



CER Bulletin

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CENTRE FOR EUROPEAN REFORM



How strong a Brexit card is Britain's money?

by John Springford

Britain's strongest card in the negotiations is the money that the 27 claim it owes to the EU. But the money card gives Britain a pair rather than a flush.

Theresa May's speech to the Conservative party conference on October 4th is expected to reaffirm her hard approach to Brexit. But her government's position on the transition to the final relationship with the EU has become more confused. Before the general election, May spoke of an "implementation period" after March 2019, in which Britain and the EU would progressively enact a long-term arrangement that had been agreed before Brexit day. Now, the government has shifted, with Chancellor Philip Hammond pressing for a transition that will largely replicate EU membership, because Britain does not have enough time to set up new customs and migration systems, or the regulations and institutions required to enforce them. Nor is there time to replicate the trade deals that the EU has with third countries or do many other things before March 2019. At the time of writing, it is not clear whether May agrees with Hammond. For their part, the 27 say that only once "sufficient progress" has been made on the money, citizens' rights and the Irish border will they move on to negotiations about the transition and the final deal. Britain's new negotiating position is to hold out the possibility of paying if the EU agrees to a transition period. The British are trying to

convince the 27 to change their line that the divorce must come first. This is a reasonable strategy, but the EU is unlikely to back down.

Britain's strongest card in the negotiations has always been its sizeable contribution to the EU budget. Since 2011, its net contribution has averaged £9.6 billion (€10.6 billion) a year, the second largest of any member-state in absolute terms, and the sixth largest in per capita terms. The EU's budget runs in seven-year cycles, with the current one running from 2014 to 2020. If the UK leaves the EU with no deal on the money in March 2019, the EU stands to lose two years of UK net contributions, in 2019 and 2020. Some spending agreed in this budget round – largely on infrastructure and other funding for economic development – will not be disbursed until after 2020. Add in EU officials' pensions, contingent financial guarantees and loans, and farm payments in 2019 and 2020, and the upfront bill the UK is being asked to pay is somewhere between €82 and €113 billion, depending on the calculation made. (After a decade this would fall to between €42 and €75 billion, as the UK received its share of EU spending and was paid back for its share of loans.)

Rather obviously, these are very large sums of money. But it does not follow that no deal would lead to much fiscal pain for the 27. The hole in the budget would have to be met by member-states which are net payers and those that are net recipients paying more. The simplest way of filling the hole in the budget would be to divide the UK's net contribution in proportion to the size of each remaining member-state's economy. This would mean that each member-state would have to contribute 0.1 per cent of GDP more to the EU budget annually, until the UK share of the EU's current liabilities were paid off. Officials in Brussels say that, in the event of no deal, they could spread any extra payments by member-states over time, and they might also choose to bear down on future expenditure.

Compare that to the fiscal cost of no deal for the UK. It would save 0.4 per cent of GDP by ending payments and receipts from the EU budget. But, according to the Office of Budget Responsibility, the UK's budget watchdog, Britain's economy would only have to shrink by 0.6 per cent as a result of Brexit for that fiscal gain to be wiped out, because tax revenues would fall. Most credible forecasts estimate that the hit from Brexit would be far higher than this, with the consensus in the 3 to 6 per cent range if the UK traded with the EU on WTO terms only. No deal would therefore lead to a big hole in Britain's public finances – and one that is far larger than the losses that the 27 member-states would incur.

Of course, the political danger that Theresa May would face if she walked out of talks would not simply be fiscal. No deal would lead to chaos at the UK's ports and on the Irish border, as the EU would impose tariffs and other customs checks on UK exports. There would be huge legal uncertainty over whether British goods and services could be sold in the 27. This would almost certainly result in a recession – and one that would have been inflicted by May's failure to negotiate a deal. It is hard to imagine the prime minister – or her government – surviving that outcome.

It should be obvious, then, that the UK is in a far weaker position to dictate the terms of the divorce – and the sequencing of talks – than the 27. And the 27 have some powerful reasons to stick to their 'divorce first' red line.

The first reason is that, while the money is ultimately a weak card, it is Britain's strongest card. This is why the EU was insistent on

sequencing: they did not want the UK to use the money as leverage at every stage of the negotiations. Michel Barnier does not want to agree a final sum before declaring sufficient progress, but he does want an accord on a methodology for calculating the final bill. Once that is nailed down, then an approximate amount will have been agreed. And it will be difficult for the UK to negotiate that sum downwards in the final stages of the negotiations, because the deadline will be near and the pressure to agree will be intense.

“Many in the 27 think that Britain should pay additional money for access to the single market during the transition.”

That leads us to the second reason: the longer the UK eats into the two-year Article 50 period by haggling over the divorce bill, the less time there will be to outline the future relationship and the transition. As the deadline approaches, the 27's negotiating power grows, because a fall from the cliff-edge would hurt Britain more than them. The UK would come under increasing pressure to agree on the money, and to accept an off-the-shelf transition deal, without 'implementation arrangements' that allow it to, say, go and negotiate new trade deals while continuing to apply the EU's Common External Tariff on imports; or to place some restrictions on free movement during the transition phase. The EU would much prefer Britain to continue to apply all of the EU's rules and remain subject to all of its institutions, including the ECJ, during a transition. And many in the 27 think that Britain should pay additional money – beyond its share of existing EU budgetary commitments – for membership of the single market during a transition.

The British government hopes that, by going around Barnier and making overtures to France, Germany and other member-states, they might help Theresa May get out of a horrible political fix. If she pays the Brexit bill without anything to show for it, she might be vulnerable to a leadership challenge, raising the risk that Britain crashes out. The 27 might be moved to help, despite the hectoring and insulting tone that many Brexiters in her party have adopted. But it would be as much an act of charity as self-interest.

John Springford
 Director of research, CER @JohnSpringford



The EU will become less monolithic

by Charles Grant

The people running the EU have always wanted it to be uniform. True, Britain and Denmark were granted opt-outs from the euro, judicial co-operation and some other areas. But the orthodoxy in Brussels, Berlin and Paris has been that most member-states are committed to the same aims and ambitions, even if some are progressing towards them more quickly than others. Thus Commission President Jean-Claude Juncker said in his State of the Union speech on September 13th that every member-state (bar those with opt-outs) should join the euro, the banking union and the Schengen area.

But as the EU navigates the challenges of Brexit, migrant flows, a still-problematic eurozone and a hostile neighbourhood, it will need to become more flexible in order to flourish. To his credit, David Cameron got the point. When he renegotiated the terms of Britain's membership, he won an opt-out from the treaty commitment to "ever closer union", plus wording that the treaties should not "compel all member-states to aim for a common destination". The European Commission disliked that language and, together with the French and German governments, prevented Cameron from pushing further in this direction. In any case, the words agreed in February 2016 had no legal standing after the British referendum.

Nevertheless Britain's vote to leave has helped some policy-makers to recognise that in an EU of 27 members with very different objectives,

not everybody will be comfortable signing up to everything. Indeed, some projects – such as common defence – may work better with a smaller number of more committed countries involved.

If governments gained the freedom to opt in or out of certain policies, on a permanent basis, it would weaken the eurosceptic narrative that the EU is an all-powerful juggernaut intent on imposing a uniform model of integration onto an entire continent. Even a federalist government like that of Italy is sympathetic to extending the ideas that Cameron promoted.

President Emmanuel Macron wants a more flexible EU. He told his ambassadors on August 29th that they "should contemplate a Europe based on several formats, go further with all those who want to move forward, without being held back by the states that want – and

that is their right – to advance slowly or not as far.” He added that the EU needed to escape a “constricted framework in which we would have to move forward ... with the agreement of 27 states, or do nothing, or with the agreement of 19, or do nothing.”

Macron’s arrival may well herald a less uniform EU. Together with Angela Merkel, who is set to win Germany’s imminent general election, Macron plans to push ahead with eurozone integration. The eurozone will become more distinct from the rest of the EU, with its own institutions. Joining the euro will become an even more demanding undertaking than it is already. Sooner or later most EU leaders will recognise that some member-states are ill-suited to euro membership and that others – such as Sweden and Poland – will just not want to join.

Two other related factors may encourage the EU to become more flexible. One is that EU enlargement has virtually ground to a halt. The last country to join was Croatia, in 2013. The next one, perhaps Serbia or Montenegro, will be lucky to get in by 2025, if ever. Enlargement has stopped because in many EU countries voters do not want to see new entrants. The halting of enlargement has undermined EU influence in the Balkans – where Russia and Turkey are gaining ground – and in Eastern Europe.

The second factor is that the EU’s neighbourhood policy has largely failed. It was supposed to create a ‘ring of friends’ around the EU, persuading neighbours to reform their economies and political systems by offering trade, aid, freer movement and stronger political ties. But the EU offered too little to motivate most of these countries to reform – with a few exceptions like Georgia and Tunisia. Many southern and eastern neighbours have turned their backs on the EU rather than become its friends.

The way forward for the EU’s enlargement and neighbourhood policies is to invent new forms of partial membership. A dozen years ago, Merkel talked of offering Turkey a kind of half-membership called ‘privileged partnership’. The concept should be revisited. Voters in EU countries would be less hostile to enlargement if the candidates concerned joined only certain policies – perhaps excluding, for example, free movement. And if countries such as Morocco or Ukraine became eligible for partial EU membership, Brussels’ gravitational influence in its neighbourhood would grow.

The EU will be very careful about preserving its legal order. Non-members that wanted to

participate in the EU’s defence or trade policies, or aspects of the single market, would have to accept its rules and the jurisdiction of its courts. Full EU membership would have to entail a commitment to common trade, single market, environmental and foreign policies. But members could be allowed to opt out in other areas, such as judicial co-operation, intelligence-sharing, corporate taxation or the euro.

“In an EU of 27 members with very different objectives, not everyone will be comfortable signing up to everything.”

This variegation would have implications for budgets and accountability – which is why Macron has asked for the eurozone to have its own budget and parliament. And countries left outside avant-garde groups will demand safeguards. Poland and other Central European states fear that in a multi-track Europe they will be treated as second-class.

Andrzej Duda, the Polish President, warned at Krynica on September 5th that “if EU membership became less attractive for countries that are thrown out of the first decision-making circle, then this moment ... will be the actual beginning of the end of the union.” He continued: “Sooner or later the societies of states that today view the EU positively ... will feel rejected and support for the EU will decline, [leading to] further Brexits.”

So proponents of flexibility need to emphasise that avant-gardes will not exclude any member wishing to join that meets objective criteria. And smaller groups should be transparent about what they do, to ensure that a differentiated EU does not become a fragmented Union.

In the long run the EU is likely to become more flexible. This could have big implications for Britain, as well as others on the outside such as Norway and Switzerland. At the moment the chances of post-Brexit Britain wanting to rejoin as a full member seem minimal. But once they have experienced the chill winds of solitude, the British may wish to join an outer tier of the EU.

Charles Grant
Director, CER @CER_Grant

An earlier version of this article appeared in the New Statesman. The ideas are developed further in a forthcoming CER report, ‘The EU rescue project’.



Can the world live with North Korea's bomb?

by Ian Bond

North Korea will soon become the ninth country on earth with a useable nuclear weapon. It carried out its sixth nuclear test on September 3rd 2017; and in the first eight months of the year it carried out about a dozen tests of ballistic missiles (some capable of reaching the continental United States or Europe).

The US, China, Russia and others have been trying to stop North Korea developing nuclear weapons since the late 1980s. Presidents Bill Clinton, George W Bush, Barack Obama and Donald Trump have tried many different approaches: from bilateral talks and aid programmes to military threats and economic sanctions. They have flattered China, hoping to persuade it to put pressure on its 'client' in Pyongyang, and (particularly under Trump) threatened it with economic punishment for failing to do so. Nothing has worked. Russian President Vladimir Putin may have been right when he said on September 5th that the North Koreans would "rather eat grass" than give up their nuclear programme.

If Washington had possessed a usable military option for taking out North Korea's nuclear programme, it would have used it before the North had a viable nuclear device. But the cost of conflict would be immense: Seoul lies within easy range of North Korea's large holdings of artillery and missiles. The UN Security Council has approved more sanctions on North Korea, which will make life there even harder, but its largely autarkic system makes it less vulnerable to

economic pressure than Iran was. As part of the latest package, China agreed to reduce but not cut off energy supplies: it fears the collapse of Kim Jong-Un's regime more than his nuclear weapons, both because it might result in large-scale refugee flows into China, and because Korean unification might put US troops on China's border.

The world has no choice now but to live with a nuclear-armed North Korea while trying to prevent the situation getting worse. That means defending the non-proliferation regime; deterring conflict; and diminishing the risk of accidental nuclear war.

To prevent the further spread of nuclear weapons, the permanent members of the UN Security Council must keep trying to slow the further progress of North Korea's nuclear programme by hindering its access to technology and equipment. They must ensure that the regime continues to suffer economically and politically, and show that countries that do not seek nuclear weapons end up more prosperous and secure than those that do. They must therefore also stick to their side of the bargain that ended Iran's nuclear programme.

The Trump administration must stop looking for ways to declare Iran in breach: if the deal breaks down, proliferation risks will increase.

But defending the non-proliferation regime will not take away North Korea's weapons. Pyongyang must therefore be deterred from using them. When two parties have nuclear weapons, deterrence works as long as each believes that the other might use their weapons in some circumstances, and that both would suffer catastrophic damage. If one side stops believing that, it might risk (for example) a major conventional attack in order to achieve a quick victory, expecting that even in extremis the other would not go nuclear. The US and its allies must be strong enough to make a quick conventional victory impossible; and must show that if Pyongyang tried to blackmail them by threatening a nuclear first strike, they could and would respond. The US is sending this message by maintaining strong forces in and around South Korea and flying nuclear capable aircraft in the area.

On the other hand, there is a risk that steps to reinforce deterrence are mistaken for preparations for a pre-emptive strike. If there is one thing worse than North Korea having nuclear weapons, it is a situation in which the United States and North Korea misunderstand each other's military activity. The two have very few bilateral contacts. But nuclear powers need to know when to worry and when to stay calm.

In the Cold War, even though a US-Soviet hotline had operated since 1963, the Soviet Union still came close to confusing a NATO nuclear command-post exercise in 1983 with a pre-emptive strike.

To diminish the risk of nuclear conflict occurring as a result of such misinterpretations, the US (and ideally other nuclear powers) should propose informal discussions on nuclear issues to the North Koreans. The US has had several similar dialogues with China over more than a decade, led (among other organisations) by the Center for Strategic and International Studies and the US Naval Post-Graduate School. They involve think-tankers and officials, but are not inter-governmental talks, allowing participants more freedom to speak. According to the US Institute for Defense Analyses, over an extended period they have given the US and China a better understanding of each other's "motivations, roles and missions, doctrine, strategy, posture [and] readiness".

It will be anathema to many current and former US officials to 'reward' North Korea with such talks; and getting an inevitably suspicious North to engage in them may take a very long time. But not talking will not make Pyongyang's weapons go away; it just increases the risk of accidental Armageddon.

Ian Bond

Director of foreign policy, CER @CER_IanBond

CER in the press

Bloomberg

1st September 2017
"Most German voters still have a very hard time understanding why British voters decided to leave the EU," Christian Odendahl and Sophia Besch of the CER wrote. "They fail to see how retreating from a club of like-minded democratic countries gives Britain more control."

The Daily Mail

29th August 2017
Charles Grant, director of the CER, said: "Many top officials in the EU and governments would welcome an offer of €10 billion a year for three years as part of a transitional deal

that would move the talks forward."

Le Monde

28th August 2017
Simon Tilford, deputy director of the CER, compares his country to a drunken man returning to reality: "The United Kingdom is sobering up."

The Financial Times

17th August 2017
Christian Odendahl, chief economist at the CER, said that despite the efforts to distance the [safe bonds] plan from the concept of debt mutualisation, Germany was likely to regard it with suspicion. "The Germans feel that

this is a clever way of persuading them to sign up to something which at least has the potential to become debt mutualisation by the back door," he said.

The Guardian

13th August 2017
"The golden age of British retirees heading to the Costas is probably over," said John Springford, director of research at the CER. He pointed to research that found that while young immigrants provided an economic boost in most OECD countries, people turned into a net drain on national finances somewhere between the age of 40 and 45.

Frankfurter Allgemeine Zeitung

30th July 2017
"Britain's defence policy is in part serving a Brexit prosperity agenda to position the country as a global power, and not just a narrowly specialised military ally in the European context", says Sophia Besch from the CER.

The Telegraph

27th July 2017
"Relations between Berlin and Warsaw are already tense and Merkel wouldn't want to risk strengthening the anti-German narrative in Poland," says Agata Gostynska-Jakubowska of the CER.

Recent events



Peter Ptassek

13 September

Conference on 'The German election: Implications for Europe', London

Speakers included: Jochen Andritzky, Michael Arthur, Elga Bartsch, Claudia Major, Christine Ockrent, Stefan Profit and Peter Ptassek

12 September

CER/Clifford Chance lunch on 'The future of tax competition in Europe', Brussels

With Gert-Jan Koopman and Pascal Saint-Amans



(L to R) Pascal Saint-Amans, Gert-Jan Koopman and Simon Tilford

Forthcoming events

Fringe event at the Labour party conference: 'How to handle Brexit'

25 September 2017, 17.30-19.00, GB2, The Grand, Brighton

Speakers: Hilary Benn, MP for Leeds Central, Yvette Cooper, MP for Normanton, Pontefract and Castleford, Keir Starmer, MP for Holborn and St Pancras and Chuka Umunna, MP for Streatham

Fringe event at the Conservative party conference: 'How to handle Brexit'

2 October 2017, 17.45-19.00, Exchange 11, Manchester Central, Manchester

Speakers: Juliet Samuel, Columnist, *The Telegraph*, Vicky Ford, MP for Chelmsford, Andrea Leadsom, MP for South Northamptonshire, Lord President of the Council and Leader of the House of Commons, Dominic Grieve, MP for Beaconsfield and Konrad Szymański, Secretary of State for European Affairs, Ministry of Foreign Affairs, Poland (TBC)

These events are open to the public, but please note they are within the secure zone so passes are needed.

Forthcoming publications

Brexit and energy:
Time to make some hard choices
Philip Lowe

Democratic governance of
the eurozone
Agata Gostyńska-Jakubowska

The EU rescue project
Charles Grant et al

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