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A New Settlement for the UK: A “Leap in the Dark”

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A New Settlement for the UK: A “Leap in the Dark”¹

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Abstract

This paper examines the outcome of the negotiations for a new settlement concerning the United Kingdom’s relationship with the European Union. It reviews the nature and possible consequences of the “substantial changes” that were demanded in the areas of economic governance, competitiveness, sovereignty, and immigration. We argue that the proposed arrangements do not amount to much and can prove harmful to the future of the EU. The paper is a follow-up to our analysis of the initial proposals, available under Bruges European Economic Policy Briefings, 38/2016.

Keywords: European Union, United Kingdom, Settlement, Brexit.

JEL-Codes: O11, F02, E61, H5

¹ On 22 February 2016, in [a speech in Parliament](#), David Cameron, the British Prime Minister, described a possible UK exit from the EU as a “leap in the dark” in pursuit of the illusion of sovereignty.

Introduction

Precisely thirty years ago, the Member States of the then European Economic Community signed the Single European Act that introduced "qualified-majority" voting. The change from unanimity to qualified majority made possible the adoption of nearly 300 measures that removed national barriers and built the largest single market in the world. To this day, the single market is the European Union's proudest and most significant achievement.

Thirty years later, almost to the date, European leaders signed a new agreement. This time, however, they agreed to limit integration and to constrain the ability of the Member States to adopt common rules.

In this paper, we examine the outcome of the negotiations that took place at the European Council meeting of 18-19 February 2016 to define a "new settlement" for the United Kingdom.² This is a follow-up paper to our assessment of the initial proposals that were tabled by the European Council President, Donald Tusk.³ We review the contents of the agreement on a new settlement and consider the implications for the functioning of the European Union and the possible impact on the evolution of the EU.

The UK appears to have achieved its objectives and has extracted all the concessions it had initially demanded. This success is unlikely to placate the proponents of UK exit from the EU. Whether the UK will eventually remain in the EU will depend on the outcome of the referendum that is scheduled to take place on 23 June 2016. Two days after he returned from Brussels, the British Prime Minister, David Cameron, presented the provisions of the agreement to the House of Commons. In the ensuing debate, he argued that exit from the EU would be a "leap in the dark".

² The agreement of 19 February 2016 has been published in OJ C69I, 23/2/2016.

³ See P. Nicolaides, R. Nedelescu, J. Hornik, G. Watfe, "The New Deal with the United Kingdom: the Downside of Flexibility", BEEP 38, February 2016.

We agree with that assessment. We argue in this paper that the agreement itself is very much a leap in the dark. Many of the points of the agreement are couched in vague and conditional terms. Extensive work will have to be done to give them substance. The process will unavoidably be acrimonious. The agreement has not really settled much. In fact, it may encourage other Member States to seek to undo old bargains which they may perceive as skewed against their interests.

How did we get here?

The agreement of the European Heads of State or Government on 19 February 2016 concerning a new settlement with the United Kingdom was the culmination of a two-year process of informal meetings and formal negotiations on reforms that were intended to change the European Union so as to accommodate the UK's demands.

In the run-up to the general election in 2015, the British Prime Minister, David Cameron announced on 23 January 2013 that an "in-out" referendum would be held before the end of 2017. This promise was conditional on his re-election in 2015. As part of the re-election campaign, the Conservative Party put forward a new manifesto on 14 April 2015 demanding EU reforms and calling for a new settlement between the UK and the EU. Following the Conservatives' electoral success in May 2015, Philip Hammond, the UK's Secretary of State for foreign affairs, introduced the European Union Referendum Act to the House of Commons. Thereby, he formally paved the way for the referendum to be held before the end of 2017.

Subsequently, a Task Force was formed by the European Commission to negotiate British demands at expert level. Finally, on 10 November 2015, David Cameron publicly announced the UK's objectives in a letter to the President of the European Council, Donald Tusk. He requested reform of the EU in four areas: economic governance, competitiveness, sovereignty as well as social benefits and free movement. Following a series of bilateral and multilateral exchanges, Donald Tusk submitted a draft Decision to the members of the European Council on 2 February 2016.

During the European Council meeting on 18-19 February 2016, the proposed text formed the basis for negotiation and eventual agreement. It was expected to be adopted relatively quickly. However, the Heads of State or Government extended the schedule of their meetings several times. Undoubtedly, the final agreement between the UK and the EU is the outcome of intense discussions and hard bargaining. The substance of the text, however, does not appear to be commensurate to the amount of effort that has gone into it. We explain why in the rest of the paper.

The agreement is contained in the conclusions of the European Council. The agreement itself is in the form of a Decision by the Heads of State or Government and has a preamble and four main sections. Section A deals with economic governance, section B is short and focuses on competitiveness, section C concerns sovereignty, while section D addresses the issues of social benefits and free movement. The last section E is made up of just two short final provisions on the coming into force of the Decision. The European Council conclusions also include the text of a draft decision of the Council on how important issues may be raised for discussion and five declarations by the Commission.

The legality of the new arrangements

The conclusions mention twice that the new arrangements are “fully compatible with the Treaties”. This implies that none of the changes requires a Treaty revision. That is good news for the EU and for the UK alike as Treaty amendments would be an unavoidably long and uneasy process, subject to ratification by all Member States. Nevertheless, the Decision of the Heads of State or Government is clearly “legally binding”, even if contingent on the outcome of the UK referendum to be held in June. It is stated that it will take legal effect on the date that the UK informs the Secretary General of the Council that the UK will remain in the EU. If the referendum scheduled for 23 June is positive, the Decision will come into force on 24 or 25 June.

The EU is not monolithic

Reinforcing the text of the conclusions, the preamble to the Decision once again emphasises that the proposed arrangements are “in conformity with the Treaties” and

should be used as “an instrument for the interpretation of the Treaties”. It also recalls the existing opt-outs enjoyed by certain Member States, the UK in particular, and reiterates that they allow for “different paths of integration”, without the need for Treaty changes.

Section A: Economic governance

The first part of this section acknowledges that Eurozone countries can deepen integration among themselves and that others may join if they wish. It distinguishes between Member States with a permanent opt-out from the single currency and those which are only temporarily outside of the euro area [i.e. Member States “with a derogation”]. In order to prevent the latter group of Member States from using the Decision to claim that they do not have an obligation to join the Eurozone, the Decision emphasises that they are still committed to fulfil the necessary conditions to adopt the euro. Moreover, the non-euro countries may not obstruct further integration of the euro area.

The Decision contains a reference to the need for a consistent single institutional framework. Furthermore, it calls for maintaining a “level-playing field and the integrity of the internal market” and prohibits discrimination between Member States. This means that the Eurozone cannot act to the disadvantage of non-euro countries.

The second part of the section reiterates that the single rulebook applies to financial institutions in all Member States. While the draft Decision referred to “different sets of Union rules”, the final Decision foresees “specific provisions within the single rulebook and other relevant instruments”. The word “within” is important. It allows certain flexibility to both the Eurozone and non-euro countries; yet at the same time it prevents them from relying on the Decision to justify a deviation from the provisions of the single rulebook. This change in the wording ensures a consistent application of financial regulation. This point is again made in part four of the section. Accordingly, the implementation of measures for the supervision and resolution of financial institutions is a matter for national authorities which must act, however, “without prejudice to the development of the single rulebook”.

The next section stipulates that the ECB shall exercise its authority and supervisory powers only on Eurozone financial institutions but also allows the Eurozone to go further. Accordingly, "substantive Union law to be applied by the European Central Bank in the exercise of its functions of single supervisor, or by the Single Resolution Board or Union bodies exercising similar functions, ..., may need to be conceived in a more uniform manner than corresponding rules to be applied by national authorities of Member States that do not take part in the banking union." [emphasis added] Thus more harmonisation is possible within the Eurozone.

Moreover, the UK is assured that it will not have to bear any financial cost from the crisis and that it would be reimbursed if measures to deal with the crisis and possible bail-outs would fall on the budget of the EU. It is important to note that arrangements that address this concern have already been put in place. The additional financial assistance granted to Greece last year sparked fears in the UK that its taxpayers could be held liable for Eurozone bailouts. However, a joint Declaration by the Commission and the Council then specified a safeguard for non-Eurozone countries. In case the debtor country would not be able to repay any loans, there would be immediate reimbursements of the non-euro countries. The Declaration was followed by appropriate adjustments of the relevant legal instruments.

Part five asks the Eurogroup – the gathering of Eurozone ministers of finance – to respect the powers of the Council. Here the Decision implicitly acknowledges the tension between the Eurogroup and the Ecofin Council – the gathering of ministers of economics and finance from all Member States. Certainly, there has been friction which should be resolved. This proposal seeks to mitigate British fears that the in-built majority of Eurozone Member States in the Ecofin Council (since 1 November 2014) will render non-euro Member States powerless in influencing future financial rules. Understandably, the UK want to have a say in financial services regulation, given that the financial institutions in the City of London constitute an important sector of the UK economy.

The formerly bracketed part seven of the section on its incorporation into the Treaties is now included in the text. Therefore, a future change of the Treaties will be used to include the substance of the section following the standard procedure for Treaty

change. This means that discussions on the substantive provisions of this section will likely occur again.

The section on economic governance is masterfully drafted. While it confirms the pre-eminence of a single European market, it assuages the concerns of the UK and provides it with the means to request further deliberation on legislation that may be perceived to be harmful to its interests and at the same time allows the Eurozone to deepen integration without being obstructed by non-euro countries.

However, the fine principles which are enunciated in this section will have to be interpreted, elaborated, and enforced. Any action to preserve financial stability or to resolve failing banks is bound to have cross-border repercussions. While it is perfectly conceivable that new laws can be free of discriminatory provisions, it is hard to see how, in a genuine single market, action in a time of crisis can be compartmentalised across national boundaries.

What is needed is an innovative cooperation procedure that can be activated in times of crisis. The first step in this direction is Annex II of the Decision which contains a statement on the effective management of the banking union and the consequences of further integration of the euro area. Annex II outlines a draft for a Council decision that creates a safeguard mechanism for Member States not participating in the banking union. It supplements Council Decision 2009/857 that enables Member States which happen to be in a minority in the Council to raise concerns and to have the Council address these concerns to find a satisfactory solution when the Council adopts a legislative act on the basis of qualified majority voting.

Accordingly, whenever legislative acts regarding the effective management of the banking union or the consequences of further integration of the euro area are to be adopted, Member States not participating in the banking union can trigger a safeguard mechanism. The mechanism works as follows. The Member State has to indicate its "reasoned opposition", prompting the Council to "discuss the issue". The opposition has to be justified by specifying which provisions of the Decision are not respected by the legislative act (Article 1(1)).

As a consequence, the Council has to "do all in its power to reach (...) a satisfactory solution to address (the) concerns" (Article 1(2)). This means that the President of the Council has to take "any initiative necessary" to reach broad agreement between the Member States. More concretely, such initiative might be to refer the issue to the European Council. However, it is made explicit that this mechanism shall not amount to a veto right for one or more Member States (Article 1(3)).

Finally, Article 2 clarifies that the Council decision will enter into force on the same date as the final Decision takes effect.

The draft Council decision represents a watered-down version of the demand of the UK for a right of appeal against Eurozone-specific legislation. It certainly does not give the UK a veto over further deepening of the Eurozone. However, it is likely to slow down the legislative process as the Council is obliged to adopt more consensus-oriented decisions if a Member State that is outside of the banking union invokes reasoned opposition against legislation based on this Decision.

Section B: Competitiveness

The final Decision regarding competitiveness is arguably the least innovative. The draft Decision already exhorted EU institutions and Member States to "make all efforts to fully implement and strengthen the internal market", "take concrete steps towards better regulation", lower "administrative burdens and compliance costs on economic operators", repeal "unnecessary legislation" and pursue "an active and ambitious trade" policy.

However, the final Decision does include in Annex III a declaration of the European Council on competitiveness which stresses that Europe must become more competitive to generate growth and jobs. More can be done to fully exploit the internal market, promote entrepreneurship and job creation, invest for the future and facilitate trade. The internal market, with the freedom of movement of goods, persons, services and capital, is clearly of enormous value to all Member States.

The European Council urges EU institutions and Member States to strive for better and leaner regulations. It highlights the Inter-institutional Agreement on Better Law Making between the Council and the Commission to facilitate effective cooperation to simplify Union legislation, avoid overregulation, and reduce the burden of compliance.

The European Council also underlines the importance of expanding trade with 3rd countries.

Nothing really new is added by section B or Annex III. One wonders why the UK was so keen on reforms to boost competitiveness if it only got the EU to commit to what it had already been doing.

Perhaps the reason is that Mr Cameron wanted to weaken the arguments of the advocates of exit from the EU. According to its proponents, UK's exit is supposed to unshackle it from regulation and allow it to trade freely with the rest of the world. Undoubtedly, some regulation can be avoided by not having to comply with all of the EU's rules. But modern economies cannot function without regulation. Many of the current European rules will simply have to be replaced by British ones.

Indeed, it is the difference in national rules that hampers international trade.⁴ After successive GATT and WTO rounds, tariffs are very low and represent only minor obstacles to trade. As attested by almost all of the recently concluded international trade agreements, the single biggest problem is divergent domestic rules on such things as product standards, safety conditions, qualifications of service providers and public procurement.

A UK that can act on its own will have much more freedom to choose the countries with which to negotiate and the issues it will want to tackle. Setting aside the non-trivial question of whether there would be many other countries equally interested in starting tedious and time-consuming trade negotiations with a single country, the object of such negotiations cannot be simple removal of unwanted rules. If that were the case, it could

⁴ For example, the majority of transatlantic trade is already subject to very low tariffs since "two-thirds (by value) of non-agricultural trade, and over 40% of agricultural trade, already enters duty-free". (Eric Hayes, 2015, p. 115).

be done unilaterally. As the recent trade agreements have shown, the crux of the issue is harmonisation of rules, or convergence of rules coupled with mutual recognition, and adoption of similar or equivalent standards and procedures for verification and certification.

Once it is understood that trade liberalisation today is not about border restrictions but about regulatory convergence and investment protection, then the ability of the UK to negotiate bilateral deals is really illusory. It is logically impossible to achieve convergence of different national standards and regulations unless they all converge to the same standard and regulation. This is what the EU has been trying to do with its trade partners: to get them to accept more open, liberal and objective means of product and service regulation. The EU can do that because it has the clout of a single market of 500 million consumers. How Britain would do it on its own is difficult to envisage.

Section C: Sovereignty

The first part in this section refers to the concept of "ever closer Union" as included in the Treaties. The Decision explains that this objective does not automatically imply further political integration of the Member States and that any extension of Union competences remains subject to the principles of subsidiarity, proportionality, and conferral. It explicitly recognises that the UK is not committed to further integration. What was previously included only in square brackets now features prominently in the first paragraph, stating that "the substance of this will be incorporated into the Treaties at the time of their next revision".

This can be seen as a major success for the UK. David Cameron has now obtained the "formal, legally-binding and irreversible" change he requested in the letter of 10 November 2015. Although in practice such a provision might have little impact (given the existing opt-outs and the general nature of the concept), the fact that the European Council agreed to exclude the UK from references to "ever closer union" shows how far the other 27 Member States were willing to go to keep the UK in the EU.

Arguably, such a statement could give the UK an excuse to seek more opt-outs and exemptions from binding EU decisions and rules in the future. But, in addition to how the UK may behave in the future, the explicit acknowledgement that integration is not inevitable is bound to influence the attitude of other Member States and have an impact on the fragile European solidarity which is already under strain due to the multiple crises that the continent has experienced.

The three subsequent parts refer to the request of Mr Cameron for more power to be given to national parliaments. To this end, the Decision establishes a "red card" mechanism that gives a *de facto* veto to national parliaments on EU legislation. If 55% of national parliaments objects to a legislative proposal within 12 weeks of its transmission, then the Council will have to abandon it, unless it is appropriately amended.

This appears as a significant win for the UK but in practice may prove moot as it only adds to the already existing "yellow" and "orange" card mechanisms which are rarely used. Will it empower national parliaments to act more frequently to oppose EU legislation on grounds of subsidiarity? It is hard to imagine that 55% of national parliaments would often gather to act against the decisions of the representatives of their own governments in the Council.

Part five of this section recognises "the benefits of collective action" on security issues affecting all Member States. If taken in the context of the migration crisis and terrorist threats, this provision underlines the need for serious security issues to be tackled at EU level, rather than by national governments. This is hardly surprising and very important in the current security situation in Europe.

Annex IV to the Decision contains a declaration by the European Commission on the implementation of subsidiarity. The Commission commits itself to establishing a "mechanism to review the body of existing EU legislation" regarding the compliance with principles of subsidiarity and proportionality. However, the declaration in fact simply restates the priorities of the 2015 Better Regulation Agenda which already deals with simplification of EU law.

The provisions of the Decision on sovereignty will be claimed to be one of the most important concessions exacted by the UK. The text accommodates all of Mr Cameron's demands in a legally binding manner. National parliaments are given a virtual veto right on EU legislation and Britain is exempted from the "ever closer union" aim. Yet the practical impact of these changes is unlikely to be significant. Experience has shown that national parliaments act in most cases in unison with the governments in office. Respect for the principle of subsidiarity has already been put on the agenda of the Juncker Commission, with First Vice-President Timmermans being in charge of ensuring the conformity of any legislative proposal with the requirements of subsidiarity and proportionality.

The question that arises is how the changes introduced by the new settlement can strengthen the sovereignty of the UK. At face value, the new provisions are more democratic and accept different integration paths within the EU. In substance, however, they will not change the working reality of the EU. Yet, occasionally, symbols matter. If the EU does not have to bring its peoples closer together, perhaps pretty soon Member States will start asking for reversal of the process of integration and for more distance between their nations.

Section D: Social benefits and free movement

This section first reminds us that free movement of workers is a fundamental aspect of the internal market. It explains that workers move precisely because levels of remuneration differ between Member States. Indeed, labour movement that reduces wage differentials is a natural consequence of market dynamics. More importantly, reduction in wage differentials is beneficial to all countries in the long run, despite the fact that some workers lose out.

Then, the Decision goes on to state that the differences in social security systems "attract workers to certain Member States". However, the extent to which people move in order to exploit social security differences is an empirical question. Even if it happens, there is no clear evidence that it is substantial.

But the Decision acknowledges that "it is legitimate to take this situation into account and to provide, both at Union and at national level, and without creating unjustified direct or indirect discrimination, for measures limiting flows of workers of such a scale that they have negative effects both for the Member States of origin and for the Member States of destination."

Part one of this section provides an interpretation of current EU rules on labour movement. It recalls that Member States have the right to define their own social security systems and also that the right of movement under Article 45 of TFEU is not absolute. It is limited on grounds of public policy, public security or public health, which are specified in the Treaty, and by overriding reasons of public interest, which have been identified in the case law. In fact, recent judgments of the Court of Justice⁵ have reiterated that Member States may impose restrictions for the purpose of ensuring a real connection between workers and host countries and for preventing persons without rights of residence from becoming an excessive burden on social security systems. Member States are also free to take action to prevent the abuse of rights or fraudulent claims.

Part two proposes changes to secondary EU legislation. It refers to: (a) exportation and indexation of child benefits; and (b) establishment of an "alert and safeguard mechanism" that would be triggered in case of "inflow of workers" from other Member States that is of an "exceptional magnitude over an extended period of time".

Point (a) clarifies that exportation and indexation of child benefits is applicable only to new claims. Moreover, indexation of existing claims may be extended as of 1 January 2020 to "child benefits already exported by EU workers". It is also stated that "optional indexation of child benefits" is not intended to be applied to other exportable benefits, such as pensions.

Point (b) mentions that the "inflow of workers" may be the result of EU policies related to past enlargements and clearly states that the Member State concerned could be

⁵ Case C-333/13 *Elisabeta Dano and Florin Dano v Jobcenter Leipzig*; Case C-67/14 *Jobcenter Berlin Neukölln v Nazifa, Sonita, Valentina and Valentino Alimanovic*.

authorized by the Council to restrict the access of newly arrived EU workers to "non-contributory in-work benefits".

Any restriction on non-contributory in-work benefits should be gradual and only up to four years starting when the newly arrived worker enters employment in the host Member State. The Council authorisation concerning these restrictions will have a limited duration and may be applied to incoming EU workers during a maximum period of 7 years.

These provisions are intended to apply to all Member States and not just to allow for privileged treatment of the UK. This in itself is a sound approach and avoids creating first- and second-class Member States. The provisions are also heavily qualified. Safeguards will become operational only in exceptional situations, will be only temporary and will have to be approved by the EU. The latter point is important because it implies that no unilateral action is allowed by the Decision.

While indexing child benefits in accordance with the country of residence of the child will weaken any incentives that parents may have to leave children behind and will reduce the cost from fraudulent claims, restricting in-work benefits will create a differential treatment between nationals and non-nationals. So far, EU legislation and case law allow for restrictions of non-contributory benefits for non-nationals who do not try to integrate in the labour market and, therefore, protect the social security systems of individual Member States from excessive demands. This approach is reasonable. The same can be argued about access to social housing. But restricting in-work benefits goes a step further.

As the name suggests, in-work benefits are granted to individuals who have taken up a full-time or a part-time job. The scope of these benefits is to increase the difference between in-work income and out-of-work income by raising the net income from work. Increasing the minimum working period for non-nationals before they are entitled to in-work benefits is equivalent to paying lower salaries based on nationality. Will this be an effective measure to discourage workers from other EU countries from going to the UK? Not necessarily.

First, as long as the wage differences across countries are high enough, some workers will surely move. Second, while restricting in-work benefits could reduce the public expenditure of the receiving country, it may also increase demand for out-of-work benefits if the difference between working income and non-working support becomes smaller and out-of-work benefits access is not restricted for the same period. Third, less favourable treatment of foreign workers may have a more pronounced negative impact on high-skilled foreign professionals and discourage precisely those workers that the UK wishes to attract.

Nevertheless, introduction of non-contributory in-work restrictions for new arrivals for a limited amount of time could have a fiscal relief effect on the public finances of the host Member State, given that payment of such contributions is not necessarily linked to or conditional on actual payment of taxes and other mandatory contributions.

Part three deals with changes to primary EU law. It states that appropriate transitional measures on the free movement of persons in future EU enlargements will have to be agreed by all Member States. Also, EU workers should not be subject to less favourable conditions than non-EU nationals.

Annex V of the Decision contains a declaration by the European Commission on the indexation of child benefits that will be incorporated in a revision of the current Regulation 883/2004 on the coordination of social security systems. Annex VI contains a declaration by the Commission that it will make a proposal to amend current Regulation 492/2011 on free movement of workers so that a "safeguard mechanism" can be used in case of extraordinary influx of workers from another Member State.

Surprisingly, the Commission considers that in the UK, there is at present an "exceptional situation" and that the UK should trigger the safeguard mechanism in "full expectation of obtaining approval". This is surprising not because the UK does not experience an exceptional situation but because the Commission has not yet defined what exceptional may be, does not know what the UK may request and, above all, it is not within its powers to predetermine what the Council may decide.

Annex VII contains a declaration by the Commission to propose revision of the current Directive 2004/38 on the free movement of persons so as to discourage abuse through bogus marriages.

Overall, the agreed safeguards can be invoked by any Member State. But the application of the safeguards will not be automatic. The Commission and the Council will have to interpret what "exceptional", "excessive pressure" and "serious difficulties" mean. Opinions are bound to differ and divergent interpretations will be a source of friction in the future. Unless people stop moving in large numbers, disagreement between Member States may be mitigated but will not cease.

Is the outcome of the negotiations surprising?

The suspense and the reportedly tough bargaining that lasted well into the night of 19 February 2016 were predictable. The UK could not go away without extracting sufficient concessions to enable Prime Minister Cameron to declare victory. Mr Cameron's negotiating position was strong because he had put his back against the wall of the forthcoming referendum. The other Member States knew that and they were well aware that they had to make concessions. Hence, the real objective of the negotiations was to find language that could accommodate both sides.

A brief game-theoretic analysis shows that the UK played very smartly right from the beginning.

Assume that a Member State wants to negotiate a new deal with the EU. If its demands are not satisfied, it may wish to withdraw from the EU. The analysis below outlines the payoffs for the Member State and the EU for all possible contingencies.

For the Member State, the payoffs are:

- a) If its position is conciliatory:
 - 1 in case EU is conciliatory; no exit, but some of its demands are satisfied;
 - 0 in case EU is intransigent; no exit, no demands are satisfied.

b) If its position is intransigent:

- 2 in case EU is conciliatory; exit with most of its demands satisfied;
- 3 in case EU is intransigent; exit without access to the internal market.

For the EU, the payoffs are:

a) If its position is conciliatory:

- 1 in case the Member State is conciliatory; no exit of the Member State, EU makes concessions;
- 2 in case the Member State is intransigent; exit of the Member State, the EU loses a member but maintains good post-exit relations.

b) If its position is intransigent:

- 0 in case the Member State is conciliatory; no exit of the Member State, no concessions;
- 3 in case the Member State is intransigent; exit of the Member State without post-exit agreement.

As can be seen in the matrix below, on the basis of the above assumptions, the outcome is indeterminate. It can be either of the two yellow cells, depending on who makes the first move. Indeed, the UK made the first move by committing itself to put the outcome of the negotiations to a referendum. This meant that when the negotiations came, the UK had to extract sufficient concessions to prove to its citizens that it had bargained hard to extract reforms. In other words, the consequence of declaring a referendum beforehand was that afterwards the UK had to be intransigent.

		European Union	
		Conciliatory	Intransigent
Withdrawing Member State	Conciliatory	1, -1	0, 0
	Intransigent	2, -2	-3, -3

But, one victory does not guarantee another

While the prospect of the referendum shaped decisively the outcome of the negotiations, the outcome of the referendum itself is unpredictable. It can be influenced by many factors which are outside the control of the UK government. And it is rather obvious that for certain elements in the Conservative party and in the British society, nothing short of outright exit would be acceptable. In this sense, Mr Cameron must have hoped that with the referendum, he could kill two birds with one stone. It could help him secure a good enough deal in Brussels which he could then use to persuade a large enough proportion of the British people to back him against the opponents of continued membership in the EU. But calling a referendum is always a high-risk strategy. Will it be worth it? This is the issue we examine in the concluding section below.

Conclusions: The likely consequences

If the outcome of the referendum is in support of the agreement achieved in Brussels, certainly the whole process will have been to the advantage of the UK. Although it will not stop internecine divisions within the Conservative party, it will settle the "EU question" for at least a generation. British industry will continue to reap the benefits of access to the internal market and the City of London will not have to be afraid of covert discrimination.

But with a few exceptions, the provisions of the Decision are modest and not specific enough. This has already been seized upon by the proponents of exit to argue that Mr Cameron failed to return with the text of a "fundamental reform". In this sense, Mr Cameron committed a strategic mistake. He set the bar too high. Falling short of it was unavoidable.

In the short-term, the worst outcome is a rejection of the agreement and a vote for exit at the forthcoming referendum. The UK will then have to formally trigger the withdrawal procedure under Article 50 of the Treaty on the European Union. That would indeed be a leap into the unknown in pursuit of the "illusion of sovereignty", as Mr Cameron

characterised a negative vote when he defended the agreement before Parliament on 22 February 2016.

In the long term, the EU without the UK will be poorer and less dynamic. Most credible studies indicate that both sides will lose out.⁶

But even if the UK remains a member, the EU has already been damaged. Resentment against the UK is rising. It remains to be seen how willing other Member States will be to agree to emergency brakes and safeguard action. Also, there bound to be politicians who will aspire to seek similar or other concessions and special deals. They will think "if them, why not us"?

Because many have lamented the loss of the aspiration to an "ever closer union", one may legitimately ask what is wrong with proceeding on a more pragmatic basis that ensures that everybody gains, rather than pursuing an idealistic, divisive and rather vacuous goal. Most economists appreciate the power of the Pareto principle according to which a policy change is welcome only when at least one person is better off without making anyone less worse off. The ever closer union is a motto that probably violates the Pareto principle. This is because, notwithstanding the principles of subsidiarity and proportionality, it is expressed unconditionally.

But economists also recognise that implementing policies according to the Pareto principle is a vote for the status quo. If no one is to be made worse off, then it is as if everybody has the right of veto. Seeking consensus before doing anything is a recipe for inaction. Hence, modern public policy-making is predicated on the assumption that a good policy is one that increases collective benefits so that those who gain can in principle compensate those who lose out. In practice this means that no one gains at all times but most people gain from most policies in the long run.

Mr Cameron missed a great opportunity. Instead of demanding that the UK be left out of the ever closer union, he should have asked for a revision that would have made

⁶ See for example: Dhingra, Ottaviano & Sampson (2015). *Should We Stay or Should We Go? The economic consequences of leaving the EU*; Aichele & Felbermayr (2015). *Costs and benefits of a United Kingdom exit from the European Union*.

sense to both the UK and the rest of the EU. He should have asked for "an ever closer union in the common European interest". This would have meant an end to integration for the sake of integration. In fact, it reflects the reality of the European project. At any particular point in time, some countries gain while others lose out, not necessarily to the same extent. But in the longer term, everybody is better off.

Will the Decision make most of us better-off in the longer term? Is the Decision in the "common European interest"? This is the benchmark against which it should be judged. We think that the provisions on competitiveness and the safeguards on movement of people are in the common interest, those on economic governance are neutral while those on sovereignty are more likely to do harm than good.

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