before or after Brexit.
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Even after the United Kingdom's (UK) exit from the European Union (EU), Brexit will not disappear from the Union's agenda – if anything, it will become even more important. The EU institutions and member states will not only have to deal with immediate day-to-day issues such as the EU-UK trade negotiations, but also with more strategic questions on the future relationship between the EU and the UK and the broader implications of the divorce for the Union's role in the world and its own future architecture.

In part, this is a damage-control exercise. The aim is to reach the closest possible EU-UK relationship within the limitations of dealing with a third country, not only in economic terms but also on issues such as security. However, there is also the broader question of how to integrate countries such as the UK in the European integration process, possibly based on refined or new models of differentiated integration.

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Tactical successes, strategic deficiencies

The outcome of the June 2016 Brexit referendum has thrown the EU into less disarray than many observers predicted at the time. A domino effect triggering similar membership votes in countries such as France, Denmark or the Netherlands has not materialised. On the contrary, polls have shown growing popular support for EU membership as it has become clear just how difficult and costly it is to extricate a country from the Union.

Perhaps even more remarkable has been the unexpected unity of the EU27 in the Brexit negotiations. Many predicted the UK would speak with one voice, while the EU27 would be in hopeless disarray unable to manage their diverging interests and to contain internal tensions. The opposite has happened. This has strengthened the EU27's negotiating position, helping them to stand by the Union's red lines, such as the backstop for the Irish border, the financial settlement and the sequencing of the Article 50 and trade talks (which then-Brexit Secretary David Davis predicted in 2017 would be the "row of the summer", before the UK government quickly and quietly folded).

However, the tactical success of the first phase of the negotiations cannot hide that the EU has not yet fully engaged with Brexit at a strategic level. There is no single, coherent vision of what the long-term EU-UK relationship should look like once the dust of departure has settled. How close a relationship should the two sides aim for and how may it change over time? In which areas is close political, economic, diplomatic or security cooperation essential and where is there greater scope for divergence? How can the EU and the UK prevent a loss of influence on the global stage? To what

extent will the EU-UK model be an example for the EU's relationship with other third countries?

The EU's overwhelming objective in the Brexit negotiations is to maintain the integrity of the single market and ensure that the ultimate arrangement with the UK does not threaten the long-term viability and attractiveness of the Union by setting a precedent of cherry-picking or by prioritising reaching a deal over a member state's vital interests. As long as that is ensured, it is in the Union's interest to pursue a relationship that is as close as possible to minimise the costs associated with Brexit.²

However, if cherry-picking is ruled out, developing a very close economic relationship will be difficult since the conditions for doing so violate the UK's red lines on free movement and an independent trade policy. Barring a significant shift in the UK domestic political context, a more distanced (and for the EU suboptimal) model such as Canada plus (i.e. a free trade agreement in goods with some liberalisation in services) appears more likely. This also implies a separate solution for the Northern Ireland border, most probably reverting to the backstop. Given the political volatility in the UK, the EU needs to plan for the worst-case scenario: a break-down in the relationship either at the end of the Article 50 or the transition period.³ However, a stable equilibrium is unlikely whatever the outcome of the Brexit process. Debates about the UK's relationship with the EU are likely to continue whether there is a deal, no deal or the UK decides to remain after all, and such debates could play a role in future general elections or party leadership contests.

Navigating these issues and developing a strategic view of Brexit, taking into account the UK's aspirations and limitations, will be one of the key tasks for the EU institutions and the future EU leadership in the years to come.

Painful losses ahead

Though the costs of Brexit will be asymmetrically distributed – with the UK much more affected than the EU27 – neither side will emerge unscathed. The UK remains an important player for a number of reasons and its departure will weaken the EU27 in various ways and change its position and role in the world.

First, Brexit has direct economic consequences for the EU. They can be divided into two categories: transition costs and long-term costs. Any change to the status quo will impose transition costs on EU firms, which may have to spend resources on contingency planning and re-organising supply chains. In the longer term, any additional friction caused by a UK departure from the customs union and single market could impact trade flows and reduce economic growth.

However, it is not all bad from the EU's perspective. There will probably be a gain from firms relocating to the Union, and EU companies could benefit from reduced competition if friction caused by Brexit leads their UK rivals to abandon the EU market or puts them at a disadvantage, for example in public procurement.

But the EU's loss of economic weight also has an external dimension. The UK's economy was the fifth-largest in the world in 2018, with a value of \$2.94 trillion.⁴ It was the second-largest in the Union, surpassed only by Germany. If the UK leaves the EU's customs union, the European Commission will no longer be able to offer access to the UK market to third countries it negotiates trade deals with. This will reduce its leverage and could make it more difficult to achieve favourable outcomes for the Union.

Moreover, London is a powerful financial centre and arguably the only one in Europe that can compete with the likes of New York, Hong Kong and Singapore. Brexit will almost certainly reduce Europe's weight. While London initially hoped to agree on future access to the EU market for UK-based financial services firms on the basis of mutual recognition, it has now accepted Brussels' position that financial services trade will be

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Brexit might lead to a more unified model, creating a sharp distinction between (full) membership and those outside the EU, which would limit the level of integration with third countries.

The EU should analyse the reasons for the unexpected and remarkable unity of the EU27.

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based on the EU's equivalence regime.⁵ The UK government is still seeking to include certain elements of mutual recognition but these attempts are likely to be unsuccessful, while the EU is likely to push for standard equivalence, not least to prevent regulatory arbitrage.⁶ Such an outcome would have implications for the financial services sector. Equivalence does not apply to wholesale banking and can be withdrawn unilaterally by the EU with a 30-day notice, so it will not provide financial services firms with the predictability they require. Cities in remaining member states such as Paris and Frankfurt could benefit somewhat as banks relocate some staff, but it is not just a European competition. If European capital markets fragment further due to Brexit and the financial competitiveness of the EU decreases, financial services firms could decide to abandon the EU altogether and focus on the United States or Asia.

Second, Brexit is set to weaken the EU politically. A smaller EU that is not perceived to be speaking for all major European countries will be a less powerful one. This could make it harder for the Union to defend its interests at a time when Russia is becoming more assertive, concerns are growing over China's expanding political and economic reach and US politics are increasingly unpredictable and unstable (see also contribution of Giovanni Grevi in this volume).

In terms of international clout, the EU is arguably losing one of its most powerful member states. The UK is one of two European countries with a permanent seat on the UN Security Council and continues to derive considerable influence from its history, soft power and ties with non-European countries (for example through the Commonwealth). It has a highly regarded diplomatic service and has played a key role in shaping EU foreign policy, not least by traditionally serving as a link to the US. Its departure will be a blow to advocates of a close transatlantic relationship and a

tough stance on Russia. It could shift the balance of power in the EU towards those that are sceptical of some of the EU's current foreign policy orientations.

Brexit could, for example, have negative spill-over effects on the EU's sanctions regimes vis-à-vis Russia. Without the UK, the EU's determination to address Moscow's actions in Ukraine and Crimea could diminish. While this may not affect the EU's current sanctions (the renewal of three sets of sanctions against Russia every six months has become a largely routine task), the Union may become less willing to introduce new measures to respond to fresh Russian aggressions for fear of upending the fragile consensus among member states, and might be less able to react to future foreign policy crises. At the same time, the EU's loss of economic weight after Brexit means that economic sanctions – unless they are coordinated with the UK and other major countries such as the US – will lose some of their bite. Similarly, as the EU single market will be smaller after Brexit, the prize of market access, which the EU can offer to third countries to promote certain values, may become less attractive. Both developments mean that the ability of the EU to reward and punish third countries' behaviour will be diminished.

Third, Brexit may undermine the EU's security capacity. The UK and France are the only global military powers in the EU. The UK also plays a crucial role in NATO and was one of only six EU countries to hit NATO's target of spending 2% of GDP on defence in 2018.⁷ Brexit means that the UK cannot participate in EU initiatives such as PESCO (though it could be argued that the momentum to agree PESCO probably would not have been there if the UK had not voted to leave, or that the UK would have blocked the initiative) and that the EU could become less relevant as a security player. The loss may also be felt in counterterrorism, where the UK has well-regarded capabilities.

Differentiated integration and enhanced cooperation

Brexit is closely linked to strategic concepts about the future of the EU, including the notion of differentiated integration and ideas about an EU core and periphery.

After the UK's exit, the EU's centre of gravity is likely to shift further towards Germany and France, and the eurozone. Non-eurozone countries and economically liberal northern member states – long-time allies of the UK – could lose influence as the EU becomes more centralistic in its areas of competence. Member states have already started trying to fill the void. One expression of the counterbalancing act against a potential dominance of Berlin and Paris is the creation of the New Hanseatic League in 2018, which groups eight fiscally conservative northern member states.

Regardless of Brexit, future progress in the EU will also require a higher level of differentiated integration, for example in areas such as taxation or defence. This could reinforce the shift of power towards the EU's 'core' around Berlin and Paris and widen asymmetries between those regularly participating and those abstaining.

At the same time, Brexit could provide an impetus to extend the concept of differentiated integration to non-EU countries by tying these countries closer to the Union beneath the level of full and unlimited EU membership (see also the contributions of Janis A. Emmanouilidis

and Julian Rappold in this volume). The UK may wish to continue participating in parts of the EU architecture such as Euratom, without making concessions in other, more politically sensitive areas.

However, this raises several difficulties. A preference could emerge in the UK for membership of the single market for goods, services and capital but not for people, while for the EU the indivisibility of the four freedoms would be non-negotiable. Applying the concept of differentiated integration would also be complex in legal, political and institutional terms, especially if it fails to respect the exclusive prerogatives of those who are member of the 'club'. The EU will, therefore, be wary of setting a precedent if the UK's deal is perceived to be more attractive than full EU membership. Politically speaking this implies that certain proposals such as the continental partnership⁸ or a 'shared market' between the UK and EU⁹ are unlikely to gain much support at EU level, regardless of their merits. Any form of differentiated integration involving non-EU countries is likely to be tightly restricted and come with numerous conditions, such as financial contributions without offering access to EU institutions and to the Union's decision-making mechanisms. Brexit might lead to a more unified model, creating a sharp distinction between (full) membership and those outside the EU, which would limit the level of integration with third countries.

Key recommendations

What can the EU do to address the strategic challenges posed by Brexit?

► First, it should focus on ensuring an orderly withdrawal, but not at any cost. Unlike for the UK, the mantra ‘no deal is better than a bad deal’ rings true for the EU. Any deal that would compromise its core values, disadvantage member states vis-à-vis a third country or undermine the integrity of the single market would threaten its long-term viability. Even though an orderly withdrawal would avoid chaos and create a feasible path towards the long-term EU-UK relationship.

► Second, the EU should develop a vision for a close and stable future relationship that both sides can live with¹⁰, going beyond mere economic ties. Close alignment and cooperation on economic, political and security issues would be an effective way for both the EU and the UK to maintain as much global influence as possible. To achieve this, it is important that despite any frustration with the day-to-day Brexit process, bridges are not burnt and resentment on both sides is minimised. However, it is hard to see how this could be achieved in case of an acrimonious divorce.

► Third, the EU should engage in contingency planning for the worst-case scenario, i.e. no deal before or after Brexit. A breakdown in relations could see the UK, no longer tied to EU rules, emerge as a fierce competitor for foreign investment and resources. The EU needs to be prepared in case London shifts towards a more mercantilistic model, lowering tax, social and environmental standards to gain a competitive advantage. Cooperation across all policy areas would become much less likely.

But the significance of Brexit goes far beyond the future UK-EU relationship. As

a starting point there are valuable lessons that can be taken from the Brexit process. The EU should analyse the reasons for the unexpected and remarkable unity of the EU27. These may include shared goals during the first phase of the negotiations, a sense of existential threat and the desire to avoid setting a precedent of a member state being abandoned by the Union in favour of a (soon to be) third country. Identifying the reasons for the EU’s remarkable unity will enable the Union to apply the lessons of Brexit to other policy areas and help to ‘Re-unite Europe’ (see also contribution of Janis A. Emmanouilidis).

Most importantly, the EU institutions and member states must consider whether, and if so to what extent, differentiated integration could serve as a model for the EU’s relationship with third countries, especially in the Union’s direct neighbourhood, including the future EU-UK relationship. This will have significant implications for the future of European integration.

From the EU’s perspective, the best version of a relationship with a third country is one that is as close as possible but, at the same time, shows very clearly the costs of being outside the club. This poses a paradox: it implies that those third countries that are integrated most have to, de facto, become members without rights, creating a politically unstable and conflictual situation, especially for countries that have a significant political and economic weight but are not willing to accept the terms and conditions of membership.

This conflict can clearly be seen in the negotiations with the UK and implies that any deal that will now be reached will probably evolve over time. If, for example, the next phase of negotiations between the EU and the UK would shift to a Norway

plus-style model (i.e. single market and customs union membership with close cooperation on many issues), the UK would be facing major political issues, essentially becoming a rule-taker. But barring such a shift, a Canada plus model with deeper integration in certain policy areas, while politically feasible, would not deliver the close integration that is desirable, in economic terms and for Europe's role in the world.

This tension between economic and political benefits at the price of adhering to a common set of values and rules will also play itself out within the EU. The current model of differentiated integration, which foresees that some countries progress while others follow at a later point in time, is

no longer functioning. Those who are not part of the more integrated policy areas have a significant and broad disadvantages from being outside the inner circle. But, at the same time, we have seen that these countries are simply not willing to join the euro, Schengen or other forms of closer cooperation. On the contrary, they have used whatever powers they have to counter or even block further steps of integration. We might have reached the limit of what can be achieved within the current model, which could also explain why we have witnessed a number of (unsuccessful) initiatives outside the EU system. Brexit is a stark reminder that we have to revisit and reform the current model of European integration and its reliance on limited forms of differentiated integration.

1. The final version of this piece was concluded on 1 April 2019.

2. See also Duff, Andrew (2019), "[New proposal for amending the Political Declaration on Britain's future in Europe](#)", Brussels: European Policy Centre.

3. See also Lock, Tobias and Zuleeg, Fabian (2018), "[Extending the transition period](#)", Brussels: European Policy Centre.

4. See here: <https://www.weforum.org/agenda/2018/04/the-worlds-biggest-economies-in-2018/>

5. Under mutual recognition all financial products and services that comply with UK regulation could be sold in the EU and vice versa, while under equivalence the EU would assess for each set of products whether UK regulatory standards satisfy its own requirements before trade would be permitted. This would lead to different default positions: under the UK's proposal for mutual recognition, the default would be to allow trade, while no market access would be the default under equivalence.

6. See Tarrant, Andy et al., (2019), "[Equivalence, mutual recognition in financial services and the UK negotiating position](#)", UKTPO.

7. As of March 2019; figures are [estimates](#).

8. The continental partnership proposes combining mobility in goods, services and capital with some restrictions in the free movement of people and a new system of inter-governmental decision-making. The result would be an inner, politically integrated 'core' and an outer, less integrated 'periphery'. See Pisany-Ferry, Jean, Röttgen, Norbert, et. al., (2016), "[Europe after Brexit. A proposal for a continental partnership](#)", Brussels: Bruegel.

9. Under the 'shared market' model put forward by the IPPR, the UK and EU would share their markets, which would be facilitated by continued regulatory alignment and the creation of a comprehensive customs union. Regulatory divergence over time on part of the UK would be allowed, though this would have consequences for its trading arrangement with the EU. The EU would compromise on free movement of people. See IPPR, (2017), "[IPPR proposes creation of shared market between the UK and EU](#)".

10. See Zuleeg, Fabian (2018), "[The road to nowhere? Prospects for a post-Brexit trade deal](#)", Brussels: European Policy Centre.