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The New Deal with the United Kingdom: the Downside of Flexibility

Phedon Nicolaides, Roxana Nedelescu,
Joanna Hornik, Gibran Watfe



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About the authors:

Phedon Nicolaides is Director and Jan Tinbergen Chair in the Department of European Economic Studies at the College of Europe in Bruges, where he teaches several courses. He is also a Professor at Maastricht University and Academic Director of Lexxion Publishing. Professor Nicolaides has published extensively on European integration, competition policy and state aid, and policy implementation. He is on the editorial boards of several journals.

Roxana Nedelescu is a Senior Academic Assistant in the Economics Department at the College of Europe, Bruges. She holds a PhD in Economics and Finance of Public Administration from Catholic University of Sacred Heart in Milan, a MA in Management and Communication from the National School of Political and Administrative Studies in Bucharest and a BA in Economics of European Integration from Romanian-American University. Her research interests cover EU economic governance and decision-making process, public economics, labour market and applied econometrics.

Joanna Hornik is an Academic Assistant for the European Law and Economic Analysis (ELEA) and European Public Policy Analysis (EPPA) options at the Bruges campus of the College of Europe. She has an MA in European Economic Studies (ELEA) from the College of Europe and a BA in Economics, Political Science and International Relations from University College Roosevelt (NL). Her fields of interest include EU competition law and policy, intellectual property rights, analysis of European public policy, and EU politics and institutions.

Gibran Watfe is an Academic Assistant in the Economics Department at the College of Europe, Bruges. He holds an MA in European Economic Studies from the College of Europe and an MSc in Economics from Humboldt University. Gibran has previously founded *rethink finance*, a financial services start-up company and has worked as teaching assistant at Maastricht University's School of Business and Economics. His research interests include monetary economics, financial markets and applied econometrics.

Addresses for Correspondence:

Prof. Phedon Nicolaides: phedon.nicolaides@coleurope.eu

Dr. Roxana Nedelescu: roxana.nedelescu@coleurope.eu

Ms. Joanna Hornik: joanna.hornik@coleurope.eu

Mr. Gibran Watfe: gibran.watfe@coleurope.eu

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Abstract

This paper examines the proposals listed by the President of the European Council, Donald Tusk, in response to the letter sent by the British Prime Minister, David Cameron, asking for a fresh settlement concerning the United Kingdom's relationship with the European Union. The paper reviews the nature and possible consequences of the "substantial changes" that were demanded in the areas of economic governance, competitiveness, sovereignty, and immigration.

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

JEL-Codes: O11, F02, E61, H50.

Introduction

In June 2016, the United Kingdom will hold a referendum to “settle” the issue of its membership of the European Union for the “next generation”. It is not unusual for Member States to put to plebiscite important developments in their relations with the Union, as for example, in Denmark in 1992 and 1993, France and the Netherlands in 2005 and Ireland in 2008 and 2009.

The British people will be asked whether they agree or not with the new arrangements that still have to be negotiated with the Union and the other Member States. On 10 November 2015, the British Prime Minister, David Cameron, sent a [letter to the President of the European Council, Donald Tusk](#), outlining the issues where the UK wanted reforms in order to “address the concerns of the British people”. His proposals for reform were grouped in four categories: Economic governance, competitiveness, sovereignty and immigration. Mr Cameron then embarked on a tour of European capitals to drum up support for his ideas and demands.

On 2 February 2015, after multiple meetings, Mr Tusk submitted a [draft Decision](#) for the Heads of State or Government to be approved at a meeting on 18 February 2016. A [revised version](#) of the draft Decision was circulated on 11 February 2016. Mr Cameron was reported to be very much in favour of the draft Decision. To reach an agreement in the space of barely two and half months is a remarkable feat.

The structure of the draft Decision mirrors the categories of reform outlined in Mr Cameron’s letter. Apart from a preamble and a concluding section on application and final provisions, the draft Decision is also divided in sections entitled economic governance, competitiveness, and sovereignty. But perhaps tellingly, the penultimate section is entitled “social benefits and free movement”, instead of “immigration”.

If the draft Decision is adopted by the European Council, it will not only signify a success for Mr Cameron, but also have substantial repercussions for the rest of the Union. One thing is clear: not only will it reshape the relations between the UK

and the EU, but it will also change how the EU operates, not necessarily for the better.

In this short paper, we review the proposals tabled by Mr Tusk, identify the issues that are likely to be contentious and consider their impact. In his November letter, Mr Cameron wrote that "our concerns really boil down to one word: flexibility" and he hoped that "reforms would provide a fresh and lasting settlement for our membership of the European Union". The questions now are what is the likely cost of that flexibility and how will it affect the membership of other countries.

Preamble: Membership is not a uniform straitjacket

The preamble explains that Member States have considerable leeway with respect to how extensively they are involved in defence matters, common border controls and fighting crime. More broadly, the procedure of "enhanced cooperation" does allow like-minded Member States to deepen their links without obliging all others to join them.

The preamble also makes it clear that in fact the UK already has a "flexible" and, in some respects, privileged membership. Several recitals summarise exceptions enjoyed by the UK:

- No obligation to adopt the euro [Protocol 15];
- Opt-out from the Schengen acquis [Protocols 19 & 20];
- Choice of whether to adopt measures in the area of freedom, security and justice [Protocol 21];
- Exception from the jurisdiction of the European Court of Justice with respect to fundamental rights [Protocol 30];
- Choice of whether to apply measures in the area of police and judicial cooperation [Protocol 36].

Economic governance: Warm but fuzzy words

The first part of this section focuses on "respect". It stresses that Eurozone countries will "respect" the rights of non-participating countries, while the latter will not create obstacles to deeper integration in the Eurozone. Then the draft Decision goes on to refer to "mutual respect" and to "respect" for the internal market and economic and social cohesion as well as the prohibition of discrimination.

Hardly anyone can object to the requests for the respect of rights and of the internal market. Perhaps the draft Decision recalls the fundamental principle of non-discrimination because recently the European Court of Justice concluded that the ECB had exceeded its powers when it required counter-party clearing houses to be located in the Eurozone.¹ The UK claimed that that amounted to discrimination on the grounds of location. The Court of Justice did not get to adjudicate on this point but the ECB would have had a hard time demonstrating that it was not possible to find a less restrictive means of exercising its supervisory powers and that it was absolutely necessary for counter-party clearing houses to be located within the Eurozone.

The unprecedented introduction of capital controls in Cyprus in 2013 and in Greece in 2015 impacted to varying degrees all Member States. From the British perspective, a crisis within the Eurozone was partly contained with an instrument that impeded capital movement between those two countries and the rest of the single market.

An addition contained in the revised draft Decision differentiates between Member States with a permanent opt-out from the Economic and Monetary Union and those that are supposed to adopt the euro as soon as they fulfil the required conditions. The emphasis on the latter's commitment "under the Treaties to make progress towards fulfilling the conditions" for joining the Eurozone stems from the worry of some Member States that eurosceptic governments could claim that they no longer have the legal obligation to join the bloc.

¹ UK v ECB, Case T-496/11.

The draft Decision also mentions that "any difference in treatment must be based on objective reasons". Internal market rules do allow restrictions on free movement when they are objectively justified. For example, a product that harms human health is objectively different from other innocuous products and therefore its trade may be restricted. It is not clear how objective differentiation is understood in the context of the draft Decision.

The second part states that EU law, including its application by the European Central Bank and the Single Resolution Board, is to be conceived "in a more uniform manner" than corresponding rules applied by national authorities of non-Eurozone countries. For this purpose, changes of the single rulebook "may be necessary". This rather vague wording does not hide the intention of the EU to limit the regulatory freedom of the UK in the field of financial services. Possible changes of the single rulebook are mentioned in order to maintain enough legal space for a future deepening of Eurozone integration.

It is conceivable that the UK is concerned about moves by the ECB to establish the Single Supervisory Mechanism as the common oversight framework also for securities markets in the Eurozone. During the negotiations on the structure of the banking union, the UK secured a special double-majority voting procedure within the European Banking Authority. A simple majority of non-Eurozone countries can stall decision-making within the EBA. A demand for extension of this double-majority rule to European Securities Markets Authority and the European Insurance and Occupational Pensions Authority may surface after a deal in the European Council.

Part three requires that the costs of any crisis measures to safeguard the euro will not be borne by countries outside the Eurozone. This is at first glance quite fair. However, given the rather high degree of integration of both the financial sector and the real economy across the EU, any measure that supports the euro and resolves crises eventually benefits all Member States, not just the Eurozone countries. Some burden sharing is, therefore, not unreasonable.

It is also important to note that arrangements that address this concern have already been found. 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-Eurozone countries. The Declaration was followed by appropriate adjustments of the relevant legal instruments.

Part four specifies that the supervision and resolution of banks in the non-Eurozone countries is a matter for those countries. Well, this is not correct. The single rulebook developed by the European Banking Authority applies to all Member States. So does the Banking Recovery and Resolution Directive. Moreover, all cases of restructuring and resolution of banks are subject to State aid rules which are common to all Member States. Indeed, immediately afterwards in the draft Decision it is recognised that the autonomy of non-Eurozone countries is "without prejudice" to Union mechanisms on oversight and stability.

Part five asks the Eurogroup – the gathering of Eurozone ministers of finance – to respect the powers of the Council. Here the draft 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-Eurozone Member States powerless in influencing future financial rules. Understandably, the UK does want to have a say in financial services regulation, given that the City is an important sector of the UK economy.

Part six refers to the right of any Member State to have issues covered by the draft Decision discussed within the European Council. This section is a watered down version of the demand of the UK for a right of appeal against Eurozone-specific legislation. Still, this could lead to a slowing down of the legislative process, even though Part six explicitly refers to the need that the "urgency of the matter" be taken into account.

At the end of this section, a bracketed sentence states that "the substance of this Section will be incorporated into the Treaties at the time of their next revision". The fact that it is bracketed indicates that views are divided as to whether the reforms can be implemented and secured without Treaty revision.

This section supposedly addresses one of Mr Cameron's strongest demands: that integration in the Eurozone should not disadvantage the UK and other non-Eurozone countries. Yet, apart from conceding that rules in the Eurozone should be conceived in a more uniform manner, it says nothing else than what already emanates from the general principles of EU law.

This is a greatly missed opportunity because this section should have made a crucial distinction between discrimination against non-Eurozone countries [which should be prohibited] and the disadvantage of non-Eurozone countries from keeping their own currency and rules [which is an inevitable consequence of further integration of the Eurozone]. For example, the establishment of the ECB as the single supervisory authority in the Eurozone is intended to improve the effectiveness of regulation of banks with cross-border operations. As such, it may strengthen the stability of the Eurozone financial system and consequently make it more attractive to foreign banks. The establishment of the Single Resolution Board may make resolution of banks with international operations more predictable because just one authority will be responsible. At the same time, the Single Resolution Fund will be larger than national resolution funds and, if bank failure in different countries is not correlated, the SRF's larger size may enable it to withstand more failures. This in itself will make the Eurozone a safer place for investment. All these changes may disadvantage the UK by tilting the competitive field in favour of the Eurozone without, however, overtly or covertly discriminating against UK banks.

It is also possible, however, that certain changes in the Eurozone may prove to be to the advantage of the UK. For example, resolution of banks in the Eurozone will be institutionally and procedurally more complex. Decisions will have to be taken by the SRB together with national authorities and approved by the Commission. By contrast, resolution in non-Eurozone countries will be simpler because any national authority will have to obtain the approval only of the Commission and not of other

national authorities or a supranational body, such as the SRB. In general, integration in the Eurozone has created new layers of bureaucracy which have an impact on operational efficiency.

The UK will unavoidably be affected by and may also benefit from deeper integration in the Eurozone by virtue of its extensive ties to the Eurozone economies. But it is impossible and rather nonsensical for any country to seek to reap the benefits of integration without accepting also the possibility that there may be disadvantageous developments which are not caused by discrimination.

Competitiveness: Nothing new

This section is the least imaginative. It demands that "the EU must enhance competitiveness". EU institutions and Member States are exhorted 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".

Nonetheless, this wording clarifies the importance of the single market for all of the EU. It may help the UK government to gain support back home for the eventual outcome of the negotiations. Certainly, no Treaty changes are needed to achieve these objectives which have been repeated in numerous European Council conclusions.

Sovereignty: Less flexibility in the name of democracy

The first part of this section offers an extensive interpretation of the objective of "ever closer union" that appears in the preamble and Article 1 of the Treaty on the European Union. According to the draft Decision, this objective does not imply further political integration but rather better trust and understanding among the peoples of Europe. As the draft Decision points out, further integration is neither automatic, nor unavoidable. At any rate, any extension of the competences of the EU must follow established procedures and is tempered by the principles of conferral,

subsidiarity, and proportionality. The draft Decision recognizes that the UK "is not committed to further political integration". The commitment to include a corresponding provision in the Treaties remains in square brackets, meaning that the "formal, legally-binding and irreversible" change requested by Mr Cameron will not be achieved any time soon. But it may simply not be necessary as the Treaties in their current form already provide sufficient flexibility.

Part two states that "reasoned opinions" issued by national Parliaments in accordance with Article 7(1) of Protocol 2 on the application of the principles of subsidiarity and proportionality should be "duly taken into account" by EU institutions and that "appropriate arrangements" will be made to that effect. No more specific mention is made regarding the nature of those arrangements. It should be recalled that Article 7(1) already requires that the opinions of national Parliaments are taken into account, so the proposal simply reiterates the status quo.

Part three directly responds to Mr Cameron's demand for more power of national parliaments by strengthening the procedure laid down in Article 7(3) of Protocol 2. The British prime minister has repeatedly expressed his dissatisfaction with the existing "yellow" and "orange" card procedures established by Article 7(2 & 3).² When at least a third or a half of national parliaments object to a legislative proposal, Article 7(2 & 3) imposes an obligation on the decision-making institutions to "maintain, amend or withdraw" legislative proposals. In case they are maintained, they have to be justified.

According to the draft Decision, 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. Such a real "red card" mechanism arguably

² The "yellow card" and "orange card" procedures constitute a part of the Subsidiarity Control Mechanism introduced by the Lisbon Treaty. The different mechanisms define the formal effects of reasoned opinions issued by national Parliaments on the legislative procedure. According to Protocol 2, each Member State has two votes. The "yellow card" procedure is triggered by a reasoned decision supported by at least one third (or one fourth in the area of freedom, security and justice) of the votes. The "orange card" procedure requires a simple majority of the votes if the draft is submitted under the ordinary legislative procedure.

offers more time to gather the necessary support and improves the current system of eight weeks which makes it virtually impossible for national parliaments to act within the short time frame.

While the new mechanism may be more useful to national parliaments, its overall effectiveness as a means of strengthening democratic legitimacy is doubtful. The proposal appears at first glance to make the EU more responsive to the views of the people as expressed through their elected representatives. When more than half of national parliaments raise objections, one cannot but accept that they do reflect the will of the majority. However, it is more likely that the new procedure will only add to the maze of mechanisms that are already in place but rarely used³, having a potentially negative impact on the speed and efficiency of EU decision-making. How such an arrangement would introduce more "flexibility" is difficult to fathom.

The fact that the existing "yellow" and "orange" card arrangements are rarely invoked suggests that a new arrangement may in fact be unnecessary. Out of the 28 Member States, 27 have political systems whereby the government is formed by the party or coalition that commands majority in parliament. It is unlikely that the majority of these governments would support a legislative proposal in the Council while a majority of the parties or coalitions they represent would oppose it in national parliaments.

Parts four and five restate well-known principles that protocols are an integral part of the Treaties and that national security is the sole responsibility of Member States.

Social benefits and free movement: Safeguards for all?

This section first reminds us that free movement of workers is a fundamental feature of the internal market. It explains that workers move precisely because levels of remuneration differ between Member States. Indeed, labour movement that reduces

³ So far, the "yellow card" procedure has been initiated in two cases: in relation to the proposed Council Regulation on the exercise of the right to take collective action within the context of the freedom of establishment and the freedom to provide services (2012); and in relation to the Council Regulation on the European Public Prosecutor's office (2013). No "orange card" procedures have been triggered.

wage differentials is a natural consequence of the 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 draft Decision goes on to state that differences in the social security systems of the Member States may induce labour movement which is not "a natural consequence of a well-functioning market". However, the extent to which people move in order to exploit social security differences is an empirical issue. Even if it happens, there is no clear evidence that it is substantial.

But the draft 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 avoiding or 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." This favours measures that can be applied to all Member States, not just the UK.

Then 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 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 Justice 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 EU legislation with respect to i) the exportation and indexing of child benefits, ii) the establishment of an "alert and safeguard mechanism" in case of inflows of "exceptional magnitude" over an "extended period" of time. Member States will have to notify the Commission and the Council that an "exceptional situation" exists and that it leads to "serious" difficulties or to "excessive

pressure" on their public services. Then the Council may authorise Member States to restrict access to welfare benefits to the "extent necessary" and to limit the access of new workers for a period of up to four years, with one or two extensions.

These proposals 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 proposals are heavily qualified. Safeguards will become operational only in exceptional situations and will be only temporary.

While indexing child benefits in accordance with the country of residence of the child is a reasonable proposal that gives fewer incentives to parents to leave children behind, restricting in-work benefits will create a differential treatment between nationals and non-nationals. So far, EU legislation and the 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. 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 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 those workers that the UK wishes to attract.

Even if Member States would agree to these proposals, the new safeguard mechanisms will apply only to new arrivals. Existing migrant workers from other Member States will not be affected. It remains to be seen whether this is acceptable to the UK.

The application of the safeguards will not be automatic. The Commission and the Council will have to interpret what "exceptional", "extended period", "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, the problem will not be truly solved even if Member States agree to the ideas which are outlined in the draft Decision.

Conclusion

The draft Decision has already performed a useful function by showing that much of what the UK has asked for already exists in one form or another. However, the inter-governmental method that mobilised all EU Member States in order to negotiate particular concerns of the UK also shows the strength and influence of the UK within the EU.

Additional measures, procedures, and safeguards will not necessarily improve the functioning of the European Union. Ironically, there is a significant risk that they will make it less flexible. Safeguards will not apply automatically, even if they can be invoked by any Member State. Agreeing to implement them will also be highly contentious.

Will failure of the UK to secure these changes in the forthcoming negotiations be worth leaving the EU? One only hopes that UK voters will conclude that the answer is no. However, it will not be surprising if they still vote in favour of exit from the EU, simply because they perceive a "fresh settlement" as a sham.