Brexit: Roads without exits?

By [Catherine Mathieu](#)and [Henri Sterdyniak](#)

The result of the referendum of 23 June 2016 in favour of leaving the European Union has led to a period of great economic and political uncertainty in the United Kingdom. It is also raising sensitive issues for the EU: for the first time, a country has chosen to leave the Union. At a time when populist parties are gaining momentum in several European countries, Euroscepticism is rising in others (Poland, Hungary, Czech Republic, Slovenia, Slovakia), and the migrant crisis is dividing the Member States, the EU-27 must negotiate Britain's departure with the aim of not offering an attractive alternative to opponents of European integration. There can be no satisfactory end to the UK-EU negotiations, since the EU's goal cannot be an agreement that is favourable to the UK, but, on the contrary, to make an example, to show that leaving the EU has a substantial economic cost but no significant financial gain, that it does not give room for developing an alternative economic strategy.

According to the current timetable, the UK will exit the EU on 29 March 2019, two years after the official UK government announcement on 29 March 2017 of its departure from the EU. Negotiations with the EU officially started in April 2017.

So far, under the auspices of the European Commission and its chief negotiator, Michel Barnier, the EU-27 has maintained a firm and united position. This position has hardly given rise to democratic debates, either at the national level or European level. The partisans of more conciliatory approaches have not expressed themselves in the European Council or in Parliament for fear of being accused of breaking European unity.

The EU-27 are refusing to question, in any respect, the way

that the EU is functioning to reach an agreement with the UK; they consider that the four freedoms of movement (goods, services, capital and persons) are inseparable; they are refusing to call into question the role of the European Court of Justice as the supreme tribunal; they are rejecting any effort by the UK to "cherry pick", to choose the European programmes in which it will participate. At the same time, the EU-27 countries are seizing the opportunity to question the status of the City, Northern Ireland (for the Republic of Ireland) and Gibraltar (for Spain).

Difficult negotiations

On 29 April 2017, the European Council adopted its negotiating positions and appointed Michel Barnier as chief negotiator. The British wanted to negotiate as a matter of priority the future partnership between the EU and the UK, but the EU-27 insisted that negotiations should focus first and foremost on three points: the rights of citizens, the financial settlement for the separation, and the border between Ireland and Northern Ireland. The EU-27 has taken a hard line on each of these three points, and has refused to discuss the future partnership before these are settled, banning any bilateral discussions (between the UK and a member country) and any pre-negotiation between the UK and a third country on their future trade relations.

On 8 December 2017, an agreement was finally reached between the United Kingdom and the European Commission on the three initial points[1]; this agreement was ratified at the European Council meeting of 14-15 December[2]. However, strong ambiguities persist, especially on the question of Ireland.

The European Council accepted the British request for a transitional period, with this to end on 31 December 2020 (so as to coincide with the end of the current EU budgeting). Thus, from March 2019 to the end of 2020, the UK will have to respect all the obligations of the single market (including

the four freedoms and the competence of the CJEU), even though it no longer has a voice in Brussels.

The EU-27 agreed to open negotiations on the transition period and the future partnership. These negotiations were to culminate at the European summit in October 2018 in an agreement setting out the conditions for withdrawal and the rules for the transition period while outlining in a political statement the future treaty determining the relations between the United Kingdom and the EU-27, so that the European and British authorities have time to examine and approve them before 30 March 2019.

However, both the EU-27 and the UK have proclaimed that “there is no agreement on anything until there is an agreement on everything”, meaning that the agreements on the three points as well as on the transition period are subject to agreement on the future partnership.

Negotiations for the British side

The members of the government formed by Theresa May in July 2016 were divided on the terms for Brexit from the outset: on one side were supporters of a hard Brexit, including Boris Johnson, who was then in charge of foreign affairs, and David Davis, then tasked to negotiate the UK’s departure from the EU; on the other side were members who favoured a compromise to limit Brexit’s impact on the British economy, including Philip Hammond, Chancellor of the Exchequer. The proponents of a hard Brexit had argued during the campaign that leaving the EU would mean no more financial contributions to the EU, so the savings could be put to “better use” financing the UK health system; that the United Kingdom could turn to the outside world and freely sign trade agreements with non-EU countries, which would be beneficial for the UK economy; and that getting out of the shackles of European regulations would boost the economy. The hard Brexiteers argue against giving in to the EU-27’s demands, even at the risk of leaving without an

agreement. The goal is to get free of Europe's constraints and "regain control". For those in favour of a compromise with the EU, it is essential to avoid a no-deal Brexit – "going over the cliff" would be detrimental to British business and jobs. In recent months, it has been this camp that has gradually strengthened its positions within the government, leading Theresa May to ask the EU-27 for a transitional period during her Florence speech of September 2017, which also responded to the demands of British business representatives (including the Confederation of British Industrialists, the CBI). On 6 July 2018, Theresa May held a government meeting in the Prime Minister's Chequers residence to agree on British proposals on the future relationship between the United Kingdom and the European Union. The concessions made in recent months by the British government together with the Chequers proposals led David Davis and Boris Johnson to resign from the Cabinet on 8 July 2018.

On 12 July 2018, the British government published a White Paper on the future partnership[3]. It proposes a "principled and practical Brexit"[4]. This must "respect the result of the 2016 referendum and the decision of the UK public to take back control of the UK's laws, borders and money". It is about building a new relationship between the UK and the EU, "broader in scope" than the current relationship between the EU and any third country, taking into account the "deep history and close ties".

The White Paper has four chapters: economic partnership, security partnership, cross-cutting and other cooperation, and institutional arrangements. As far as the economic partnership is concerned, the agreement must allow for a "broad and deep economic relationship with the rest of the EU". The United Kingdom proposes the establishment of a free trade area for goods. This would allow British and European companies to maintain production chains and avoid border and customs controls. This free trade area would "meet the commitment" of

maintaining the absence of a border between Northern Ireland and the Republic of Ireland. The UK would align with the relevant EU rules to allow friction-free trade at the border; it would participate in the European agencies for chemicals, aviation safety and medicines. The White Paper proposes applying EU customs rules to the imports of goods arriving in the UK on behalf of the EU and collecting VAT on these goods also on its behalf.

For services, the UK would regain its regulatory freedom, agreeing to forego the European passport for financial services, while referring to provisions for the mutual recognition of regulations, which would preserve the benefits of integrated markets. It wishes to maintain cooperation in the fields of energy and transport. In return, the UK is committed to maintaining cooperative provisions on competition regulation, labour law and the environment. Freedom of movement would be maintained for citizens of the EU and the UK.

The security partnership would include the maintenance of cooperation on police and legal matters, the UK's participation in Europol and Eurojust, and coordination on foreign policy, defence, and the fight against terrorism.

The White Paper proposes close cooperation on the circulation and protection of personal data as well as agreements for scientific cooperation in the fields of innovation, culture, education, development, international action, and R&D in the defence and aerospace sector. The UK wishes to continue to participate in European programmes on scientific cooperation, with a corresponding financial contribution. Finally, the United Kingdom would no longer participate in the common fisheries policy, but proposes negotiations on the subject.

In institutional matters, the UK proposes an Association Agreement, with regular dialogue between EU and UK Ministers, in a Joint Committee. The UK would recognize the exclusive

jurisdiction of the CJEU to interpret EU rules, but disputes between the UK and the EU would be settled by the Joint Committee or by independent arbitration.

Up to now Theresa May has tried to assuage both the hard Brexiteers – the UK will indeed leave the EU – and supporters of a flexible Brexit – the UK wants a deep and special partnership with the EU. Theresa May regularly repeats that the UK is leaving the EU but not Europe, but her compromise position is not satisfying supporters of a net Brexit. In September 2018, Boris Johnson has been accusing Theresa May of capitulating to the EU: "At every stage in the talks so far, Brussels gets what Brussels wants…. We have wrapped a suicide vest around the British Constitution – and handed the detonator to Michel Barnier. We have given him a jemmy with which Brussels can choose – at any time – to crack apart the union between Great Britain and Northern Ireland"[5]. According to Johnson, the Chequers plan loses all the benefits of Brexit. The Remainers, those in favour of staying in the EU, are campaigning for a new referendum. This is nevertheless unlikely. Theresa May rejects it out of hand as a "betrayal of democracy".

The Conservative Party's annual convention, to be held from September 30 to October 3, could see Boris Johnson or Jacob Rees-Mogg[6] run for head of the Party. They do not have majority support, however, and the polls show Theresa May with greater popularity than her challengers. Barring a dramatic twist, Theresa May will continue to lead the Brexit negotiations in the coming months.

The British Parliament decided last December 13 that it will have a vote on any agreement with the European Union. So Theresa May must also find a parliamentary majority concerning the UK's orderly withdrawal, in the face of opposition from both Remainers and hard Brexiteers, which will require the support of some Labour MPs and will therefore be difficult.

The proposals of the July White Paper were not deemed acceptable by Michel Barnier. In August, Jeremy Hunt, the UK's new Foreign Minister, estimated the risks of a lack of agreement at 60%. On 23 August 2018, the government published 25 technical notes (out of 80 planned) that spell out the government's measures to be taken in case of a no-deal exit in March 2019. Their objective is to reassure businesses and households about the risks of shortages of imported products, including certain food products and medicines. At the time these notes were published, Dominic Raab, the new Minister in charge of the Brexit negotiations, took care to recall that the government does want an agreement be signed and that the negotiators agree on 80% of the provisions of the withdrawal agreement.

If the EU-27 remains inflexible, the British government will face a choice between leaving without an agreement, which the "hard" Brexiteers are ready to do, and making further concessions. Philip Hammond recalled the risks of failing to reach an agreement. But Theresa May is sticking to her line that the lack of an agreement would be preferable to a bad deal. On 28 August, she echoed the words of WTO Director-General Roberto Azevedo, that leaving without an agreement would not be "the end of the world", but nor would it be "a walk in the park". In an opinion column in the *Sunday Telegraph* of 1 September 2018, she reaffirmed her desire to build a United Kingdom that is stronger, more daring, based on meritocracy, and adapted to the future, outside the EU.

The negotiations from the EU viewpoint

The EU-27 is refusing that the UK could stay in the single market and the customs union while choosing which rules it wants to apply. It does not want the UK to benefit from more favourable rules than other third countries, in particular the current members of the European Economic Area (the EEA: Norway, Iceland, Liechtenstein) or Switzerland. EEA members currently have to integrate all the single market legislation

(in particular the free movement of persons) and contribute to the European budget. They benefit from the European passport for financial institutions, while Switzerland does not.

In December 2017, Michel Barnier made it clear that lessons had to be drawn from the United Kingdom's refusal to respect the four freedoms, its regaining of its commercial sovereignty, and its termination of its recognition of the authority of the European Court of Justice. This rules out any possibility of its participation in the single market and the customs union. The agreement with the UK will be a free trade agreement, along the lines of the agreements signed with Canada (the CETA), South Korea and more recently Japan. It will not concern financial services.

During the 2018 negotiations, the EU-27 was not particularly conciliatory about a series of issues: the UK's obligation to apply all EU rules and the guarantee of the freedom of establishment of people until the end of the transitional period; the Irish border (arguing that the absence of physical borders was not compatible with the UK's withdrawal from the customs union, demanding that Northern Ireland remain in the single market as long as the UK does not come up with a solution guaranteeing the integrity of the internal market without a physical border with Ireland); the role of the CJEU (which must have jurisdiction to interpret the withdrawal agreement); the EU's decision-making autonomy (refusing the establishment of permanent joint decision-making bodies with the UK); and even Gibraltar and the British military bases in Cyprus.

Thus, on 2 July 2018, Michel Barnier[7] accepted the principle of an ambitious partnership, but refused any land border between the two parts of Ireland, while indicating that a land border is necessary to protect the EU (this would mean that the only acceptable deal would involve a border crossing between Northern Ireland and the rest of the UK, which is unacceptable to the UK). He refused that the EU "loses control

of its borders and its laws”. Barnier therefore rejected the idea that the UK would be responsible for enforcing European customs rules and collecting VAT for the EU. He insisted that future cooperation with the UK could not rely on the same degree of trust as between EU member countries. He called for precise and controllable commitments from the United Kingdom, particularly with respect to health standards and the protection of Geographical indications. He wanted the agreement to be limited to a free trade agreement, with UK guarantees on regulations and state subsidies, and with cooperation on customs and regulations.

The UK would have to renegotiate all trade agreements, both with the EU and with third countries. These agreements will probably take a long time to set up, and in any case more than two years. The lack of preparation and the disorganization with which the UK has tackled the Brexit negotiations augurs poorly for its ability to negotiate such agreements quickly. The matter of re-establishing customs controls is crucial and delicate, whether in Ireland, Gibraltar or Calais. Many multinational corporations will relocate their factories and headquarters to continental Europe. The loss of the financial passport is a given. It is on this point that the British could see further losses, given the weight of the City’s business (7.5% of British GDP). The United Kingdom will have to choose between abiding by European rules to maintain some access to European markets and entering into confrontation by a policy of liberalization. The EU-27 could seize the opportunity of the UK’s departure to return to a Rhine-based financial model, centred on banks and credit rather than on markets or, on the contrary, it could try to supplant the City’s market activities through liberalization measures. It is the second branch of these alternative that will prevail.

Choosing between three strategies

So far, the EU-27 countries have taken a position that is tough but easy to hold: since it is the UK that has chosen to

leave the Union, it is up to it to make acceptable proposals for the EU-27, with regard both to its withdrawal and to subsequent relations. This is the approach that led to the current stagnant situation. The EU-27 now has to choose between three strategies:

– Not to make proposals acceptable to the British and resign themselves to a no-deal Brexit: relations between the UK and the EU-27 would be managed according to WTO principles; and the financial terms of the divorce would be decided legally. The United Kingdom would regain full sovereignty. There are two reasons to fear this scenario: trade would be disrupted by the re-erection of customs barriers in ports and in Ireland; and this "hard Brexit" would encourage the UK to become a tax and regulatory haven, meaning that the EU would be faced with the alternative either of following along or retaliating, both of which would be destructive;

– Face the issue head on and establish a third circle for countries that want to participate in a customs union with the EU countries in the short term, i.e. the United Kingdom and the EEA countries. It is within this framework that agreements on technical regulations and standards for goods and services would be negotiated. Thus, "freedom of trade" issue would be dissociated from issues of political sovereignty. However, this poses two problems: these agreements would need to be negotiated in technical committees where public opinion and national parliaments such as the European Parliament would have little voice. The fields of the customs union are problematic, in particular for fiscal matters, financial regulations, and the freedom of movement of persons and services;

– Choose the "special and deep partnership" solution, which would entail reciprocal concessions. This would necessarily be able to serve as a model for relations between the EU and other countries. It would include a customs union limited to goods, committees for harmonizing standards, piecemeal

agreements for services, the right of the UK to limit the movement of persons, undoubtedly a court of arbitration (which would limit the powers of the CJEU), and a commitment to avoid fiscal and regulatory competition. As is clear, this would satisfy neither supporters of a hard Brexit nor supporters of an autonomous and integrated European Union.

[1] See: *Joint report from the negotiators of the EU and the UK government on progress during phase 1 of negotiations under Article 50 on the UK's orderly withdrawal from the EU*, 8 December 2017.

[2] See Catherine Mathieu and Henri Sterdyniak: Brexit, réussir sa sortie, *Blog de l'OFCE*, 6 December 2017.

[3] HM Government: "The future relationship between the United Kingdom and the European Union", July 2018.

[4] The expression is in the original text: "A principled and practical Brexit". Translations of the summary note in the 25 languages of the EU are available on the web site of the Department for Exiting the European Union. The French version uses the term: "Brexit vertueux et pratique".

[5] Opinion column by Boris Johnson, *Mail on Sunday*, 9 September 2018.

[6] Favourable to a hard Brexit – from Eton-Oxford, a traditionalist Catholic who is opposed to abortion, public spending and the fight against climate change.

[7] See Un partenariat ambitieux avec le Royaume-Uni après le Brexit , 2 July 2018.

Brexit: Pulling off a success?

By Catherine Mathieu and Henri Sterdyniak

Will the EU summit of 14-15 December 2017 usher in a new phase of negotiations on the exit of the United Kingdom from the European Union?

British Prime Minister Theresa May wants to make Brexit a success and to arrange a special partnership between the UK and the EU, a tailor-made partnership that would allow trade and finance to continue with minimal friction after the UK leaves the EU, while restoring the UK's national sovereignty, in particular by regaining the ability to limit the immigration of workers from the EU and by no longer being subject to the European Union Court of Justice (EUCJ). For the EU-27 countries, on the contrary, it must be made clear that leaving the EU incurs a significant economic cost, with no significant budgetary gain, that those who leave must continue to accept a major share of European rules and that they cannot claim the benefits of the single market without bearing the costs. Other Member States should not be tempted to follow the British example.

This post examines the negotiating positions of the EU-27 and the British government and the divisions in the UK in the run-up to the European summit. The negotiations, which have been going on for almost six months, are difficult and cover numerous issues: citizens' rights, financial regulations, the Irish border and the future partnership between the United Kingdom and the EU-27.

Will the EU summit of 14-15 December 2017 usher in a new phase

of negotiations on the United Kingdom's departure from the European Union? As we approach the summit, the stakes are high for the British. On 23 June 2016, a majority of the British people voted in favor of leaving the EU, but it was not until 29 March 2017 that Theresa May officially notified the British decision to leave by triggering Article 50 of the Treaty on the European Union. This article stipulates that, "A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union." The triggering of Article 50 opens a two-year period to negotiate the exit of the UK on 29 March 2019.

The negotiations have been going on for almost six months. They are difficult and cover numerous issues. This is the first time a country has asked to leave the EU, and neither the UK nor the EU-27 want to lose out. For the British government, the key goal is to establish a future commercial and financial partnership with the EU. Theresa May wants to make Brexit a success and to arrange a special partnership between the UK and the EU, a tailor-made agreement that would allow trade and finance to continue with minimal friction after leaving the EU, while restoring the UK's national sovereignty, in particular by regaining the ability to limit the immigration of workers from the EU and by no longer being subject to the EU Court of Justice. For the EU-27 countries, on the contrary, it must be shown that leaving the EU incurs a significant economic cost, with no significant budgetary gain, that those who leave must continue to accept a major share of European rules and that they cannot claim the benefits of the single market without bearing the costs. Other Member States should not be tempted to follow the British example.

The EU-27 position and the divisions in Britain

On 29 April 2017, the European Council set out its negotiating lines and appointed Michel Barnier chief negotiator on behalf of the EU. In the EU’s view the negotiations need to focus initially on an “orderly withdrawal”, i.e. exclusively on three points: the rights of European citizens in the UK; a financial settlement for the British departure; and the border separating the Republic of Ireland and Northern Ireland. The EU-27 has taken a tough stance on each of these three points and is refusing to discuss any future relationship between the EU and the UK before these are settled. It has banned any bilateral talks (between the UK and an EU member country) and blocked any pre-negotiations between the UK and a third country on their future trade relations. This has placed the United Kingdom in a difficult position, as companies (British and foreign) want to remove any uncertainties about UK-EU trade conditions after March 2019, and are threatening to cut their investments in the UK, or even to relocate within the EU-27, if this uncertainty is not removed.

The EU is in a strong position, since trade with the EU is five times larger for the UK than trade with the UK is for the EU. Moreover, the EU demonstrated its unity in the face of the British exit (as it did during the Greek crisis). In both cases, firm positions prevailed. More conciliatory lines did not come out in the European Council or in the European Parliament, as if the partisans of such positions were afraid to be accused of breaking Europe’s unity.

The British, in contrast, are split into four positions that divide the ranks of both Conservatives and Labour. Among the supporters of staying in the EU, the Remainers, some, like Tony Blair and Michael Heseltine, who are very much in the minority, still hope that, in the face of difficulties, the United Kingdom will give up on leaving the EU. Lord Kerr, who drafted Article 50, has pointed out that the decision to trigger the article is reversible. But it would be contrary to British democratic tradition not to respect the popular vote.

A new referendum could be organized, but in view of the polls there is no guarantee that a vote would have a different result today than it did on 23 June 2016.

For most Remainers, Brexit will indeed take place, and what is needed now is to minimize its economic cost. Some Remainers, especially in Labour, are currently advocating a “soft Brexit”, which would allow the UK to remain in the single market. But, given the conditions imposed by the EU-27 (respect for the “4 fundamental freedoms” – free movement of goods, services, capital and labor – and maintaining the CJEU’s authority), Brexit would then ultimately simply deprive the United Kingdom of having a voice in the decisions that it would have to implement. Proponents of a soft Brexit are also in favor of a transition period (provided for by the Treaty, subject to the unanimous agreement of the EU countries), which would postpone for two years the UK’s exit and avoid the risk of it leaving the EU on 29 March 2019 without a negotiated agreement.

The most ardent Brexiteers are willing to run the risk of a “hard Brexit”, i.e. leaving with no agreement with the EU. The UK would no longer have to contribute to the EU budget (about 0.5 GDP point per year in net terms), and it would have the status of a third country under WTO rules. The United Kingdom would then renegotiate trade agreements with all its partners, including the United States. Border controls would be reinstated. Proponents of a hard Brexit are not in favor of a transitional period, which they feel would only delay the moment when the United Kingdom “would regain control” and prevent it from negotiating agreements with non-EU countries. In the case of a hard Brexit, the risk is that the multinationals would relocate their factories and head offices to continental Europe, that in general it would become less attractive to invest in the United Kingdom and that a large part of the euro zone’s banking and financial activities would leave London for Paris, Frankfurt, Amsterdam or Dublin.

London could, however, play the card of tax competition (in particular by cutting the corporation tax rate) and become a regulatory paradise, especially in financial matters. However, it would be very difficult for the United Kingdom to free itself of international constraints (agreements such as COP21, on the fight against tax optimization, on the exchange of tax and banking information, or Basel III). The financial conditions for the UK's departure would be subject to a judicial settlement. For more ardent free marketeers, Brexit would help to strengthen the UK's laissez-faire model. However, it is unlikely that the United Kingdom, whose legislation is already very liberal, would enjoy a substantial growth shock induced by even more liberal reforms.

The British government is evolving an intermediate position. In 2016, when Theresa May was a minister in David Cameron's government, she called for voting to stay in the EU, but she is now aiming to make Brexit a success: the UK must become a champion of globalization ("A global Britain") and of free trade, in the British liberal tradition, which must turn its face towards the open sea. The country also has a trade surplus vis-à-vis its non-EU partners, primarily with the United States, and has maintained historical ties with the Commonwealth countries, while it has a large trade deficit with the EU countries (although it runs a surplus in services).

Theresa May has taken note of the EU-27 position that the UK will not be able to remain in the single market if it does not respect the four "fundamental freedoms". She is nevertheless trying to maintain privileged trade and financial relations with the EU by setting up a specific free trade partnership. Since the UK wants to be able to regain control of its borders, manage the entry of workers from the EU, and no longer submit to the EU Court of Justice, and unlike the EFTA countries refuses to submit to standards on which it will have no say in exchange for free access to the European market,

Theresa May is proposing that a “specific and in-depth partnership” be established between the UK and the EU. In addition, since her September 2017 speech in Florence, she has called for a two-year transition period from March 2019 to March 2021.

Theresa May held early parliamentary elections in June 2017 in an effort to strengthen her Tory majority in Parliament. In fact, Labour’s attacks on austerity and on Tory positions favouring a reduction in welfare benefits led to the loss of the Tory majority. Theresa May had to reach an agreement with the Democratic Unionist Party (DUP), a Northern Ireland pro-Union party that is conservative on social affairs, but opposed to austerity and to any compromise with the Republic of Ireland. Theresa May has therefore entered the Brexit negotiations with a weakened and divided majority, with some of her ministers (David Davis, Secretary of State for Brexit Negotiations; Boris Johnson, Secretary of State for Foreign Affairs; Liam Fox, Secretary State for International Trade) declaring themselves ready to take the risk of leaving without an agreement.

On 15 November 2017, the UK Parliament finally passed the EU Withdrawal Bill, called the “Great Repeal Bill”, ending the application of EU law in the UK and giving the government the task of transposing (or not) European laws and regulations (i.e. 12,000 texts) into British law. However, it was agreed that any agreement signed with the EU will be submitted to Parliament, with the latter’s refusal implying an exit with no agreement.

The state of negotiations on the eve of the 14-15 December summit

Five rounds of negotiations were initially planned in 2017, from June to October. The objective was that, by the European summit of 19-20 October, sufficient progress was to be made in negotiations on the three points set in April so that the

EU-27 countries would agree to start negotiations over the future partnership. On 19 June in the first round, David Davis accepted the EU’s request for sequencing. Thus, only the three points desired by the EU-27 have been discussed, while for the UK government (and the country’s businesses), what is crucial is the future partnership. At the end of the fifth round, on 12 October 2017, the EU’s chief negotiator Michel Barnier declared that the negotiations on the financial aspects were deadlocked and that he could not propose to the October 19th European summit that discussions be started on an agreement. Barnier hoped, however, that progress would be made in time for the 14-15 December EU summit. On 20 October, however, the European Council nevertheless agreed to the possibility of a transition agreement and proposed that preparatory talks be held for the December summit, which would therefore be crucial.

With regard to the rights of citizens, especially the 3.2 million EU citizens living in the UK, Theresa May proposed that all EU citizens who had settled in the UK by 29 March 2017 could obtain a residency status that guarantees them the same rights as British citizens in terms of employment and social rights. This would be automatic for those who have resided there for more than 5 years, and for the rest when they reach 5 years of residence. The nnegotiations hit stumbling blocks on the reference date (March 2017 or 2019?), on maintaining the right to family reunion and especially on supervision of the application of the agreement by the EUCJ, which the EU-27 is demanding in order to ensure that the UK does not tighten its regulations, but which the UK cannot accept (it could, however, agree to the establishment of an arbitration tribunal).

On the issue of the Irish border, both parties have agreed to preserve the peace agreement in Northern Ireland and to maintain the absence of a land border, so as not to put obstacles to the lively trade between the two parts of the

island or to freedom of movement between the two areas (30,000 people a day cross the border), which is difficult if the United Kingdom is no longer in the single market or in the customs union. The Republic of Ireland is refusing any hard border, and threatens to veto any agreement that would erect additional barriers between the Republic and Northern Ireland. It is asking for special status for Northern Ireland, which would keep it in the customs union. The DUP, working in a contrary sense, opposes Northern Ireland staying in the customs union after Brexit, or at least any agreement that would not apply to the whole of the United Kingdom; the British government, desirous of maintaining the integrity of the United Kingdom, must refuse to allow Northern Ireland to be subject to EU regulations with a border between Northern Ireland and the rest of the UK. The DUP proposes setting up an invisible border, which will require great creativity. On this point, the EU-27 believes that it is up to the UK to make acceptable proposals. Faced with the difficulties of reconciling the irreconcilable, the two parties could agree to postpone the issue to the end of negotiations on their future partnership.

On the issue of the financial settlement, the positions seem to have drawn closer. On the EU side, some 60 billion to 100 billion euros were mentioned as a British contribution to the European expenditures already committed, while the United Kingdom did not want to tackle the issue of a financial settlement independently of negotiations on the future agreement. In September 2017, however, Theresa May made it clear that the UK would honour its financial commitments to the EU, namely its share of spending in 2017-19, its commitments for 2020, the investment expenditure committed beyond that, and its share of the pensions of European officials. The United Kingdom is to pay between 45 and 50 billion euros. As part of the negotiations on the future partnership, the UK government could commit to possible future contributions to the functioning of the single market.

Although none of the three initial negotiating points are really resolved today, it seems that the EU-27 will agree that negotiations on the future partnership can begin in 2018. This will require the EU-27 countries to agree on a common position, which will mean postponing the beginning of a new round of negotiations until March 2018. It is likely, and desirable, that the European Council meeting of 14-15 December accepts the British request for a two-year transition period in order to eliminate the risk that it could leave without an agreement in March 2019.

It will then be necessary to come to an agreement on the future partnership between the EU-27 and the United Kingdom. The EU-27 must not give in to the temptation to punish a departing country by applying only WTO rules to it, which would also harm EU exports to Britain, especially as the EU has a current account surplus of 130 billion euros vis-à-vis the country. Similarly, industrial cooperation agreements (Airbus, arms, energy, etc.) can hardly be called into question. It seems impossible for the EU-27 to accept that the UK remains in the single market and chooses which rules it wishes to apply. The minimum would be a trade agreement, modeled on the Canada-EU Comprehensive Economic and Trade Agreement (CETA). The most promising outcome for both parties would undoubtedly be to reach an agreement for a balanced commercial partnership that would serve as a model for creating a third circle in Europe, which could eventually make it possible to bring on board Norway, Iceland, Switzerland, Ukraine, Turkey, Morocco and other countries, and which would avoid leaving third countries to face a choice between keeping their national sovereignty and the benefits of trade liberalization.

Growth and inequality in the European Union

By Catherine Mathieu and Henri Sterdyniak

"Growth and Inequality: Challenges for the Economies of the European Union" was the theme of the 14th EUROFRAME Symposium on Economic Policy Issues in the European Union held on 9 June 2017 in Berlin. EUROFRAME is a network of European economic institutes that includes DIW and IFW (Germany), WIFO (Austria), ETLA (Finland), OFCE (France), ESRI (Ireland), PROMETEIA (Italy), CPB (Netherlands), CASE (Poland) and NIESR (United Kingdom). Since 2004, EUROFRAME has organized a symposium on an important subject for the European economies every year.

This year, 27 contributions from researchers, selected by a scientific committee, were presented at the symposium, most of which are available on the conference web page. This text provides a summary of the studies presented and discussed at the symposium.

As DIW President Marcel Fratzcher pointed out in his opening remarks, the rise in inequality over the last 30 years has meant that inequalities that were previously subjects of study reserved for researchers in social policy have now become subjects for numerous economists. Several questions were posed: why this rise in inequality? Is the increase in inequality in each country a necessary consequence of the reduction in inequality between countries, in Europe or at the global level? What are the macroeconomic consequences of this increase? What economic policies could avoid this?

Income inequality: the facts. Mark Dabrowski (CASE, Warsaw) –

“Is there a trade-off between global and national inequality?” – stresses that the growth of inequalities within each country (especially in the United States and China) goes hand in hand with the reduction of inequalities between countries, as both are fuelled by commercial and financial globalization. However, some advanced countries have succeeded in halting the growth in internal inequalities, which shows the continuing importance of national policy.

Oliver Denk (OECD) – “Who are the Top 1 Percent Earners in Europe?” – analyses the structure of the 1% of employees earning the highest incomes in the EU countries. They represent between 9% of total payroll in the United Kingdom to 3.8% in Finland (4.7% in France). Statistically, they are older than the mass of overall employees (this is less clear in the East European countries), more masculine (this is less clear in the Nordic countries), and more highly educated. They are more numerous in finance, communication and business services.

Tim Callan, Karina Doorley and Michael Savage (ESRI Dublin), analyse the growth in income inequality in the countries most affected by the crisis (“Inequality in EU crisis countries: Identifying the impacts of automatic stabilisers and discretionary policy”). In these five countries, Spain, Greece, Ireland, Portugal and Cyprus, primary income inequalities have increased due to the crisis, but thanks to automatic tax and social transfers, inequalities in disposable income have remained stable in Ireland and Portugal and (to a lesser degree) in Greece.

Carlos Vacas-Soriano and Enrique Fernández-Macías (Eurofound) – “Inequalities and employment patterns in Europe before and after the Great Recession” – show that income inequality decreased overall in the EU before 2008, as new entrants caught up with the older members. Since 2008, the Great Recession has deepened inequalities between countries and within many countries. The growth of internal inequality is

due mainly to rising unemployment; it is striking traditionally egalitarian countries (Germany, Sweden, Denmark); and it is mitigated by family solidarity and social protection, whose roles are nevertheless under question.

Modelling the growth / inequality relationship. Alberto Cardiac (University of Cattolica del Sacro Cuore, Milan) and Francesco Saraceno (OFCE, Paris) – "Inequality and Imbalances: An open-economy agent-based model" – present a two-country model. In one, the search for external surpluses leads to pressure on wages and a depression of domestic demand, which is offset by export earnings. In the other, the growth of inequality leads to a downward trend in consumption, which is offset by the expansion of credit. The result is an endogenous debt crisis when the household debt of the second country reaches a limit value.

Alain Desdoigts (IEDES, University of Paris 1 Panthéon-Sorbonne) and Fernando Jaramillo (Universidad del Rosario, Bogota) – "Learning by doing, inequality, and sustained growth: A middle-class perspective" – present a model where innovations can be applied in production only in sectors with a sufficient size, hence those that produce the goods purchased by the middle class (so neither in the luxury goods sector nor in the low-end goods sector). Growth is therefore stronger as the middle class expands. Redistribution is favourable to growth if it is made from the rich to the middle class, and unfavourable if it goes from the middle class to the poor.

Inequality, financialisation, monetary policy. The article by Dirk Bezemer and Anna Samarina (University of Groningen) – "Debt shift, financial development and income inequality in Europe" – distinguishes between two types of bank credit: credit for financial and real estate activities, and credit for non-financial enterprises and consumption. They explain the growth of inequality in the developed countries by the growing role of credit that finances finance to the detriment

of credit that finances production.

The article by Mathias Klein (DIW Berlin) and Roland Winkler (TU Dortmund University) – “Austerity, inequality, and private debt overhang” – argues that restrictive fiscal policies have little impact on activity and employment when private debt is low (because there is a full Barro effect); they have a restrictive effect on activity and increase income inequality when private debt is high. Therefore, fiscal restraint should be applied only once private debt has been reduced.

Davide Furceri, Prakash Loungani and Aleksandra Zdzienicka (IMF) – “The effect of monetary policy shocks on inequality” – point out that the impact of monetary policy on income inequality is ambiguous. An expansionary policy can reduce unemployment and lower interest rates (which reduces inequality); it can also lead to inflation and raise the price of assets (which increases inequality). Empirically, it appears that a restrictive policy increases income inequality unless it is caused by higher growth.

Inequalities and social policy. Alexei Kireyev and Jingyang Chen (IMF) – “Inclusive growth framework” – advocate for growth indicators that include trends in poverty and in inequality in income and consumption.

Dorothee Ihle (University of Muenster) – “Treatment effects of Riester participation along the wealth distribution: An instrumental quantile regression analysis” – analyses the impact of Riester pension plans on the wealth of German households. They significantly increase the wealth of the participating households at the bottom of the income distribution, but these are relatively few in number, while this mainly has wealth redistribution effects for middle-class households.

Inequality, poverty and mobility. Katharina Weddige-Haaf (Utrecht University) and Clemens Kool (CPB and Utrecht

University) – “The impact of fiscal policy and internal migration on regional growth and convergence in Germany” – analyse the factors for convergence of per capita income between the old and new German Länder. Convergence has been driven by internal migration, investment subsidies and structural funds, but fiscal transfers in general have had no effect. The 2008 crisis favoured convergence by hitting the richest regions in particular.

Elizabeth Jane Casabianca and Elena Giarda (Prometeia, Bologna) – “From rags to riches, from riches to rags: Intra-generational mobility in Europe before and after the Great Recession” – analyse the mobility of individual incomes in four European countries: Spain, France, Italy and the United Kingdom. Before the crisis, this was strong in Spain and weak in Italy. It declined markedly after the crisis, particularly in Spain; it remained stable in the United Kingdom.

Luigi Campiglio (Università Cattolica del S. Cuore di Milano) – “Absolute poverty, food and housing” – analyses absolute poverty in Italy using an indicator based on food consumption. He shows that poor families bear particularly high housing costs, which cuts into their food consumption and health care spending. Poor families with children are tenants and were hit especially hard by the crisis. Social policy should offer them better protection through targeted transfers in cash or in kind (health, education).

Georgia Kaplanoglou and Vassilis T. Rapanos (National and Kapodistrian University of Athens and Academy of Athens) – “Evolutions in consumption inequality and poverty in Greece: The impact of the crisis and austerity policies” – point out that the crisis and austerity policies have reduced GDP and household consumption by about 30% in Greece. This has been accompanied by an increase in inequality in consumption, which the paper documents in detail. It analyses in particular the effect of VAT hikes. Families with children were especially hard hit.

Labour market. Christian Hutter (IAB, German Federal Employment Agency) and Enzo Weber (IAB and Universität Regensburg) – "Labour market effects of wage inequality and skill-biased technical change in Germany" – use German data to estimate a structural vector model for analysing the link between wage inequalities, employment, neutral technical progress and technical progress favouring skilled labour. The latter raises labour productivity and wages, but also wage inequalities, and it reduces employment. Wage inequalities have a negative impact on employment and overall productivity.

Eckhard Hein and Achim Truger (Berlin School of Economics and Law, Institute for International Political Economy) – "Opportunities and limits of rebalancing the Eurozone via wage policies: Theoretical considerations and empirical illustrations for the case of Germany" – analyse the impact of wage increases in Germany on the rebalancing of current account balances in Europe. They show that these play a role not only through a competitiveness effect, but also through a demand effect by modifying the wage / profit distribution and by boosting consumption. They must therefore also be supported by an increase in public spending.

Camille Logeay and Heike Joebges (HTW Berlin) – "Could a wage formula prevent excessive current account imbalances in euro area countries? A study on wage costs and profit developments in peripheral countries" – show that the rule "wages must grow in line with labour productivity and the inflation target" should have had stabilizing effects in Europe both on the competitiveness of the member countries as well as on their domestic demand. This nevertheless assumes that companies do not take advantage of this to boost their profits and that no country seeks to increase its competitiveness.

Hassan Molana (University of Dundee), Catia Montagna (University of Aberdeen) and George E. Onwordi (University of Aberdeen) – "Reforming the Liberal Welfare State: International Shocks, unemployment and household income

shares" – construct a model to show that a free market country, such as the United Kingdom, could improve the functioning of its labour market by reducing flexibility to move towards a flexi-security model: higher unemployment benefits, restrictions on redundancies, greater spending on training, and support for hiring. By boosting labour productivity, this strategy would reduce the structural unemployment rate and increase the share of profits.

Guillaume Claveres (Centre d'Economie de la Sorbonne, Paris) and Marius Clemens (DIW, Berlin) – "Unemployment Insurance Union" – propose a model for European unemployment insurance that would cover part of the expenses of unemployment benefits. This could reduce fluctuations in consumption and unemployment resulting from specific shocks. This assumes, however, that it would apply only to cyclical unemployment, which is difficult to define.

Bruno Contini (Università di Torino and Collegio Carlo Alberto), José Ignacio Garcia Perez (Universidad Pablo de Olavide), Toralf Pusch (Hans-Boeckler Stiftung, Düsseldorf) and Roberto Quaranta (Collegio Carlo Alberto) – "New approaches to the study of long-term non-employment duration via survival analysis: Italy, Germany and Spain" – analyse involuntary non-activity (people who would like to work but have given up looking for a job and lost their rights to unemployment benefits) in Germany, Italy and Spain. This is particularly important and sustainable in Spain and Italy. They caution against measures to encourage redundancies, job insecurity and incentives for undeclared work.

Taxation. Markku Lehmus, (ETLA, Helsinki) – "Distributional and employment effects of labour tax changes: Finnish evidence over the period 1996-2008" – uses a general equilibrium model with heterogeneous agents to evaluate the impact of the reduction in the taxation of employment in Finland from 1996 to 2008. He shows that this explains only a small share of the rise in employment (1.4 points out of 16%) and of the rise in

income inequality.

Sarah Godar (Berlin School of Economics and Law) and Achim Truger (IMK and Berlin School of Economics and Law) – “Shifting priorities in EU tax policies: A stock-taking exercise over three decades” – analyse the evolution of taxation in the EU states: from 1980 to 2007, taxation became less progressive with lower marginal rates of income tax and corporation tax, and preferred treatment of capital income. The crisis of 2008 and the difficulties with the public finances temporarily slowed this trend; an increase in revenues was, however, often sought by raising VAT.

Alexander Krenek and Margit Schratzenstaller (WIFO) – “Sustainability-oriented future EU funding: A European net wealth tax” – argue for the introduction of a European household wealth tax, which could help finance the European budget.

The macroeconomic consequences of inequalities. Bjoern O. Meyer (University of Rome – Tor Vergata) – “Savings glut without saving: Retirement saving and the interest rate decline in the United States between 1984 and 2013” – explains 60% of the decline in the interest rate in the United States, despite the decline in the overall household saving rate, by demographic factors (the differential rise in life expectancy), the slowdown in labour productivity gains and the increase in income inequality.

Marius Clemens, Ferdinand Fichtner, Stefan Gebauer, Simon Junker and Konstantin A. Kholodilin (DIW Berlin) – “How does income inequality influence economic growth in Germany?” – present a macroeconomic model in which short-term income inequalities increase the productivity of each asset (incentive effect), but reduce overall consumption (savings effect); in the long term, they have a negative impact on the formation of the human capital of young people in the working classes. Hence an exogenous increase in income inequalities

first has a negative effect on GDP (demand effect), then positive (individual incentive effect) and then again negative in the long term (human capital effect). The effect is always negative on household consumption and positive on the external balance.

Brexit: What are the lessons for Europe?

By Catherine Mathieu and Henri Sterdyniak

The British vote to leave the European Union is aggravating the political crisis in Europe and in many European countries. Leaving the EU has become a possible alternative for the peoples of Europe, which may encourage parties advocating national sovereignty. The United Kingdom's departure automatically increases the weight of the Franco-German couple, which could destabilize Europe. If Scotland leaves the UK to join the EU, independence movements in other regions (Catalonia, Corsica, etc.) could seek a similar outcome. But the fragility of Europe also stems from the failure of the strategy of "fiscal discipline / structural reforms".

The departure of the United Kingdom, a fierce advocate of economic liberalism and opponent of any increase in the European budget and in the powers of Europe's institutions, as well as of a social Europe, could change the dynamics of the debate in Europe, but some East European countries, the Netherlands and Germany have always had the same position as the UK. The departure will not, by itself, cause a shift in European policy. On the other hand, the liberalization of services and the financial sector, which the UK has been

pushing for, could be slowed. The British Commissioner, Jonathan Hill, head of financial services and capital markets, should be promptly replaced. This will raise the sensitive issue of British EU officials, who in any case can no longer occupy positions of responsibility.

This will also open up a period of economic and financial uncertainty. The reaction of the financial markets, which do not like uncertainty and are in any case volatile, should not be accorded an excessive importance. The pound sterling has of course rapidly depreciated by 10% against the euro, but it was probably overvalued, as evidenced by the British current account deficit of around 6.5% of GDP in 2015.

According to Article 50 of the European Constitution, any country that decides to leave the EU should negotiate a withdrawal agreement, which sets the exit date[1]. Otherwise, after two years the country is automatically outside the Union. The negotiations will be delicate, and must of necessity deal with all the issues. During this period, the UK will remain in the EU. European countries will have to choose between two attitudes. An understanding attitude would be to sign a free trade agreement quickly, with the goal of maintaining trade and financial relations with the UK as a privileged partner of Europe. This would minimize the economic consequences of Brexit for both the EU and the UK. However, it seems difficult to see how the UK could simultaneously enjoy both complete freedom for its own economic organization and full access to Europe's markets. The UK should not enjoy more favourable conditions than those of the current members of the European Free Trade Association (EFTA – Norway, Iceland and Liechtenstein) and Switzerland; like them, it should undoubtedly integrate the single market legislation (in particular the free movement of persons) and contribute to the EU budget. The issue of standards, such as the European passport for financial institutions (this is now granted to the EFTA countries, but not to Switzerland), etc., would be

posed very quickly. The UK may have to choose whether to comply with European standards on which it will not have a say or to be subject to regulatory barriers. The negotiations will of course be open-ended. The UK could argue for a Europe that is more open to countries outside the EU. But how much weight will it have once it’s out?

A tough attitude intended to punish London so as to set an example and deter future candidates from leaving would instead require the UK to renegotiate all trade treaties from scratch (i.e. from WTO rules) so as to encourage multinational companies to relocate their factories and headquarters to mainland Europe and close British banks’ access to the European market in order to push them to repatriate euro zone banking and financial activity to Paris or Frankfurt. But it would be difficult for Europe, a supporter of the free movement of goods, services, people and business, to start erecting barriers against the UK. The euro zone has a current account surplus of 130 billion euros with the UK: does it want to call this into question? European companies that export to the UK would oppose this. Industrial cooperation agreements (Airbus, arms, energy, etc.) could only be challenged with difficulty. A priori it would seem unlikely that London would erect tariff barriers against European products, unless in retaliation. Conversely, London could play the card of setting up tax and regulatory havens, particularly in financial matters. It could not, however, avoid international constraints (agreements such as at COP21, on the fight against tax avoidance, on the international exchange of tax and banking information, etc.). The risk would be to start a costly game of mutual reprisals (one that it would be difficult for Europe, divided between countries with different interests, to lead).

Upon leaving the European Union, the United Kingdom, a net contributor to the EU, would a priori save about 9 billion euros per year, or 0.35% of its GDP. However, the EFTA

countries and Switzerland contribute to the EU budget as part of the single market. Again, everything depends on the negotiations. It would seem that the savings for the UK will be only about 4.5 billion euros, which the other Member countries will have to make up (at a cost of around 0.5 billion euros for France).

Given the uncertainty of the negotiations (and of exchange rate trends), all assessments of Brexit's impact on other EU countries can only be very tentative. Moreover, this will necessarily have only a second-order impact on the EU countries: if tariff or non-tariff barriers reduce French exports of cars to the UK and of British cars to France, French manufacturers can supply their national markets while facing less competition and can also turn to third countries. It is nevertheless useful to have an order of magnitude: in 2015, exports from France (from the EU) to the UK represented 1.45% of GDP (respectively 2.2%); exports from the UK to the EU represented 7.1% of British GDP. A priori, an equivalent impact on UK / EU trade will have 3.2 times less impact on the EU than on the UK.

According to the OECD[2], the fall in EU GDP will come to 0.8% by 2023 (against 2.5% for the UK), whereas remaining in the EU, participating in the deepening of the single market and signing free trade agreements with the rest of the world would lead to a rise in GDP for all EU countries. But how credible is this last assertion, given the euro zone's current poor performance and the cost for the economic and social cohesion of European countries of opening the borders? But if Europe is functioning poorly, then leaving should improve market prospects. The UK's foreign trade would suffer a contraction, which would hurt its long-term productivity, but despite its openness the British economy's productivity is already weak. The OECD does not raise the question of principle: should a country give up its political sovereignty to benefit from the potential positive effects of trade liberalization?

According to the Bertelsmann Foundation[3], the reduction in EU GDP (excluding the UK) in 2030 would range from 0.10% in the case of a soft exit (the UK having a status similar to that of Norway) to 0.36% in the worst case (the UK having to renegotiate all its trade treaties); France would be little affected (-0.06% to -0.27%), but Ireland, Belgium and Luxembourg more so. The study multiplied these figures by five to incorporate medium-term dynamics, with the reduction in foreign trade expected to have adverse effects on productivity.

Euler-Hermes also reported very weak figures for the EU countries: a fall of 0.4% in GDP with a free trade agreement and of 0.6% without an agreement. The impact would be greater for the Netherlands, Ireland and Belgium.

Europe needs to rebound, with or without the United Kingdom…

Europe must learn the lessons from the British crisis, which follows on the debt crisis of the southern European countries, the Greek crisis, and austerity, as well as from the migrant crisis. It will not be easy. There is a need to rethink both the content of EU policies and their institutional framework. Is the EU up to the challenge?

The imbalances between EU Member countries grew from 1999 to 2007. Since 2010, the euro zone has not been able to develop a coordinated strategy enabling it to restore a satisfactory level of employment and reduce the imbalances between Member states. The economic performance of many euro zone countries has been poor, and downright catastrophic in southern Europe. The strategy implemented in the euro zone since 1999, and strengthened since 2010 – “fiscal discipline / structural reforms” – has hardly produced satisfactory results socially or economically. On the contrary, it gives people the feeling of being dispossessed of any democratic power. This is especially true for countries that benefited from assistance from the Troika (Greece, Portugal, Ireland) or the European

Central Bank (Italy, Spain). The Juncker plan that was intended to boost investment in Europe marked a turning point in 2015, but it remains timid and poorly taken up: it was not accompanied by a review of macroeconomic and structural policy. There are important disagreements in Europe both between nations and between political and social forces. In the current situation, Europe needs a strong economic strategy, but it has not been possible to agree on one collectively in today's Europe.

There are two fundamental reasons for this morass. The first concerns all the developed countries. Globalization is creating a deeper and deeper divide between those who benefit from it and those who lose[4]. Inequalities in income and status are widening. Stable, well-paid jobs are disappearing. The working classes are the direct victims of competition from low-wage countries (Asian countries and former Soviet bloc countries). They are being asked to accept cuts in wages, social benefits, and employment rights. In this situation, the elite and the ruling classes can be open-spirited, globalist and pro-European, while the people are protectionist and nationalist. This same phenomenon underlies the rise of France's National Front, Germany's AFD, UKIP, and in the US the Republican Donald Trump.

Europe is currently operated according to a liberal, technocratic federalism, which seeks to impose on people policies and reforms that they are refusing, sometimes for reasons that are legitimate, sometimes questionable, and sometimes contradictory. The fact is that Europe in its current state is undermining solidarity and national cohesion and preventing countries from choosing a specific strategy. The return to national sovereignty is a general temptation.

Furthermore, Europe is not a country. There are significant differences in interests, situations, institutions and ideologies between peoples, which render progress difficult.

Because of the differences in national situations, many arrangements (the single monetary policy, the free movement of capital and people) pose problems. Rules that had no real economic foundation were introduced in the Stability Pact and the Budgetary Treaty: these did not come into question after the financial crisis. In many countries, the ruling classes, political leaders and senior civil servants have chosen to minimize these problems, so as not to upset European construction. Crucial issues concerning the harmonization of taxes, social welfare, wages and regulations have been deliberately forgotten. How can convergence towards a social Europe and a fiscal Europe be achieved between countries whose peoples are attached to structurally different systems? Given the difficulties of monetary Europe, who would wish for a budgetary Europe, which would take Europe further from democracy?

In the UK-EU Agreement of 19 February, the UK has recalled the principles of subsidiarity. It is understandable that countries concerned about national sovereignty are annoyed (if not more) by the EU’s relentless intrusions into areas that fall under national jurisdiction, where European intervention does not bring added value. It is also understandable that these countries refuse to constantly justify their economic policies and their economic, social or legal rules to Brussels when these have no impact on the other Member states. The UK noted that the issues of justice, security and individual liberties are still subject to national competence. Europe needs to take this feeling of exasperation into account. After the British departure, it needs to decide between two strategies: to strengthen Europe at the risk of further fuelling people’s sense of being powerless, or to scale down the ambition of European construction.

The departure of the United Kingdom, the de facto distancing of some Central European countries (Poland, Hungary) and the reticence of Denmark and Sweden could lead to an explicit

switch to a two-tiered EU. Many national or European intellectuals and politicians think that this crisis could provide just such an opportunity. Europe would be explicitly divided into three groupings. The first would bring together the countries of the euro zone, which would all agree to new transfers of sovereignty and to build a stronger budgetary, fiscal, social and political union. A second grouping would bring together the European countries that do not wish to participate in such a union. The last grouping would include countries linked to Europe through a free trade agreement (currently Norway, Iceland, Liechtenstein and Switzerland, and later the UK and other countries).

Such a project would, however, pose many problems. Europe’s institutions would have to be split between euro zone institutions operating on a federal basis (which need to be made more democratic) and EU institutions continuing to operate in the Union manner of the Member states. Many countries currently outside the euro zone are opposed to this kind of change, which they feel would marginalize them as “second-class” members. The functioning of Europe would become even more complicated if there were both a European Parliament and a euro zone Parliament, euro zone commissioners, euro zone and EU financial transfers, and so on. This is already the case for instance with the European Banking Agency and the European Central Bank. Many questions would have to be decided two or three times (once in the euro zone, again at the EU level, and again for the free trade area).

Depending on the issue, the Member country could choose its grouping, and things would quickly head towards an à la carte union. This is hardly compatible with the democratization of Europe, as soon there would be a Parliament for every question.

The members of the third grouping would then be in an even more difficult situation, with the obligation to comply with regulations over which they had no power. Should our partner

countries be placed in the dilemma of either accepting heavy losses of sovereignty (in political and social matters) or being denied the benefits of free trade?

There is clearly no agreement between the peoples of Europe, even within the euro zone, on moving towards a federal Europe, with all the convergences that this would imply. In the recent period, the five Council Presidents and the Commission proposed new steps towards European federalism: creating a European Budget Committee, establishing independent Competitiveness Councils, conditioning the granting of Structural Funds on respect for budgetary discipline and the implementation of structural reforms, establishing a European Treasury and a euro zone minister of finance, moving towards a financial union, and partially unifying the unemployment insurance systems. These developments would reinforce the technocratic bodies to the detriment of democratically elected governments. It would be unpleasant if these were implemented, as is already partially the case, without the people being consulted.

Furthermore, no one knows how to proceed with convergence on tax and social matters. Upwards or downwards? Some proposals call for a political union in which decisions are taken democratically by a euro zone government and parliament. But can anyone imagine a federal authority, even a democratic one, that is able to take into account national specificities in a Europe composed of heterogeneous countries? What about decisions concerning the French pension system taken by a European Parliament? Or a finance minister for the zone imposing spending cuts on Member countries (as the Troika did in Greece)? Or automatic standards on public deficits? In our opinion, given the current disparity in Europe, economic policies must be coordinated between countries, not decided by a central authority.

Europe needs to reflect on its future. Using the current crisis to move forward towards an “ever closer union” without

more thought would be dangerous. Europe must live with a contradiction: the national sovereignties that peoples are attached to have to be respected as much as possible, while Europe must implement a strong and consistent macroeconomic and social strategy. Europe has no meaning in itself, but only in so far as it implements the project of defending a specific model of society, developing it to integrate the ecological transition, eradicating mass unemployment, and solving the imbalances within Europe in a concerted and united manner. But there is no agreement within Europe on the strategy needed to achieve these goals. Europe, which has been unable to generally lead the Member countries out of recession or to implement a coherent strategy to deal with globalization, has become unpopular. Only after a successful change of policies will it regain the support of the peoples and be able to make institutional progress.

[1] See in particular the report of the French Senate by Albéric de Montgolfier*: Les conséquences économiques et budgétaires d'une éventuelle sortie du Royaume-Uni de l'Union Européenne [The economic and budgetary consequences of a future withdrawal of the United Kingdom from the European Union],* June 2016.

[2] OECD, 2016, *The Economic Consequences of Brexit: A Taxing Decision*, April. Note that to treat leaving the euro as a tax increase does not make economic sense and represents a communication that is unworthy of the OECD.

[3] *Brexit – potential economic consequences if the UK exits the EU*, Policy Brief, 2015/05.

[4] See, for example, Joseph E. Stiglitz, 2014, "Le prix de l'inégalité", *Les Liens qui libèrent*, Paris.

A new EU arrangement for the United Kingdom: European lessons from the February 19th agreement

By Catherine Mathieu and Henri Sterdyniak

Following the demand made by David Cameron on 10 November 2015 for a new arrangement for the United Kingdom in the European Union, the European Council came to an agreement at its meeting of 18 and 19 February. On the basis of this text, the British people will be called to the polls on 23 June to decide whether to stay in the EU. This episode raises a number of questions about the functioning of the EU.

– The United Kingdom has challenged European policy on matters that it deems crucial for itself and largely got what it wanted. Its firmness paid off. This has given rise to regrets on this side of the Channel. Why didn't France (and Italy) adopt a similar attitude in 2012, for instance, when Europe imposed the signing of the fiscal treaty and the implementation of austerity policies? This is a cause for concern: will what has been accepted for a big country be tolerated for a smaller one? The UK's threat to leave is credible because the EU has become very unpopular among the population (especially in England), and because the UK is independent financially (it borrows easily on the capital markets) and economically (it is a net contributor to the EU budget). A country that is more dependent on Europe would have little choice. This raises worries: won't we see other countries follow suit in the future? Will Europe be able to

avoid becoming a Europe á la carte (each country taking part in the activities that interest it)? But is a model based on forced participation preferable? Europe must allow a country to abstain from policies that it deems harmful.

– The United Kingdom will therefore organize a referendum, which is satisfactory from a democratic perspective. The most recent referendums have hardly yielded favourable results for European construction (France and the Netherlands in 2005, Greece in July 2015, Denmark in December 2015). The British will be limited to choosing between leaving the EU (the February agreement clearly rejects the possibility of new renegotiations if the referendum results in a majority in favour of an EU exit) or staying with a reduced status; the possibility of the UK remaining in the EU and seeking to strengthen its social dimensions, as advocated by some of the Labour Party and the Scottish Nationalists, will not be offered. Too bad.

– The United Kingdom is explicitly exempted from the need to deepen the EMU or from an “ever closer union” or “deeper integration”, all formulas contained in the treaties. The proposed arrangement clarifies that these notions are not a legal basis to extend the competences of the EU. States that are not members of the euro zone retain the right to take part or not in further integration. This clarification is, in our opinion, welcome. It would not be legitimate for the Union’s powers to be extended continuously without the consent of the people. In the recent period, the five presidents and the EU Commission have proposed new steps towards European federalism: creating a European Fiscal Committee; establishing independent Competitiveness Councils; conditioning the granting of Structural Funds on fiscal discipline; implementing structural reforms; creating a European Treasury department; moving towards a financial union; and partially unifying the unemployment insurance systems. These moves would strengthen the technocratic bodies to the detriment of

democratically elected governments. Wouldn't it be necessary to explicitly request and obtain the agreement of the peoples before embarking on such a path?

– The exit of the United Kingdom, a certain distancing by some Central and Eastern Europe countries (Poland, Hungary), plus the reluctance of Denmark and Sweden could push towards an explicit move to a two-tier Union, or even, to take David Cameron's formulation, to an EU in which countries are heading to different destinations. The countries of the euro zone would for their part accept new transfers of sovereignty and would build a stronger fiscal and political union. In our opinion this proposal should be submitted to the people.

– At the same time, the draft agreement provides that the Eurogroup has no legislative power, which remains in the hands of the Council as a whole. The UK has had it clarified that a non-member state of the euro zone could ask the European Council to take up a decision on the euro zone or the banking union that it believes harms its interests. The principle of the euro zone's autonomy has thus not been proclaimed.

– The United Kingdom has had it clarified that it is not required to contribute financially to bail out the euro zone or the financial institutions of the banking union. This may be considered discomforting vis-à-vis the European principle of solidarity, but it is understandable. This is because the establishment of the euro zone has abolished the principle: "Every sovereign country is fully backed by a central bank, a lender of last resort", which is posed by the bailout problem. The UK (and its banks) are backed by the Bank of England.

– The United Kingdom has had the principles of subsidiarity reviewed. A new provision states that parliaments representing 55% of the Member States may challenge a law that does not respect this principle. The UK has had it noted that the issues of justice, security, and liberty remain under national competence. It is a pity that countries devoted to their

specific social systems and their wage bargaining systems have not done the same.

– It is understandable that countries concerned about national sovereignty are annoyed (if not more) by the EU's relentless intrusions into areas under national jurisdiction, where Europe's intervention does not bring added value. It is understandable that these countries are refusing to have to incessantly justify to Brussels their economic policies or their economic, social or legal regulations when these have no impact on other Member States. Europe must undoubtedly take these feelings of exasperation into account.

– As regards the banking union, the draft text is deliberately confusing. It is recalled that the "single rule book" managed by the European Banking Agency (EBA) applies to all banks in the EU, and that financial stability and equal competitive conditions must be guaranteed. But at the same time, it says that Member States that do not participate in the banking union retain responsibility for their banking systems and can apply special provisions. Moreover, countries that are not members of the euro zone have a right of veto on the EBA. This raises the question of the very content of the banking union. Will it make it possible to take the measures needed to reduce the scale of speculative financial activity in Europe and steer the banks towards financing the real economy? Or is the objective to liberalize the markets for the development of financial activity in Europe so as to compete with London and non-European financial centres? In the first case, what was needed was to clearly take in hand the market in London, telling it that membership in the EU requires close monitoring of financial activities. And that its departure would allow the EU to take capital control measures to limit speculative activities and encourage banks in the euro zone to repatriate their activities.

– Likewise, Belgium, Luxembourg, the Netherlands and Ireland would have needed to be told that EU membership means the end

of tax avoidance schemes for the multinationals.

– The United Kingdom has had a declaration passed affirming the need both to improve regulations and repeal unnecessary provisions to improve competitiveness while at the same time maintaining high standards of protection for consumers, labour, health and the environment. This compatibility undoubtedly amounts to wishful thinking.

– The text recognizes that the disparity in wage levels and social protection in European countries is hardly compatible with the principle of the free movement of persons in Europe. This has long been an unspoken part of European construction. The United Kingdom, which was one of the only countries not to take interim measures to restrict the entry of foreign workers at the time of the accession of central and eastern European countries in 2004, is now demanding that such measures be provided for in any future accessions. The draft agreement states that a European person’s stay in a country other than his or her own is not the responsibility of the host country, meaning that the person either must have sufficient resources or must work.

– The question of the right to family benefits when children are not living in the same country as their parents is a tangled web. In most countries, family benefits are universal (not dependent on parental contributions). Both principles cannot be met at the same time: that all children living in a country are entitled to the same benefit; and that everyone working in a given country is entitled to the same benefits. The United Kingdom has won the right to be able to reduce these allowances based on the standard of living and family benefits in the child’s country of residence. But fortunately this right cannot be extended to pension benefits.

– Most European countries currently have mechanisms to promote the employment of unskilled workers. Thanks to exemptions on social contribution, to tax credits and to specific benefits

(like in-work credits or housing benefits in France), the income that they receive is largely disconnected from their wage costs. The British example shows that these programmes can become problematic in case of the free movement of workers. How does a country encourage its own citizens to work without attracting too many foreign workers? Here is another of the unspoken issues of open borders. It is paradoxical that it is the United Kingdom that is raising the question, while it is near full employment and is claiming that the flexibility of its labour market allows it to easily take in foreign workers. In any case, the UK was granted that a country facing an exceptional influx of workers from other EU Member States can obtain the right from the Council, for seven years, to grant non-contributory aid to new workers from other member countries in a graduated process over a period of up to four years from the start of their employment. The UK has also had it clarified that it can use this right immediately. This is a challenge to European citizenship, but this concept had already been chipped away for the inactive and unemployed.

The European Union, as currently constructed, poses many problems. The Member States have divergent interests and views. Because of differences in their national situations (the single monetary policy, freedom of movement of capital and people), many arrangements are problematic. Rules without an economic foundation have been introduced into fiscal policy. In many countries, the ruling classes, the political leaders, and the top officials have chosen to minimize these problems so as not to upset European construction. Crucial issues concerning the harmonization of taxes, social conditions, wages and regulations have been deliberately forgotten.

The UK has always chosen to keep its distance from European integration, safeguarding its sovereignty. Today it is putting its finger on sensitive points. To rejoice at its departure would be irrelevant. To use this to move mindlessly towards an

“ever closer union” would be dangerous. Europe should seize this crisis to acknowledge that it has to live with a contradiction: national sovereignty must be respected as much as possible; Europe has no meaning in and of itself, but only if it implements a project that supports a specific model of society, adapting it to integrate the ecological transition, to eradicate poverty and mass unemployment, and to solve European imbalances in a concerted and united manner. If the agreement negotiated by the British could contribute to this, it would be a good thing – but will Europe’s countries have the courage to do so?

Concerning the Macron law “to promote growth, activity and equal economic opportunity”

By Henri Sterdyniak

The Macron Law is certainly not the “law of the century”. It is a patchwork of about 240 provisions of varying importance. It is not some “great turn to the free market” nor does it represent a uniquely French strategy. It does nevertheless raise interesting questions about France’s economic strategy and the way the legislature works.

The latest issue of the *Note de l’OFCE (no. 43 of 13 March 2015)* examines the law’s major provisions, which oscillate between free market liberalization (let competition and the market do their work), social liberalism (certain categories of the population must be protected), economic interventionism (the state must regulate the functioning of the markets), and social democracy (the social partners must play an important

role), without a clear victory for any of these. It is a compromise text that by definition cannot really satisfy anyone.

In our view, despite its title, there are few provisions in the law that will promote activity or that are beneficial to industry, to "Made in France", to urban renewal, to the habitat, to the production of sustainable recyclable goods, or to greater employee participation in the decision-making process in their business. The law is instead in line with the myth of an economy driven by innovative start-ups, and ignores the need for industrial restructuring and an ecological transition.

Should Germany's surpluses be punished?

By Henri Sterdyniak

On the procedure for macroeconomic imbalances

Since 2012, every year the European Commission analyses the macroeconomic imbalances in Europe: in November, an alert mechanism sets out any imbalances, country by country. Countries with imbalances are then subjected to an in-depth review, leading to recommendations by the European Council based on Commission proposals. With respect to the euro zone countries, if the imbalances are considered excessive, the Member state is subject to a macroeconomic imbalance procedure (MIP) and must submit a plan for corrective action, which must be approved by the Council.

The alert mechanism is based on a scoreboard with five indicators of external imbalances [1] (current account balance, net international investment position, change in the real effective exchange rate, change in export market shares, change in nominal unit labour costs) and six indicators of internal imbalances (unemployment rate, change in housing prices, public debt, private debt, change in financial sector liabilities, credit flows to the private sector). An alert is issued when an indicator exceeds a certain threshold, *e.g.* 60% of GDP for public debt, 10% for the unemployment rate, -4% (+6% respectively) for a current account deficit (respectively surplus).

On the one hand, this process draws lessons from the rise in imbalances recorded before the crisis. At the time of the Maastricht Treaty, the negotiators were convinced that economic imbalances could only come from the way the State behaved; it therefore sufficed to set limits on government deficits and debt. However, between 1999 and 2007, the euro zone saw a steep rise in imbalances due mainly to private behaviour: financial exuberance, securities and property bubbles, swollen foreign deficits in southern Europe, and a frantic search for competitiveness in Germany. These imbalances became intolerable after the financial crisis, requiring painful adjustments. The MIP is thus designed to prevent such mistakes from happening again.

On the other hand, the analysis and the recommendations are made on a purely national basis. The Commission does not propose a European strategy that would enable the countries to move towards full employment while reabsorbing intra-zone imbalances. It does not take into account inter-country interactions when it demands that each country improve its competitiveness while cutting its deficit. The Commission's recommendations are a bit like the buzzing of a gadfly when it proclaims that Spain should reduce its unemployment, France should improve its competitiveness, etc. Its proposals are

based on a myth: it is possible to implement policies on public deficit and debt reduction, on wage austerity and on private debt reduction, while offsetting their depressive impact on growth and employment through structural reforms, which are the *deus ex machina* of the fable. This year there is also, fortunately, the European Fund for strategic investments (the 315 billion euros of the Juncker plan), meaning that the Commission can claim to be giving "a coordinated boost to investment", but this plan represents at most only 0.6% of GDP over 3 years; its actual magnitude is thus problematic.

For 2015, all the countries in the European Union have at least one imbalance according to the scoreboard [2] (see here). France has lost too much of its export market share and has an excessive public debt and private debt. Germany, too, has lost too much of its export market share, its public debt is excessive and above all its current account surplus is too high. Of the 19 countries in the euro zone, seven, however, have been absolved by the Commission and 12 are subject to an in-depth review, to be published in late February. Let's take a closer look at the German case.

On Germany's surplus

A single currency means that the economic situation and policies of each country can have consequences for its partners. A country that has excessive demand (due to its fiscal policy or to financial exuberance that leads to an excess of private credit) and is experiencing inflation (which can lead to a rise in the ECB's interest rate), thereby widening the euro zone's deficit (which may contribute to a fall in the euro), requires its partners to refinance it more or less automatically (in particular via TARGET2, the system of automatic transfers between the central banks of the euro zone); its debt can thus become a problem.

This leads to two observations:

1. Larger countries can have a more harmful impact on the zone as a whole, but they are also better able to withstand the pressures of the Commission and its partners.

2. The harm has to be real. Thus, a country that has a large public deficit will not harm its partners, on the contrary, if the deficit makes up for a shortfall in its private demand.

Imagine that a euro zone country (say, Germany) set out to boost its competitiveness by freezing its wages or ensuring that they rise much more slowly than labour productivity; it would gain market share, enabling it to boost its growth through its trade balance while reining in domestic demand, to the detriment of its euro zone partners. The partners would see their competitiveness deteriorate, their external deficits widen, and their GDP shrink. They would then have to choose between two strategies: either to imitate Germany, which would plunge Europe into a depression through a lack of demand; or to prop up demand, which would lead to a large external deficit. The more a country manages to hold down its wages, the more it would seem to be a winner. Thus, a country running a surplus could brag about its good economic performance in terms of employment and its public account and trade balances. As it is lending to other member countries, it is in a strong position to impose its choices on Europe. A country that is building up deficits would sooner or later come up against the mistrust of the financial markets, which would impose high interest rates on it; its partners may refuse to lend to it. But there is nothing stopping a country that is accumulating surpluses. With a single currency, it doesn’t have to worry about its currency appreciating; this corrective mechanism is blocked.

Germany can therefore play a dominant role in Europe without having an economic policy that befits this role. The United States played a hegemonic role at the global level while running a large current account deficit that made up for the deficits of the oil-exporting countries and the fast-growing

Asian countries, in particular China; it balanced global growth by acting as a “consumer of last resort”. Germany is doing the opposite, which is destabilizing the euro zone. It has automatically become the “lender of last resort”. The fact is that Germany’s build-up of a surplus must also be translated into the build-up of debt; it is therefore unsustainable.

Worse, Germany wants to continue to run a surplus while demanding that the Southern European countries repay their debts. This is a logical impossibility. The countries of Southern Europe cannot repay their debts unless they run a surplus, unless Germany agrees to be repaid by running a deficit, which it is currently refusing to do. This is why it is legitimate for Germany to be subject to an MIP – an MIP that must be binding.

The current situation

In 2014, Germany’s current account surplus represented 7.7% of GDP (or 295 billion euros, Table 1); for the Netherlands the figure was 8.5% of GDP. These countries represent an exception by continuing to run a strong external surplus, while most countries have come much closer to equilibrium compared with the situation in 2007. This is in particular the case of China and Japan. Germany now has the highest current account surplus of any country in the world. Its surplus would be even 1.5 GDP points higher if the euro zone countries (particularly those in Southern Europe) were closer to their potential output. Thanks to Germany and the Netherlands, the euro zone, though facing depression and high unemployment, has run a surplus of 373 billion dollars compared with a deficit of 438 billion for the United States: logically, Europe should be seeking to boost growth not by a depreciation of the euro against the dollar, which would further widen the disparity in trade balances between the euro zone and the United States, but by a strong recovery in domestic demand. If Germany owes its surplus to its competitiveness policy, it is also benefitting

from the existence of the single currency, which is allowing it to avoid a surge in its currency or a depreciation in the currency of its European partners. The counterpart of this situation is that Germany has to pay its European partners so that they remain in the euro.

Table 1. Current account balance as % of GDP

	2007	2014
Netherlands	6,7	8,5
Germany	7,5	7,7
Austria	3,5	2,5
Italy	-2,4	1,8
Belgium	1,9	-0,1
Spain	-10,0	-0,1
Portugal	-10,1	-0,2
Finland	4,1	-1,4
France	-1,0	-1,8
Greece	-14,6	-2,0
Euro zone	0,2	2,8
United Kingdom	-2,2	-4,1
Denmark	1,4	6,5
Sweden	9,3	5,9
United States	-5,0	-2,2
Japan	4,9	0,1
China	10,7	3,3

Source : European economy.

There are three possible viewpoints. For optimists, Germany's surplus is not a problem; as the country's population ages, Germans are planning for retirement by accumulating foreign assets, which will be used to fund their retirements. The Germans prefer investing abroad rather than in Germany, which they feel is less profitable. These investments have fuelled international financial speculation (many German financial institutions suffered significant losses during the financial crisis due to adventurous investments on the US markets or the

Spanish property market); now they are fuelling European debt. Thus, through the TARGET2 system, Germany's banks have indirectly lent 515 billion euros to other European banks at a virtually zero interest rate. Out of its 300 billion surplus, Germany spends a net balance of only 30 billion on direct investment. Germany needs a more coherent policy, using its current account surpluses to make productive investments in Germany, Europe and worldwide.

Another optimistic view is that the German surplus will decline automatically. The ensuing fall in unemployment would create tensions on the labour market, leading to wage increases that would also be encouraged by the establishment of the minimum wage in January 2015. It is true that in recent years, German growth has been driven more by domestic demand and less by the external balance than prior to the crisis (Table 2): in 2014, GDP grew by 1.2% in Germany (against 0.7% in France and 0.8% for the euro zone), but this pace is insufficient for a solid recovery. The introduction of the minimum wage, despite its limitations (see A minimum wage in Germany: a small step for Europe, a big one for Germany), will lead to a 3% increase in payroll in Germany and for some sectors will reduce the competitiveness gains associated with the use of workers from Eastern Europe. Even so, by 2007 (relative to 1997), Germany had gained 16.3% in competitiveness compared to France (26.1% compared to Spain, Table 3); in 2014, the gain was still 13.5% relative to France (14.7% relative to Spain). A rebalancing is taking place very slowly. And in the medium term, for demographic reasons, the need for growth in Germany is about 0.9 points lower than the need in France.

Table 2. Contributions to GDP by domestic demand and the external balance

	GDP		Domestic demand		External balance	
	1998-2007	2007-2014	1998-2007	2007-2014	1998-2007	2007-2014
Germany	1,60	0,70	0,85	0,70	0,75	0,00
France	2,25	0,30	2,60	0,35	-0,35	-0,05
Spain	3,85	-0,70	4,60	-2,10	-0,75	1,40
Italy	1,50	-1,30	1,65	-2,80	-0,15	1,50
Euro zone	2,30	-0,10	2,20	-0,55	0,10	0,45

Table 3. Indicator of relative unit labour costs

Base 100 = 1997

	2007	2013
Euro zone	99,0	105,2
Germany	86,2	90,4
Austria	94,2	98,1
Finland	98,9	109,3
France	103,0	104,5
Belgium	103,2	107,8
Italy	107,9	111,9
Portugal	110,3	101,8
Netherlands	108,2	111,9
Greece	110,5	98,3
Spain	116,6	106,0
Ireland	124,1	106,1
Outside euro zone		
United Kingdom	122,2	104,1
Sweden	92,4	98,6

Source : European economy.

Furthermore, a more pessimistic view argues that Germany should be subject to a macroeconomic imbalance procedure to get it to carry out a macroeconomic policy that is more favourable to its partners. The German people should benefit more from its excellent productivity. Four points need to be emphasised:

1. In 2014, Germany recorded a public surplus of 0.6 percent of GDP, which corresponds, according to the Commission's

estimates, to a structural surplus of about 1 GDP point, *i.e.* 1.5 points more than the target set by the Fiscal Compact. At the same time, spending on public investment was only 2.2 GDP points (against 2.8 points in the euro zone and 3.9 points in France). The country's public infrastructure is in poor condition. Germany should increase its investment by 1.5 to 2 additional GDP points.

2. Germany has undertaken a programme to reduce public pensions, which has encouraged households to increase their retirement savings. The poverty rate has increased significantly in recent years, reaching 16.1% in 2014 (against 13.7% in France). A programme to revive social protection and improve the prospects for retirement[3] would boost consumption and reduce the savings rate.

3. Germany should restore a growth rate for wages that is in line with growth in labour productivity, and even consider some catch-up. This is not easy to implement in a country where wage developments depend mainly on decentralized collective bargaining. This cannot be based solely on raising the minimum wage, which would distort the wage structure too much.

4. Finally, Germany needs to review its investment policy[4]: Germany should invest in Germany (public and private investment); it should invest in direct productive investment in Europe and significantly reduce its financial investments. This will automatically reduce its unproductive investments that go through TARGET2.

Germany currently has a relatively low rate of investment (19.7% of GDP against 22.1% for France) and a high private sector savings rate (23.4% against 19.5% for France). This should be corrected by raising wages and lowering the savings rate.

As Germany is relatively close to full employment, a

significant part of its recovery will benefit its European partners, but this is necessary to rebalance Europe. Any policy suggested by the MIP should require a change in Germany's economic strategy, which it considers to be a success. But European integration requires that each country considers its choice of economic policy and the direction of its growth model while taking into account European interdependencies, with the aim of contributing to balanced growth for the euro zone as a whole. An approach like this would not only benefit the rest of Europe, it would also be beneficial to Germany, which could then choose to reduce inequality and promote consumption and future growth through a programme of investment.

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[1] For more detail, see European Commission (2012) : "Scoreboard for the surveillance of macroeconomic imbalances", *European Economy Occasional Papers* 92.

[2] This partly reflects the fact that some of these indicators are not relevant: almost all European countries are losing market share at the global level; changes in the real effective exchange rate depend on trends in the euro, which the countries do not control; the public and private debt thresholds were set at very low levels; etc.

[3] The ruling coalition has already raised the pensions of mothers and allowed retirement at age 63 for people with lengthy careers, but this is timid compared with previous reforms.

[4] The lack of public and private investment in Germany has been denounced in particular by the economists of the DIW, see for example: "Germany must invest more for future", *DIW Economic Bulletin* 8.2013 and *Die Deutschland Illusion*, Marcel Fratzscher, October 2014.

The Greek debt – a European story …

By Catherine Mathieu and Henri Sterdyniak

At end 2014, Greece's debt was 317 billion euros, or 176% of its GDP, up from 103% in 2007, despite debt relief of 107 billion in 2012[1]. This debt is the result of a triple blindness, on the part of: the financial markets, which lent to Greece until 2009, heedless of the unsustainable level of its public deficit (6.7% of GDP in 2007) and its trade deficit (10.4% of GDP in 2007); the Greek government and ruling elite who, thanks to the low interest rates permitted by its membership in the euro zone, allowed unbalanced growth, based on financial and real estate bubbles, corruption, poor governance, fraud and tax evasion; and Europe's institutions, which after the laxism of 2001-2007, imposed crushing, humiliating austerity programmes on the country, with the oversight of the troika, a strange threesome consisting of the International Monetary Fund (IMF), the European Central Bank (ECB) and the European Commission (EC). In the eyes of the troika, the austerity programmes were needed to cut the public deficit and debt and put the Greek economy on a path to growth. While the programmes did indeed help to reduce the public deficit (which was only about 2.5% of GDP in 2014, i.e. after excluding interest expenses, a surplus of around 0.5% of GDP), they have pushed up the ratio of debt to GDP, due to the collapse in the country's GDP, which is now 25% less than in 2008. Austerity has above all plunged Greece into economic and social distress, as is sadly illustrated in an unemployment rate of over 25% and a poverty rate of 36%.

The tree of Greek debt must not, however, hide the forest:

from 2007 to 2014, the public debt of the OECD countries as a whole increased from 73% of GDP to 112%, reflecting profound imbalances in the global economy. Due to financial globalization, the victory of capital over labour and growing inequality, the developed countries need large public debts; these debts are generally not reimbursable, since reimbursement assumes that agents with a surplus agree to run deficits.

Take the example of Germany. It wants to maintain a large external surplus (7% of GDP), which weighs down its European partners and has contributed to an excessively strong euro. In order for Greece and other European countries to repay their public debts, they need to be able to export, especially to Germany; Germany would in turn have to accept an external deficit and thus greatly increase public spending and wages, which it does not want to do. The contradictory demands of the surplus countries (to maintain a surplus but be repaid) are leading the entire euro zone into depression. Fortunately for the European economy, neither France nor Italy is adhering strictly to its European commitments, while the UK is not subject to them.

Can we require Greece to continue to meet its European commitments, which have led to a deep depression? To reduce its debt to 60% of GDP within 20 years? The effort needed to do this depends on the difference between the interest rate paid on debt (1.9% in 2014) and the nominal rate of GDP growth (-1.2% in 2014). Even if Greece managed to accelerate its growth so that the growth rate equalled the interest rate for its loans, it would still have to turn over 6% of its GDP every year; this drain would unbalance the economy and put the brakes on growth. The Greek people cannot be asked to make further economic and social sacrifices.

If Greece were an emerging country, the solution would be obvious: a strong devaluation and default on the debt. The euro zone, on the contrary, cannot be maintained without

solidarity between its members and without a turnabout in its economic policies. Europe cannot ask Greece’s new government to maintain an austerity programme that has no prospects or to abandon its electoral programme and implement the failed policy negotiated by the previous government. A refusal to compromise would lead to the worst result: a showdown, a financial freeze on Greece, and then its withdrawal from the euro zone and perhaps the EU. The people would rightly feel that Europe is a straitjacket and that democratic votes don’t count. On the other hand, it will be difficult for the northern European countries and the Commission to give up their demands: tight control of national fiscal policies, a reduction in public debts and deficits, conditionalities on aid, privatization policies and structural reforms.

Syriza’s programme includes the restoration of social welfare and the public services as well as a decent standard of living for retirees and employees, but also, very clearly, tax reform, the fight against corruption and bad governance, and the search for a new development model based on the renovation of production and re-industrialization, driven by the State and a restored banking sector, based on public and private investment. This is an ambitious path that presupposes a fight against greed and the inertia of the dominant classes by mobilizing the whole of society, but it is the only future with promise.

The only solution is a compromise that would open the door to a new policy in Europe. Let’s distinguish the Greek question from the European question. Europe’s institutions must agree to negotiate a restructuring of Greek debt. This 317 billion euro debt is now held as follows: 32 billion by the IMF, and 223 billion by the ECB, the European Financial Stability Facility, and the other Member States, i.e. 80% by public institutions. This enabled the private sector to shed Greek debt, but it has not helped the Greek economy. Greece already benefits from low interest rates and lengthy repayment

deadlines [2]. Given the low level of current interest rates and the hunger of financial investors for the risk-free sovereign debt of most Member States, there is no reason for a default on Greek debt; it simply needs to be restructured and secured. We must avoid a situation where every year Greece is in the position of having to repay and refinance an excessive amount of debt, and thus finds itself at the mercy of the capital markets or new negotiations with the troika. Greece needs a long-term agreement based on mutual trust.

Europe should give the Greek people time for their economy to recover. Greece's debt needs to be made sustainable by converting it into very long-term secured debt, possibly confined within the European Stability Mechanism, so that it is sheltered from speculation. This debt could be financed by Eurobonds with very low rates (0.5% at 10 years, or even slightly negative rates by issuing securities indexed to inflation). European taxpayers would thus not be saddled with the burden, and the Greek debt load would be acceptable. It is Greek economic growth that will make it possible to cut the ratio of debt to GDP. The reimbursement should be limited and, as proposed by Greece, depend on growth (e.g. be zero when the volume of growth is less than 2%, and then 0.25 GDP point per additional point of growth). The agreements with Greece should be reviewed to allow the new government to implement its programme for social and production renewal. Two key points must guide the negotiations: that responsibility for the situation is shared between Greece and Europe, that each must bear its share of the burden (the banks have already undergone a partial default); and that Greece must be helped to recover from its deep depression, which means support for consumption in the short term, and in the medium term stimulating and financing the country's productive renewal.

France should support Syriza's proposal for a European conference on debt, because the problem is not just Greek. The Greek experience merely exemplifies the structural problems

with Europe’s economic governance and the challenges facing all the Member States. This governance needs to be overhauled in order to overcome the economic, social and political crisis gripping the euro zone. The turning point represented by the Juncker Plan must be given resolute support (investment support of 315 billion euros in three years), as must the ECB’s quantitative easing programme (1140 billion in 18 months).

The public debts of the euro zone countries must be guaranteed by the ECB and all the Member States. To absorb them, the ECB must keep long-term rates well below the rate of growth, which will require taxing financial activities and controlling the orientation of bank loans to prevent the rise of speculative bubbles. Instead of cutting public and social welfare spending, Europe must coordinate the fight against tax competition and tax evasion by the wealthy and by multinational firms. The unsustainable fiscal straitjacket imposed by the Stability Pact and the European fiscal treaty must be replaced by the coordination of economic policies aimed at full employment and resolving imbalances between euro zone countries. Finally, Europe must propose a strategy for recovery from the crisis based on boosting domestic demand in the surplus countries, coordinating wage policies, and supporting investments that prepare the ecological and social transition. The challenge here is crucial. We need to rethink the way economic policies are organized in Europe in order to allow countries to conduct policies that are different and autonomous, but coordinated. This is the only way the euro zone can survive and prosper.

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[1] More than half of which was used by the Greek state to

secure the country’s banking system.

[2] Moreover, the ECB Member states are repaying it any gains that they make on Greek bonds.

Following the decision of France’s Constitutional Council: the impossible merger of the RSA and PPE social welfare programmes

By Henri Sterdyniak

In June 2014, the government had Parliament approve a new provision for the gradual reduction of employee payroll taxes intended to boost the purchasing power of low-wage earners. Henceforth an employee on the minimum wage (SMIC) would benefit from a 3-point reduction in their contributions, representing a gain of 43 euros per month, *i.e.* a 4% increase in net income. The discount would then decline with the level of the hourly wage and terminate at 1.3 times the SMIC. On 6 August 2014, the Constitutional Council (*Conseil Constitutionnel*) barred this provision. There are three reasons to welcome its ruling.

As noted by the Constitutional Council, employee contributions fund retirement and replacement benefits, social insurance programmes that are reserved for those who have contributed

and which depend on contributions. The parliamentary measure goes against the logic of a contributory system, since employees would have been able to enjoy benefits without having fully paid.[1] The Constitutional Council emphasized the specific nature of contributory social contributions, underscoring a sound principle of our social security system. Note, however, that the Constitutional Council did not oppose the measures exempting employer social contributions for pension contributions, which are also based on a contributory logic. On the other hand, the exemptions on family or health insurance contributions are more legitimate, since these contributions do not confer individual rights. But it's never too late to correct one's oversights.

The new measure planned by the government once again led to reducing the resources of the social security system. Exemptions from social security contributions have become the weapon of choice against unemployment, to the expense of the very purpose of the contributions: to fund social security. The State would of course have offset these exemptions, but social security would have become even more dependent on government transfers, particularly since this measure came on top of the extension, for the years 2013 and 2014 alone, of employer payroll tax cuts and transfers of resources from the taxation of family pension increases and the reduction of the family quotient.

Finally, this exemption would have introduced a new complication for pay slips, which already count twenty lines for contributions. In addition, employers must calculate digressive exemptions on employer contribution, from 28 points at the SMIC level up to 1.6 times the SMIC, and in addition the competitive employment tax credit (CICE) of 6% for wages under 2.5 times the SMIC. From 2016, family contributions will be lowered by 1.8 points for wages under 3.5 times the SMIC. Is an even more digressive system really needed, with a new ceiling of 1.3 times the SMIC?

Despite the Council decision, the government has not abandoned its goal. Thus, in an article in *Le Monde* dated 21 August 2014, President François Hollande announced a reform "that will merge the *Prime pour l'emploi* (PPE) and the *Revenu de solidarité active* (RSA) to promote the return to work and improve the situation of precarious workers". Would a reform like this fulfill the President's objectives? To answer this question it is useful to review the existing arrangements.

The current situation

France has set up a particularly complicated system that aims at two somewhat contradictory goals: to help poor families and to encourage unskilled workers to find jobs.

Aid to the poorest households includes the *Revenu de solidarité active* (RSA – a family-based income supplement for the working poor), the *Prime pour l'emploi* (PPE – an individual in-work tax credit to promote employment), housing benefit (a family-based allowance) and means-tested family benefits (family income supplement, allowance for school). Despite the efforts of Martin Hirsch, the RSA's promoter, it does not include the PPE and housing benefit. It consists of a basic allowance: the base RSA (*RSA socle* – a minimum income that depends on family composition), which is reduced by 38 euros per 100 euros of earned income. The RSA is paid monthly on the basis of a quarterly income statement. As for the PPE, it is paid automatically on the basis of the income tax return, with a one year lag. The RSA is deducted from the PPE, meaning that a household that does not ask for the RSA automatically gets the PPE.

Three mechanisms are specifically designed to encourage low-wage workers to find jobs: exemptions from employer contributions, which reduce the cost of labor at the SMIC level; and the PPE and the RSA, which increase the gain from employment for unskilled workers.

A single person paid the SMIC is entitled to the PPE, but not the RSA (Table 1). It costs the company 1,671 euros (for 35 hours); the person's salary incurs 540 euros in unemployment and retirement contributions, representing deferred wages; the person receives a net transfer of 140 euros (PPE + housing benefit – CSG-CRDS [CSG wealth tax and CRDS debt contribution] – national health insurance and family contributions); their disposable income thus comes to 1,271 euros. There is therefore no net tax burden; their health insurance is offered. The exemptions of employer contributions are higher than the non-contributory contributions. By making use of all the existing schemes, it is possible to dissociate the living standard accorded to workers on the SMIC from the cost of their work.

On the other hand, a single-earner family (Table 2) benefits from the RSA so long as the household income does not exceed 1.65 times the SMIC (Table 2). The RSA increases the incomes of the poorest households: it increases the gains from employment for the first earner, but slightly reduces those of the second (Table 3). The PPE benefits dual-earner families that are above the poverty line (defined as 60% of the median income).

Table 1. Formation of the monthly income of an unmarried employee earning the SMIC (July 2014)

Wages (gross)	1,445 euros	
	Employee	Employer
CSG-CRDS	114 (7.86%)	
Health insurance-family charges		294 (20.33%)
Retirement-unemployment charges	203 (14.05%)	337 (23.33%)
Low income exemption		-405 (28%)
Net wages	1,128	
Total wage cost (or super-gross)		1,671
Income tax (IR)	0	
PPE supplement	79	
Housing benefit (AL*)	64	
Disposable income	1,271	
Net tax	-140	
Contributory charges	540	
Rate of taxation	-12.4%	

* The rent is assumed to be 450 euros. The median income (MI) in 2014 can be estimated at 1642 euros per consumption unit (CU) – the SMIC provides 77.4% of the median income.
Source: URSSAF data, author's calculations.

Table 2. Couple with two children (2.1 consumption units – CU)

	RSA	Single-earner household			Dual-earner household	
		0.5 SMIC	SMIC	1.5 SMIC	1.5*SMIC	2*SMIC
Net wage	0	564	1,128	1,692	1,692	2,255
RSA	900	543	343	128	–	–
PPE	–	–	–	–	158	164
AF/ARS	63	129+63	129+63	129+63	129+63	129+63
Housing (AL*)	483	483	353	182	185	
Total	1,446	1,782	2,016	2,194	2,225	2,611
% MI per CU	41.9	51.7	58.4	63.6	64.6	75.7
PPE**			92	13		
Total**			1 765	2 079		
% MI per CU			51.1	60.3		

* The rent is assumed to be 600 euros. The children are aged 7 to 12. MI = median income; CU = consumption unit.
** If the household does not demand the RSA activité supplement.
Sources: CAF, author's calculations.

Table 3. Gain from becoming employed. Couple with two children

	Recourse to RSA	Without recourse to RSA-activité
First working age		
RSA up to 0.5 SMIC	336 (60%)	_
0.5 SMIC up to SMIC	234 (41%)	_
RSA up to SMIC	570 (50%)	319 (28%)
SMIC up to 1.5 SMIC	178 (32%)	314 (56%)
Second working age. First working age earning SMIC		
Inactif up to 0.5 SMIC	201 (36%)	462 (82%)
Inactif up to 1 SMIC	595 (53%)	846 (75%)

Source: Author's calculations.

The limits of the existing system

– *The reduction of employer contributions*: The PPE and RSA create a class of poorly paid employees whose salary increases are very costly for the employer and not very profitable for the employee. A 10% wage hike for a worker on the SMIC (145 euros) costs the company 242 euros and brings the employee 53 euros. Companies are encouraged to create specific unskilled jobs, with no prospects for progress for the employee, who is stuck in a low-wage trap. The reduction in charges on low wages does not promote the employment of skilled workers, who are also experiencing some unemployment. Not do the jobs

created match up with the increasing qualifications of young people. The consistency of the system as a whole therefore needs to be reviewed. However, the persistence of a large mass of unskilled workers and the desire not to lower the living standards of the working poor currently make it hard to take the risk of eliminating the existing mechanisms.

– *The calculation of the PPE is complicated*: It is paid only after a year's delay, meaning that the incentive effect is probably very small. This supplement benefits employees above the poverty line rather than the poorest families. At the same time, eliminating it would decrease the living standard of those on the SMIC by 6%, which is not an option.

– *The rate of non-take-up of the RSA-activité is very high* (about 68%)[2]. Low-wage workers refuse to be subjected to ongoing monitoring just to receive a relatively small amount of benefit. Given some stigmatization of those receiving the RSA, these workers do not want to be confused with people receiving the base RSA (*RSA-socle)*.

– *The RSA provides a benefit of around 110 euros per child for families with 1 or 2 children* receiving the minimum wage, a benefit that fills a gap in our system, which was not very generous for families of the working poor. But this benefit is not paid to unemployed families. This 110 euro allocation should be paid in the form of a family supplement to all poor families with 1 or 2 children (families with 3 or more children already have a family income supplement and more generous benefits) regardless of the source of income.

– *The RSA is not paid to people under age 25*, even though this age group has particular difficulty finding jobs.

What is to be done?

As France has such a large number of social benefits and charges, it is possible to target the measure precisely depending on the objective. Several measures can be envisaged:

Increase family benefits

If the goal is to increase the purchasing power of poor families, the easiest way to do this is to significantly increase family and housing benefits. Instead, the government has decided to suspend their indexation in 2014 or 2015, inflicting a loss of purchasing power, which fortunately will be limited by low inflation. But the prevailing view today is that it is essential to encourage employment, and thus to increase net wages rather than benefits.

Lower income tax

As poor families do not pay income tax, lowering it will not affect them.

Make the CSG wealth tax progressive

As shown in Table 1, a minimum wage worker pays 114 euros in CSG-CRDS and receives 79 euros in PPE. Wouldn't it be possible to offset the removal of the PPE by making the CSG progressive, which would exempt workers on the SMIC and increase the wages they receive each month? The Constitutional Council rightly considers that any progressive tax must be family based and take into account all the family income. A genuinely progressive CSG is thus virtually impossible to implement, as employers and financial institutions would need to know the marital status of their employees and customers and all of their income, making everyone repeat the work of the tax authorities. This would only make sense in the context of a CSG-income tax merger, which is not feasible in the short term.

Furthermore, only limited progressivity would be feasible. Each person would be entitled to an exemption of around 1,445 euros per month on the amount of income subject to the CSG-CRDS; a spouse without their own resources could transfer their exemption to their partner; dependent children would be eligible for a half exemption. In return, the PPE would be

eliminated; pensioners and the unemployed could be subject to the same CSG as employees. But this exemption would have a huge cost, and in return the rate of the CSG would need to rise to 15% on income above the exemption. This possibility thus must be abandoned.

The merger of the PPE and RSA

The fusion of the PPE and RSA is the path proposed by the President of the Republic. But the devil is in the details, in how to fashion the merger.

In 2013, the report of MP Christopher Sirugue proposed a reform that would create an activity bonus (*Prime d' activité*) to replace the RSA-activité and the PPE (see the critical analysis of Guillaume Allègre, *Faut-il remplacer le RSA-activité et la PPE par une Prime d'activité? Réflexions autour du rapport Sirugue,* 2013). However, as the base RSA would continue to exist, families with very low wages would need to seek two benefits – the base RSA and the *Prime d'activité* – confronting them with a complicated system. The benefit schedule for *Prime d' activité* set out in the Sirugue report was arbitrary, with slopes and a peak at 0.7 SMIC that had no justification. The resulting system was more complicated and more arbitrary than the RSA, and did not represent any major improvement over the existing system. The proposed measure was costly for single-income families (some lost 10% of their income). The risk was that the *Prime d'activité* would suffer from the same lack of take-up as the PPE and that some families would lose the PPE without wanting to use the *Prime d'activité* [3].

A merger that would result in a family-based benefit paid by France's Family Allowance Fund (CAF) would run the risk of a high rate of non-take-up and would generate losers among dual-earner households with children. A merger that would result in an allowance paid on the pay slip would not take into account children and the spouse, and would hurt part-time workers,

raising questions about consistency with the base RSA.

In short, the merger is tricky to implement (if not impossible).

Increase the SMIC[4]

If the goal is to increase the living standard of low-wage earners, the obvious measure is to raise the level of the SMIC. An increase of about 10% would make it possible to eliminate the PPE and provide minimum-wage workers an increase in income equivalent to that under the measure overruled by the Constitutional Court. Assistance aimed specifically at part-time workers would be abandoned, as with the PPE, but this specific assistance is too complicated to have any incentive effect at all. An increase in net earnings is undoubtedly better.

Note, however, that an increase in the minimum wage would not provide enough support for poor families with one or two children, especially the families of the unemployed. The families of the working poor (between the base RSA and 2 times the SMIC) need specific support, by introducing a family supplement of about 80 euros for one child and 160 euros for two children.

The *RSA-activité* should be maintained, since it ensures that any activity actually results in higher disposable income, but its role would be reduced and, thanks to the extension of the family income supplement, non-take-up would have less impact on families with children.

It is also necessary to create an employment integration allowance, in the amount of the RSA, for young people seeking work, without a right to unemployment benefit, a benefit subject to pension contributions.

Nevertheless, in the current situation, where lowering labor costs is a top priority for government policy, the cost of

unskilled labor cannot be increased, leaving two possible approaches.

Either compensation for employers would take place through an increase in exemptions on charges on low-wage workers (which are to rise from 28% to 34.6%), which would not introduce an additional scheme. However, the exemptions on employer contributions would focus on contributory contributions, which could arouse the ire of the Constitutional Court.

Or the increase of the SMIC would take place through a PPE listed on the pay slip: it would be explicitly recognized as a supplement, which implies that the compulsory tax burden would increase, but also that the Constitutional Court could not oppose it, with the drawback that the supplement would fall with the level of the hourly wage, thus representing an additional administrative burden for business.

It seems obvious that there are no simple solutions.

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[1] The Constitutional Court wrote, "… a single social security system would continue under the provisions in question, to finance, for all of its stakeholders, the same benefits despite the absence of payment by nearly one-third of them of all the employee contributions conferring entitlement to the benefits paid by the system; that, therefore, the legislature has created a difference in treatment, which is not based on a difference in the situation of those insured by the same social security scheme, and which is unrelated to the purpose of employee social security contributions."

[2] According to P. Domingo and M. Pucci, 2012, "Le non-recours au revenu de solidarité active et ses motifs", Annex

no. 1 of the *Report of the Comité national d'évaluation du Rsa.*

[3] The *Rapport sur la fiscalité des ménages* by François Auvigne and Dominique Lefebvre, 2014, also points out deficiencies in the project.

[4] This is already the strategy recommended by Allègre (2014).

Towards a better governance in the EU?

By Catherine Mathieu and Henri Sterdyniak

The 10th EUROFRAME Conference on economic policy issues in the European Union was held on 24 May 2013 in Warsaw on the topic, "Towards a better governance in the EU?" Revised versions of twelve of the papers presented at the Conference are included in issue 132 of the "Debates and Policies" collection of the *Revue de l'OFCE* entitled "Towards a better governance in the EU?". The papers are organized around four themes: fiscal governance, analysis of fiscal policy, bank governance, and macroeconomic issues.

The global financial crisis of 2007 and the sovereign debt crisis in the euro area that begin in 2009 have highlighted shortcomings in EU governance. The intense debate that has been going on among economists over how to analyze these shortcomings and proposals for improved governance also marked the EUROFRAME Conference.

How can the Economic and Monetary Union be strengthened

between countries that are still fundamentally different? How can we get out of the financial and economic crisis, the sovereign debt crisis, fiscal austerity and depression? Is it possible to develop a governance of the euro area that ensures the strength of the single currency, that avoids widening the disparities between Member States, and that gives the Members the flexibility needed, while forbidding non-cooperative policies, whether that means the excessive pursuit of competitiveness and trade surpluses or the irresponsible swelling of their public or foreign debt?

The articles in this issue provide readers with various viewpoints on possible pathways that Europe could take:

– Some authors think that we should stick to the original Treaty, abolish solidarity mechanisms, prohibit the Central Bank from buying the debt of member countries, and make it compulsory for them to find financing on the financial markets, which, stung by the Greek experience, will now be more vigilant and impose risk premiums on countries they consider lax. But is this compatible with the single currency? Are the markets really competent in macroeconomic matters? And will the euro zone members accept being reduced to the rank of countries without monetary sovereignty, whose public debt is considered risky and who do not control their interest rates?

– Other authors believe that we should gradually move towards a federal Europe, where the European authorities would be responsible for the fiscal policy of each MemberState; this would need to be accompanied by a democratization of EU institutions, perhaps including even some form of political union. But can there be centralized management of countries in different economic circumstances with different economic and social structures, and which thus need differentiated strategies? Isn’t the euro zone just too heterogeneous for this? Would every country agree to submit its social and economic choices to European trade-offs?

– Other authors believe that such heterogeneous countries cannot share a single currency; that the Northern countries will refuse to give an unconditional guarantee of public debt, even though this is a prerequisite for maintaining the euro zone's unity; that Europe is incapable of organizing a common but differentiated strategy; and that the differentials accumulated in terms of competitiveness require large exchange rate adjustments in Europe. Exchange rates need to be allowed to reflect the Members' different situations, *i.e.* sharp exchange rate falls in the Southern countries, and sharp rises in the Northern countries, by returning to the European Monetary System, or even to flexible exchange rates. Each country would then have to face up to its responsibilities: the Northern countries will have to boost domestic demand, while the Southern ones will have to use their gains in competitiveness to rebuild their export sectors. But no country is demanding this leap into the unknown – the financial consequences could be terrible.

– Finally, some authors, including ourselves, believe that public debts should once again be risk-free assets, guaranteed by the ECB, as part of a process of genuine coordination of economic policy by the Member States, while explicitly targeting full employment and the coordinated reduction of imbalances in the zone. But isn't such coordination a myth? Is a country going to agree to change its economic policy objectives to help the situation of its partners? Don't the European countries today mistrust each other too much to agree to guarantee the public debt of their partners?

These are the questions addressed in this issue, which, as the European elections draw near, we hope will make a useful contribution to the debate on EU governance.

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[1] EUROFRAME is a network of European economic institutes,

which includes: the DIW and IFW (Germany), WIFO (Austria), ETLA (Finland), OFCE (France), ESRI (Ireland), PROMETEIA (Italy), CPB (Netherlands), CASE (Poland) and NIESR (United Kingdom).

[2] This issue is published in English.