Europe After Brexit

A Less Perfect Union

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The United Kingdom's vote to leave the European Union has triggered the worst political crisis the EU has ever faced. Since the early 1950s, the EU has steadily expanded, but on June 23, 52 percent of British voters ignored the experts' warnings of economic misery and opted to leave the bloc. At the annual British Conservative Party conference in October, Prime Minister Theresa May promised to invoke Article 50, which formally begins negotiations and sets a two-year deadline for leaving the EU, by March 2017. Now, given her determination to regain control of immigration and the stiffening resolve of other EU leaders to make an example of the United Kingdom, a so-called hard Brexit—an exit from both the single market and the customs union—is looking increasingly likely. This prospect should lay to rest the once dominant idea that European integration is an irreversible process.

When the United Kingdom leaves, as it almost certainly will, the EU will lose its largest military power, one of its two nuclear weapons states, one of its two veto-wielding members of the UN Security Council, its second-largest economy (representing 18 percent of its GDP and 13 percent of its population), and its only truly global financial center. The United Kingdom stands to lose even more. Forty-four percent of British exports go to EU countries; just eight percent of the EU's exports head to the United Kingdom. The United Kingdom will also face much less favorable terms with the rest of the world when negotiating future trade and investment deals on its own, and British citizens will lose their automatic right to study, live, work, and retire in the 27 other EU member states. What's more, the process of disentangling the country

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from 44 years of membership will consume a mind-boggling amount of human and financial resources. But the British people have made their decision, and it would be hard, if not impossible, to reverse course.

For the EU, the timing could not be worse. More than seven years after the eurozone debt crisis hit, Europe's economies remain fragile. Russia continues its saber rattling on the eastern periphery. Two of the EU's member states, Hungary and Poland, are rapidly sliding toward illiberal democracy. The refugee crisis has exposed deep divisions across the continent over immigration. Europe seems to be in a perpetual state of crisis. Antiestablishment parties on both the right and the left that question the value of the EU have gained ground, mainly at the expense of centrist Christian democratic and social democratic parties, which have never wavered in their support for further European integration. In the 1957 Treaty of Rome, which established the EU's predecessor, Europe's leaders envisioned "an ever closer union among the peoples of Europe." Six decades on, that notion has never seemed more distant.

The roots of the EU's current crisis can be traced to the 1980s. In the first four decades after World War II, leaders saw the European project primarily as a means of restoring the political legitimacy of their war-torn nation-states. In the 1980s, however, Europe's elites set their sights on a loftier goal: forging a supranational economic regional order over which an enlightened technocracy would reign supreme. The creation of the single market in 1986 and then the introduction of a single currency a decade later seemed to herald a glorious new era of economic growth and political integration.

In reality, however, these steps sowed the seeds of Europe's current crisis. Leaders on the continent failed to set up the institutions that would be necessary to make both the single market and the single currency function properly. They brought about monetary union without fiscal and financial union, leaving countries such as Greece and Italy vulnerable after the Great Recession struck in 2008. Today, Greece's economy is 26 percent smaller than it was in 2007 and remains mired in debt. Youth unemployment there stands at just below 50 percent; in Spain, it remains above 45 percent, and in Italy, it hovers around 40 percent. Europe's leaders always assumed, incorrectly, that future shocks would lead to further integration. But the economic crisis, followed closely by an ongoing political crisis over immigration, has brought the EU to the brink of disintegration.

Goodbye to all that: Theresa May at an EU summit in Brussels, October 2016

If the EU is to survive, it must restore the original division of labor between Brussels and Europe's capitals, in which national governments retained discretion over key areas of economic policy, such as the ability to conduct fiscal stimulus and defend national champions. The nation-state is here to stay, and national policies still have far more democratic legitimacy than those imposed by technocrats in Brussels or Frankfurt. The EU needs to give Europe's national governments more, not less, freedom to act.

FROM THE ASHES

The founders of the EU would be disheartened to see what their creation has morphed into. As the British historian Alan Milward argued in his 1992 book *The European Rescue of the Nation-State*, Europe's ruling elites established the European Economic Community (EEC) in the 1950s not to build a new supranational power but to rehabilitate the system of European nation-states after the horrors of World War II. They realized that if their countries were to survive, they would need some degree of continental coordination to help provide economic prosperity and political stability.

YVES HERMAN / REUTERS

Milward argued that increased European cooperation required some surrender of sovereignty, but not the wholesale replacement of the nation-state with a new form of supranational governance. Instead, the EEC was designed in keeping with the idea of "embedded liberalism": the postwar consensus that sovereign countries would gradually liberalize their economies but maintain enough discretion over their economic policies to cope with hard domestic times. The EEC's founding fathers left most political and economic powers with national governments, leaving the EEC to coordinate coal and steel production, agricultural support, and nuclear research, as well as internal trade relations and common foreign economic policies.

This political bargain ushered in three decades of successful European integration by guaranteeing peace and stability and fostering increased trade and prosperity. In the early 1990s, when Milward published his book, European integration had reached its zenith. In 1991, according to Eurobarometer polls, a record 71 percent of EU citizens considered their country's membership in the union "a good thing"; just seven percent thought it was "a bad thing."

Yet no sooner had Milward's thesis appeared than it became outdated. Starting in the mid-1980s, Europe's elites had begun to transform the nature of the European political project. Led by Jacques Delors, the president of the European Commission, and backed by French President François Mitterrand and German Chancellor Helmut Kohl, they set out to create a new form of supranational governance, rather than using European integration to strengthen the continent's old system of nation-states. Pan-European rules would take precedence over national policy discretion. Economic integration would trump domestic democratic politics. Europe's leaders would turn their countries "from nation-states to member states," as the political scientist Chris Bickerton has put it, as they progressively dismantled the postwar national corporatist state. Delors' federalist vision required the EU's member states to surrender ever more sovereignty and gradually weaken the privileged bonds that had existed between national governments and their people. Membership in the EU would no longer entail reinvigorating the nation-state; it would mean caging it.

THE GREAT EXPERIMENT

The first landmark in the transformation of the European political project came in 1986, when French socialists such as Delors and Mitterrand joined forces with conservatives such as Kohl and British Prime Minister Margaret Thatcher to sign the Single European Act. The

SEA represented a response to the "Eurosclerosis" of the 1970s and 1980s, Europe's protracted disease of low growth, labor unrest, and high unemployment and inflation. The Treaty of Rome had already established a common market and enshrined "four freedoms" into European law: the free movement of people, services, goods, and capital. But countless national regulations still held back cross-border trade. Only through more deregulation and liberalization, European policymakers argued, could Europe escape its economic doldrums. And indeed, by 1992, the EEC would become a genuine single market.

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But as the Hungarian economic sociologist Karl Polanyi warned in the mid-twentieth century, there is nothing natural about the creation of markets. They require major acts of state power, so that activities that were once "embedded" in local social and political relationships become tradable commodities among anonymous participants. Exchanges need to become "disembedded" from their social context to become market transactions. The SEA was a major exercise in disembedding countries' markets from their national protections, regulations, and traditions.

The SEA was extraordinarily ambitious. Most countries require people to hold national licenses when they provide services, whether they are designing a house, performing surgery, or offering financial advice. Many governments still monitor and restrict capital and financial flows into and out of their national jurisdictions. All kinds of nontariff barriers, such as national health, safety, and environmental standards, still hold back international trade in goods. But after the SEA, European citizens could move easily among national labor markets, capital could flow freely across European borders, and manufacturers no longer had to deal with a raft of conflicting product standards. A Portuguese pilot could fly for Air France, a Belgian bank could now invest in Greece, and a German driver could buy an Italian Lamborghini without having to worry if it complied with Germany's technical and safety standards. Intra-EEC trade in goods soared. The single market remained incomplete—fatally, it lacked a unified system for supervising and resolving Europe's most important banks and monitoring mechanisms to warn of sudden interruptions to international capital flows—but it went much further than any similar exercise in modern history.

Indeed, the political scientists Leif Hoffmann and Craig Parsons have observed that in many instances, the United States' single market has more rules than Europe's. In public procurement, for example, the state of California or the city of Chicago can give preference to state or local service providers. Member states of the EU cannot favor national companies. Similarly, the regulation of many services in the United States takes place at the state, rather than the federal, level. A licensed hairdresser who moves from Ohio to Pennsylvania must undergo 2,100 hours of training and pass written and practical exams to obtain a new license. A barber from Berlin, on the other hand, can set up shop in Paris the very next day.

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But the EU's experiment in creating a truly free market has come at a price. The increased market competition that the SEA introduced brought widespread benefits, but it also created winners and losers, such as the local producers and service providers in France or the United Kingdom who now faced stronger competition from cheaper Slovakian manufacturers, Polish plumbers, and Romanian contractors. In the boom years, Europe's economies generated enough wealth to compensate the losers. As growth has stagnated, however, large swaths of national electorates have begun to clamor for more protection from the market that the EU built.

Yet because the SEA uprooted European markets from their nationally based democratic politics and social institutions, Europe's governments have given up much of their power to intervene in their countries' economies. To some extent, this process has happened everywhere due to globalization, but European countries embraced the primacy of international markets over domestic politics to a much greater extent than countries anywhere else in the advanced industrial world. As a result, they have found themselves with much less control over their domestic economies than any of their Western peers. And because regulations concerning the EU's single market require only a qualified majority of member states, rather than unanimity, to become law, they can sometimes directly conflict with national interests. For instance, in August 2016, the EU ordered the Irish government to collect $14.5 billion in unpaid taxes from Apple, despite protestations by the Irish government that low corporate taxes were a key component of its economic model and a "fundamental matter of sovereignty."

"SOMEDAY THERE WILL BE A CRISIS"

The creation of the euro in the Treaty of Maastricht in 1992 represented an even more serious loss of power for Europe's national governments. Elites introduced the euro because they believed that a single market would function properly only with a single currency. They also argued that countries as open and integrated as the EU member states would benefit from ending exchange-rate fluctuations with one another. More quietly, they dreamed of building a common currency that could challenge the global supremacy of the U.S. dollar.

Federalists hailed the euro as another great leap forward toward European unification, but it took Europe even further away from the postwar embedded liberalism that had underpinned Milward's grand bargain. That bargain had left nation-states in control of European integration and had presupposed that democracies needed leeway when times were tough to rebalance their economies toward higher growth or lower unemployment, even if that meant temporarily pausing further liberalization.

Yet the design of the euro gave Europe's democracies no such freedom. The introduction of the common currency and the European Central Bank, which has a sole mandate to maintain price stability, prevented member states from pursuing their own monetary policies. Austere fiscal requirements, meanwhile, which Germany insisted on, made it much harder for governments to stimulate economic growth by boosting spending during a downturn. The 1997 Stability and Growth Pact mandated low public deficits and declining sovereign debt ratios, but the agreement's name is a misnomer: the pact has undermined social stability and generated little growth. Although national governments often ignored the pact, especially in the early years of the single currency, the EU, at Germany's behest, tightened the rules in response to the euro crisis and rendered any activist fiscal policy all but illegal.

Germany has been the biggest winner from the euro. Because Germany's currency can't appreciate in relation to the currencies of its European trading partners, Germany has held down the real cost of its exports, resulting in a massive trade surplus. But the euro has been a disaster for the rest of Europe. When they created the currency, Europe's elites removed the economic shock absorbers that their countries had traditionally relied on without creating any new adjustment mechanisms. Europe's leaders thought it unwise to establish a genuine fiscal, financial, and political union to complement the monetary union. They rightly judged that their electorates would not accept it, and they assumed that future crises would propel the EU toward further integration. As Romano Prodi, a former prime minister of Italy and then president of the European Commission, observed in 2001, on the eve of the launch of the euro notes and coins, "I am sure the euro will oblige us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But someday there will be a crisis and new instruments will be created."

But when the crisis struck, the European Central Bank initially refused to ease monetary policy and in fact raised interest rates; meanwhile, national governments could no longer devalue their currencies in relation to those of their main trading partners to boost exports, nor launch fiscal stimulus programs. That left harsh austerity measures as their only option. In the short term, this response only worsened the crisis. Since then, the EU has created some new instruments, including a banking union and a new fiscal compact, which have transferred responsibility for supervising the eurozone's biggest banks from national authorities to the European Central Bank, created a single resolution board to wind up failing banks, and established more intrusive monitoring of national budgets. But the logic of European integration has remained the same: more supranational rules, less national discretion. The German government, for example, could not step in to rescue Deutsche Bank, once a symbol of Germany's financial prowess, if Berlin judged it to be in the national interest to do so, nor can the Italian government run larger fiscal deficits to counter its chronic lack of economic growth.

INS AND OUTS

It is the crisis over immigration, however, that threatens to trigger the union's demise. The free movement of people within the single market used to be a minor political issue. Most people saw it as a chance for the young to study abroad through the EU's Erasmus and Socrates programs and for the educated and upwardly mobile to get work experience in a different European country. Until the early years of this century, EU-wide migration remained very low.

But when the EU expanded its membership in 2004 to include the former communist countries of central and eastern Europe, intra-EU migration started to grow. EU enlargement to the east created "a Europe whole and free," as U.S. President George H. W. Bush phrased it in 1989, but it also made the union's membership much more economically unequal. In 2004, when Poland joined the EU, its GDP per capita stood at around $6,600; in the United Kingdom, the figure was $38,300. These vast differences in income levels encouraged millions of eastern Europeans to head westward. Between 2004 and 2014, for example, over two million people moved from Poland to Germany and the United Kingdom, and almost another two million moved from Romania to Italy and Spain. Such large movements of people have put pressure on the public services and safety nets of the countries receiving them.

Then, in 2015, more than one million migrants and refugees from Afghanistan, Iraq, Syria, and sub-Saharan Africa poured across Europe's borders. The single market had no mechanism to deal with sudden movements of people within it, nor did the EU have any common external migration policy to help absorb a large influx of refugees. National governments, constrained by EU rules over fiscal spending and unable to agree on how to share the burden, have struggled to respond. True, the overall migration numbers remain relatively low, and the net contribution of migrants to their host countries is mainly positive. But many citizens feel that their own governments are powerless and that the EU fails to represent their interests, and so anti-immigrant parties have surged across Europe. For the first time, the EU's commitment to the free movement of people has begun to waver.

Eastern European governments, such as those of Viktor Orban in Hungary and Beata Szydlo in Poland, have ferociously defended their citizens' rights to live and work across the EU while refusing EU requests to take in a quota of refugees. Many western European governments are prepared to begrudgingly accept EU quotas on refugees but increasingly question the unlimited nature of migration within the EU. Fears of unlimited emigration from countries such as Turkey, a candidate for EU membership, played a major role in the United Kingdom's decision to leave the EU, and the desire to regain control over immigration to the United Kingdom will likely result in that country's departure from the single market altogether.

TAKING BACK CONTROL

So where does the EU go from here? Since the United Kingdom has always been its most reluctant member state, many Europhiles will be tempted to argue that Brussels can now finally push forward with further integration. But that would be a misreading of the current mood in Europe's capitals and a misdiagnosis of Europe's ailment. More Europe is not the answer to the EU's problems.

Instead, Europe's leaders need to return to Milward's basic idea that Europe was meant not to cage its nation-states but to rescue them. Democratic legitimacy, for better or worse, remains with Europe's national governments. There are no technocratic solutions to Europe's political problems. "I don't wish to suggest that there is something inherently superior about national institutions over others," the historian Tony Judt observed in 1996. "But we should recognize the reality of nations and states, and note the risk that, when neglected, they become an electoral resource of virulent nationalists."

The EU does not need any more rules; it needs political leadership.

European integration has taken so many policy levers away from governments that many citizens have started to wonder what their governments are still there for. As the political economist Mark Blyth and I argue in *The Future of the Euro*, "Without developing a political process to legitimately embed [the eurozone's] economic and financial institutions, the future of the euro will be fragile at best." Restoring growth in the eurozone, fighting youth unemployment, and championing EU political reforms that return some economic power to member states should take precedence over austerity and one-size-fits-all structural reforms.

Distributive policies that create winners and losers need to be legitimized democratically through regular elections and should therefore remain the sole preserve of national governments. Such policies include setting budgetary priorities, determining the generosity of the welfare state, regulating labor markets, controlling immigration, and directing industrial policy. Permitting countries to occasionally break the rules of both the single market and the single currency—by temporarily letting them protect and financially support key industries, for instance, or institute an emergency break on immigration under certain strict conditions—would empower national elites to deal with specific national problems and respond to voters' legitimate concerns by giving them a democratic choice over policy.

The EU, meanwhile, should focus on the things that member states cannot do efficiently on their own and that create mutual gains: negotiating international trade deals, supervising systemically important banks and other financial institutions, responding to global warming, and coordinating foreign and security policy. In Eurobarometer polls, about two-thirds of European citizens surveyed consistently say that they support a common foreign policy for the EU. National governments could start with a much more effective pooling of their military resources to conduct joint peacekeeping and humanitarian missions overseas.

The EU does not need any more rules; it needs political leadership. Germany must give up its opposition to eurobonds, or jointly guaranteed eurozone debt instruments, and common deposit insurance, which would go a long way toward providing long-term financial stability in the eurozone by preventing future sovereign bond market contagion and bank runs. It must relax its insistence on tough fiscal rules to allow countries such as Italy and Portugal to engage in aggregate demand stimulus. And it must take the lead in setting up new mechanisms for promoting solidarity within the EU, such as a joint refugee and migration fund, which could make up the difference in temporary shortfalls in local funding and help member states more effectively share the burden of integrating new migrants across Europe.

Germany needs to finally embrace its leadership role. If Germany can overcome its parochialism and recognize that it is in its long-term interest to act as a benign hegemon for Europe—not unlike the role the United States played in the Western world after World War II—there is no reason why the EU cannot emerge stronger from its current malaise. The leaders of the other remaining large member states—especially France, Italy, Poland, and Spain—must reassure Berlin that they are committed to reforming their economies once growth returns, pledge to actively contribute to EU-wide solidarity, and reaffirm that the European project is in their national interests. Collectively, Europe's leaders need to reimagine what Europe is for and regain control of the process of European integration. Sixty years on from the signing of the foundational Treaty of Rome, Europe needs a new grand bargain, now more than ever.