When politics prevails: the political economy of a Brexit

Article *in* Journal of European Public Policy · May 2016

DOI: 10.1080/13501763.2016.1174531

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When Politics Prevails: The Political Economy of a Brexit

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Abstract

This article analyses Britain's quest to negotiate its future membership of the EU through the lens of Liberal intergovernmentalism. The article demonstrates that despite the significant economic consequences of a potential Brexit, party political factors have hitherto proven more significant in defining the terrain of the debate than lobby group influence where a cross section of UK lobby groups are either actively or passively in favour of remaining within the EU ahead of the referendum.

Key words

Brexit, Negotiation, Liberal Intergovernmentalism, United Kingdom, Interest Groups.

1. Introduction: theory and method

Britain's position vis-à-vis the EU has historically been determined by an intricate interplay between political and economic interests (Moravcsik 1998: 123; Bank of England 2015: 13-15). As the past often is the best predictor of the future, this article takes a political economy perspective in analysing Britain's quest to negotiate its future membership of the EU. Whilst any number of theoretical frames could offer valid insights on the topic, this article utilises a critical reading of Moravcsik's (1993; 1998) Liberal intergovernmental theory (LIG) to analyse preference formation and aggregation in the UK with regard to the negotiation process. Moravcsik (1993: 482) uses theories drawn (largely) from political economy in explaining national preference formation[1] and intergovernmentalist theories in explaining interstate negotiations, therefore proving highly salient for the perspective we examine here.

The article focuses on the national preference formation part of Moravcsik's framework, which comprises three main elements, which in each case we amend slightly to reflect the specific context of Brexit. The first element is based on a liberal understanding of state-society relations, according to which societal 'groups articulate preferences and governments aggregate them' (Moravcsik 1993: 482). This tenet is potentially problematic for being built on a pluralist understanding of state-society relations where the state is seen as a 'pawn', which makes more sense in the United States of America (US) than in Europe (Dahl 1963); governments in Europe mostly enjoy considerable autonomy, which enables them to shape the national interest to a greater extent (see also Forster 1998). The second element predicts that vulnerability to externalities due to economic interdependence creates incentives for governments to co-ordinate policies internationally (Moravcsik 1993: 485-486). In the context of a potential Brexit this implies there should be a *change* in interests or incentives – such as a decrease in economic interdependence – that would render it more favourable for the UK to go it alone. The third element suggests that as the distributional consequences of policy co-ordination vary, opposition is to be expected from those who are disadvantaged (Ibid. 486-487). Again, this line of argument needs to be

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[1] A key criticism of LIG is that it assumes that political negotiations are conducted by central state actors and thus downplays the influence of devolved regions such as Scotland (Tatham 2011). In fact in the case of the UK's 'new deal' negotiations, this has largely been the case, but the domestic consequences of this strategy have yet to be felt.

recalibrated, since the reference point is not future but rather *existing* international policy co-ordination, entailing that there must either be a change in the power equilibrium of domestic groups in favour or changes in their preferences.

Based on this framework, three key questions can be distilled which will structure the following analysis: what are the issues and who are the key national actors? What is the level of interdependence between the UK and the rest of the EU? What are the distributional consequences of policy co-ordination? The paper relies on process tracing, where policy documents, newspaper articles, academic articles, economic indicators and interviews are used to create an analytical narrative (Caporaso 2009). The interviews were conducted in December 2015 with key stakeholders in the Brexit process such as the Confederation of British Industry (CBI) and the Federal Trust (FT) according to a semi-structured template that included questions such as 'Which, in your judgment, are the most powerful groups influencing the UK government's general EU policy?'; 'What were your organization's views on the government's decision to renegotiate its membership and put it to a referendum?' and 'What would be the direct impact for the stakeholders that you are represent if the UK decides to leave the EU?'. These interviews took place before the announcement of the referendum date and the contents of the 'new deal' package, but are regardless enduringly relevant for the myriad uncertainties that remain. It should also be noted that due to the centralisation of the negotiation process for the whole of the Union in Whitehall, our sources were selected to represent the central organisations' views, which may not entirely reflect the differentiated strategies they pursue across the UK's other political domains.

2. Analysis of national preference formation: the issue space and key national actors

To identify the key national actors in the UK with regard to the negotiation process the overall issue space must be specified (Butler et al. 2016). In January 2013, the British Prime Minister David Cameron promised that should the Conservative party win the 2015 election, he would 'renegotiate' the UK's future membership of the EU and put it to a referendum by 2017 at the latest (Conservative Party 2015). The decision poses a seeming challenge to LIG – predicated on economic rationales – and underscores the importance of giving weight to political factors in explaining national preferences. A significant amount of evidence suggests that the referendum decision was principally driven by the internal politics of the Conservative Party and, in particular, a ploy to maintain unity prior to the election (representative for FT, by phone 3, December 2015; representative for CBI, by phone, 16 December 2015). Cameron between 2012-2013 came under increased pressure from (mostly English) Eurosceptic backbenchers within his own party, who smelled blood because of the rise of the UK Independence Party (UKIP). To manage the dissident voices and arrest the surge of UKIP, the Prime Minister launched the negotiation proposal. During the subsequent period, Cameron issued a number of statements regarding the UK's priorities, seeking to square the minimum demands of backbenchers with what other Member States were likely to concede (representative for FT, by phone, 3 December 2015). This resulted in November 2015 in four objectives for the negotiation: 1) to prevent Eurozone Member States from unilaterally deciding on incentives that influence the functioning of the Single Market 2) to enhance the focus on competitiveness 3) to allow Member States to opt out from the attempt to create an ever closer Union and 4) to reduce migrant workers' rights to social benefits.

The gravity of a potential Brexit entails that a significant range of social actors are invested in the possibility. Having outlined the process of defining the issue space, the key national actors and interest groups influencing the latter can now be identified. The business sector, represented by the CBI, has historically been extremely influential in determining the UK's EU policy stance, which has also been the case with regards to the early phases of negotiation (Moravcsik 1993, 1998; representative for FT, by phone, 3 December 2015). The CBI, which represents both large and small businesses[2], have expressed a clear stance that they are in favour of staying in the EU and expect to maintain that stance vigorously during the referendum whilst maintaining cross party support (representative for CBI, by phone, 16 December 2015; Confederation of British Industry 2013). Informally, the CBI, and individual big businesses, have used their traditionally strong ties to the Conservative party to put intense pressure on Cameron to find a pathway which will allow for the UK to remain within the EU (representative for FT, by phone, 3 December 2015) and the CBI is seen by its members as an important campaigning organization (representative for NFU, by phone, 18 December 2015)[3]. However, they strongly stand behind Cameron's objective of reorienting the EU towards competitiveness. Another key actor in the group of economic stakeholders is 'The City' (the financial sector centred in London) and more generally the British Bankers' Association (BBA). *Prima facie*, the financial sector shares the position of big business by strongly advocating for the UK to maintain its membership (Financial Times 2015). However, a powerful minority, mainly comprising hedge funds, has emerged within the financial sector and is in favour of leaving (representative for FT, by phone, 3 December 2015). While the majority in the financial sector still favour membership, especially due to fear of exit costs, their position now focuses on remaining within the Single Market (email from BBA of December 9 2015, representative for FT, by phone, 3 December 2015).

Looking beyond the groups representing business interests, trade unions are also traditionally important actors in shaping the UK's overall EU policy. However, compared to business interests they have a much weaker link to the Conservative party and thus exert less leverage. By and large, Trade Unions are hostile to both the demands that Cameron is putting forward in Brussels and to the potential of a Brexit. More precisely, the unions perceive the negotiation as an attempt to roll back and possibly prevent future legislation coming from the EU that will enhance the rights of their members (Trades Union Congress 2015). However, the UK's biggest union Unite has for tactical reasons threatened to campaign in favour of a Brexit if Cameron uses the negotiation as an opportunity to weaken its members' right (O'Connor and Pickard 2015). Agriculture is another sphere where there is significant interest group representation. British farmers benefit not only from €3.084bn in basic payments under the Common Agricultural Policy (CAP), but also from access to the single market: the UK is a net agricultural importer, importing twice as much from the EU as it exports; but 73% of the UK's total exports go to EU States. The National Farmers Union (NFU) has been awaiting the outcome of the negotiations and canvassing its members before stipulating a firm position, but has serious reservations regarding the likelihood of the government replacing CAP subsidies at similar levels, possible

[2] The British Chambers of Commerce, one of a number of similar less influential organisations, suspended their Chief Executive on 4 March 2016 in response to his speaking in favour of Brexit.

[3] The CBI may be inclined towards a cautious stance in the wake of the Scottish referendum, where CBI Scotland was registered as a 'no' campaigner, resulting in the resignation of 18 CBI members, including universities, six Scottish government quangos and the broadcaster STV.

restrictions on migrant labour, and the subsequent risk of UK farming becoming uncompetitive with respect to European neighbours (National Farmers Union 2015; representative for NFU, by phone, 18 December 2015).

3. The level of interdependence and vulnerability to externalities

In the classic geopolitical approach, the degree of economic interdependence between the UK and the EU consists of two dimensions (Rosecrance et al. 1977): Vertical interdependence expresses how changes in the price of a factor in one state will influence other states, whereas horizontal interdependence calculates the extent of transactions between states. Focusing on the latter, in 2014, 44% of the UK's exports and 53% of imports were to and from the EU (Bank of England 2015). The EU also accounts for a significant share of inflows and outflows of foreign direct investment, with 43.2% of UK overseas assets held in the EU and 46.4% of assets held in the UK by overseas residents and businesses attributable to the EU (Ibid). Another way to gauge economic interdependence is the Exit Model developed by Baldwin (1980) which estimates the economic exit costs of leaving an interdependent relationship. The Bank of England's (2015) review of studies estimating the net impact of EU membership on the UK economy shows that these vary from a positive effect of +20% of GPD to a negative effect of –5%. Focusing only on those studies that explicitly estimate the gains and losses of a Brexit produces estimates ranging from +1.6% to –9.6% of GDP. The inconclusive results are due to the use of different economic indicators, which are rarely exhaustive and different assumptions about static or dynamic effects.

To complicate things further, estimating the economic cost (if any) of a Brexit with reference to a counterfactual situation where the UK would cut all ties to the EU is not realistic. Instead, the most likely outcome of Brexit would be some kind of association agreement with the EU (like Norway, Switzerland, and Turkey). The kind of deal the UK would be able to negotiate is axiomatically uncertain, making it difficult to estimate the externalities that the UK may experience should it leave; nonetheless, some cautious observations can be made. Externalities could particularly arise from the political actions of other Member States. Although the UK is a net importer (the benefits of which to the wider EU should provide the UK with leverage towards an advantageous agreement) there is considerable variation between Member States and those experiencing a trade deficit are unlikely to support concessions (Bank of England 2015). A post-Brexit UK would be vulnerable to market conditions imposed by the EU, as Member States such as Germany and France would like to increase their share of financial services. Furthermore a number of Member States are increasingly tired of what they perceive as the UK's demanding behaviour and have indicated willingness to inflict punitive externalities upon her (Rasmussen 2015). Finally, the UK would have to negotiate bilateral trade agreements with third countries on her own, the outcome of which is unknowable.

Leaving the EU could provide cost savings for the UK but these are also circumscribed by several complications. As a net-contributor to the EU's budget, the UK would reclaim some money, but not the entire sum. Depending upon what kind of deal it can negotiate with the EU, the UK would most likely have to pay a contribution to the budget like Norway or Switzerland. Moreover, the UK is a net recipient of research money from the EU's budget; the academic sector would likely demand some kind of restitution or the UK could continue to participate in the allocations (like Switzerland), which would again involve paying (Jensen and Stenbæk 2015). Even on budget items such as the structural funds (where the UK is a net contributor), regions including Wales and Northern Ireland benefit and would probably require compensation. In particular Scotland's relationship to the rest of the Union is relatively tenuous after the secession referendum, and a vote to leave the EU could destabilise this further. Clearly, were Scotland to leave in the wake of a Brexit vote, this would create economic repercussions far beyond the direct cost/benefit calculations of replacing EU support.

A much-touted potential benefit of leaving the EU would be regulatory easing, as it would allow the government to roll back costly legislation (Bank of England 2015). However, some caveats are in order. First, as discussed in other pieces, the process of disentangling EU legislation from national legislation is complex and associated with high transaction costs (Łazowski 2016). Second, if the UK does sign an association agreement it will need to accept some part of the *acquis communautaire*. Third, studies indicate that the UK is already one of the EU's most deregulated Member States and the benefits of further deregulation might be slighter than anticipated (Economist 2015). This section suggests that the level of interdependence between the UK and the EU is high, that the cost/benefits of leaving are highly uncertain and that the UK is vulnerable to externalities should it leave the EU. Hence, none of the factors that according to LIG should apply to prompt a negotiation are present, giving further weight to the importance of political factors. Under the existing conditions, one should expect most societal actors to have a status quo bias advocating for the UK to stay within the EU, regardless of the negotiation agreement.

4. The distributional consequences of (lack of) policy co-ordination

In the immediate aftermath, a Brexit would unbalance multifarious existing power equilibria within the UK, where various groups would assert their interests in order to ensure that the new status quo is as favourable as possible for their members (representative for FT, by phone, 3 December 2015). It could be expected that the most economically powerful social actors – summarized above – might anticipate this and view it as an opportunity to enhance their own status. The most vociferous of these actors are clearly located in the business and financial sectors. For the CBI and British Chamber of Commerce (BCC) a Brexit would be costly in the short- and medium-term, even if the UK should manage to land a favourable deal that would enable it to remain within the single market (Gordon 2015). The UK is likewise one of the world's leading financial centres and the rest of the EU is it biggest customer; British finance is clearly highly sensitive to this risk, regardless of the advantages that Brexit might bring in terms of lighter-touch regulation. Nonetheless, whilst these groups are ideally placed to exploit the potential turbulence of a Brexit, none appears to be actively *in favour*, despite their comparatively strong position to capitalize on the disequilibrium it would create. If the most powerful social groups are risk-averse in this field, it stands to reason that the other, less politically significant lobby groups (trade unions, agricultural interests) would also stand to lose out.

5. Conclusion: national preference aggregation

This article has analysed the process leading to the 'new settlement' of the UK's future membership of the EU through the lens of LIG, albeit with some necessary conceptual fitting to the context of institutional change. The analysis shows that LIG underestimates political factors and overestimates economic factors with regard to national preference formation. No evidence suggests that the decision to negotiate was demand-driven by powerful interest groups within the UK. Instead the decision was a tactical move on behalf of Cameron to appease the hardcore Eurosceptics within the Conservative party in England. The analysis suggests that the majority of powerful interest groups prefer to remain within the EU. However, interest groups have had limited influence on the formulation of the concrete objectives being put forward in Brussels. Some of them have informally put pressure on the government to find a way out of the quagmire and allow the UK to remain in the EU, whilst offering support on the objective of increased competitiveness. This stance arises not least due to the high level of interdependence between the UK and the EU as well as the degree of risk associated with potential externalities which would emerge from a Brexit. Breaking down the perceived costs for different groups in society of leaving shows that the short term 'Knightian uncertainty' supersedes anticipated possible benefits from the subsequent social reorganization. This in turn creates a strong status quo bias among the most influential interest groups.

Acknowledgments

The author would like to thank Graham Butler; European Research at the University of Copenhagen (EURECO) and Anah Maskell.

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