Chapter 6
Post-Brexit European Integration

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Abstract This article clarifies the challenge posed by Brexit for post-Brexit European integration. The principal finding is that Brexit is apt to be less disruptive than initially supposed because the EU has the ability to respond constructively filling gaps in its institutional setup that reduces the system’s vulnerability to asymmetric shocks.

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1 Introduction

Five years ago, British Prime Minister David Cameron’s decision to submit the UK’s EU membership to a referendum jolted the EU. This occurred despite the UK having secured favorable terms for remaining in the EU (EUCO 2016), during reportedly harsh secret negotiations that ended in February 2016. The British prime minister decided to go ahead anyway with the referendum to strengthen his position within the conservative party because opinion polls projected that Brexit would be rejected. The referendum took place on June 23, 2016. To many people’s surprise, the majority voted in favor of Brexit. Cameron’s government chose to resign, even though the referendum was consultative. The new Prime Minister Theresa May embraced Brexit, adopting the position that “Brexit means Brexit!” Britain, she asserted would not renegotiate the marriage contract. It would divorce. May formalized her intention in a letter to the president of the European Council, Donald Tusk, triggering Article 50 of the Treaty on the European Union (TEU) on March 29, 2017.

After a prolonged deadlock in the British government and parliament, a new British government led by Prime Minister Boris Johnson entered office after early
general election on 12 December 2019.\footnote{The first Johnson government took office on 24 July 2019 after May’s government resigned and remained in office until 12 December 2019, the day of the early election.} Following Johnson’s promise during the electoral campaign to proceed swiftly toward Brexit,\footnote{https://www.ft.com/content/b5be23ba-19d0-11ea-97df-cc63de1d73f4.} Great Britain withdrew from the European Union on 31 January 2020. This began a transition period that is set to end on 31 December 2020, during which the UK and EU will negotiate their future relationship. The UK remains subject to EU law and continues to be part of the EU customs union and single market during the transition, but is no longer part of the EU’s political bodies or institutions. No British commissioner sits in the current European Commission nor do representatives of the British government participate in common meetings, such as the meetings of the European Council. Starting on 1 February 2020 the number and distribution of seats in the European Parliament changed following the UK withdrawal. Seats were decreased from 751 to 705 seats; the difference being kept in reserve for future possible enlargements. Of the 73 UK seats, 27 were redistributed to other member countries.

During the Covid-19 crisis, this transitory situation became contentious, since the UK had a shifting position on being part of the EU joint procurement system of anti-virus medical equipment (https://www.politico.eu/article/coronavirus-who-said-what-on-uk-nonparticipation-in-eu-procurement/), while adhering to EU rulings on national financial support to fight the crisis consequences (https://ec.europa.eu/commission/presscorner/detail/en/IP_20_603).

Although EU–UK negotiations on post-Brexit settlements and agreements continue, the post-Brexit European Union now has an opportunity to create a fully integrated Eurozone and deal with open problems posed by the single market, including troublesome labor migration problems.

2 Starting Brexit, a Junior Black Swan

There are three reasons why the British Government chose to withdraw from the European Union. First, the majority of British voters may have believed that their wellbeing (including economic externalities associated with local control) would be enhanced by leaving the EU; that is, they thought that gains in liberty would outweigh losses in income. They felt that an independent UK would expand its opportunities, accepting Brexit’s short-run costs for conjectured long-term benefits.

Second, the UK and continental Europe are only weakly compatible. Their economies are moderately integrated compared to the case of the other member countries. The UK is a typical liberal market economy (Anglo-Saxon economy) which features distinct characteristics that make institutional and policy cohabitation difficult as the Varieties of Capitalism (VoC) approach maintains (Hall and Soskice 2001) and as French president Charles de Gaulle made repeatedly clear in
the early 1960s when opposing UK membership in the European Economic Community (EEC) (https://www.france24.com/en/20191013-did-charles-de-gaulle-foresee-brexit). Indeed, much of the process of EU integration has been institutional and the EU setup turned out to be an uncomfortable fit for the UK. Albion was strong and smart enough to obtain special status within the EU, the most important of which was its retention of the pound as its national currency. The UK also succeeded in slowing down the integration process in selective and sensitive areas, primarily finance, fiscal matters, international and military issues. The dominant role of the City of London in international finances was protected even in Eurozone finances (such as in the euro-clearing market). UK membership consequently was both welcome and challenging for the EU.

Third, the UK prefers an EU architecture that prioritizes a single market with national autonomy in all fields, while the other countries prefer a greater degree of EU coordination and control in selected fields including a single market with free labor mobility, a common currency and convergence in fiscal behavior, although not in taxation. The UK accepts the concept of a common market for goods, but wants restrictions on international labor mobility. It refuses to relinquish the pound, and objects to the increase of the EU budget, the coordination of fiscal systems and capital market rules, even though it coordinates with the European Central Bank (ECB). Great Britain is politically and economically important and strong. At the time of the referendum its economy recovered better than the EU average from the crisis, was fairly balanced, and its finances and currency global players. A majority of British voters considered that being a member of the EU was disadvantageous and that the UK outside of the EU would benefit from increased decision-making choice and flexibility.

The UK’s integration in the EU is looser than any other member country (Dallago 2016a). It is only in finance where the UK has a dominant position, where Albion desires strong integration. This does not include fiscal issues though, since the island of Jersey and some of its dependent overseas territories (including the British Virgin Islands, Bermuda and the Cayman Islands) have among the most aggressive tax jurisdictions in the world, often to the disadvantage of other EU member countries (Cobham and Garcia-Bernardo 2020; Oxfam 2016). This weak relationship facilitated divorce, even if it proves to be costly. There are mitigating externalities on both sides. Divorce offers the EU a chance to resume the process of integration in critical issues, such as capital market and fiscal rules, regain control over the euro-clearing market, strengthen its hand with Hungary and Poland, and discourage other

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3 According to the Financial Times, the City of London processes up to three-quarters of global euro denominated derivatives, clearing a notional €850 bn a day (Brunsden and Barker 2017). The financial sector produces some 10% of the British GDP.

4 The UK secured an opt-out from adopting the euro during the negotiations for the Maastricht Treaty in 1992.

5 There are also some industrial branches in which the EU market plays an outstanding role for the UK. This is so in particular in the case of foreign investments in the automotive industry, whose production is largely exported to continental EU countries.
dissidents from emulating the UK’s example. Brexit is likely to enhance European integration, if properly managed.

3 Questions and Facts

Let us review the fundamentals. The core problem for the EU has been that converging fiscal parameters, particularly in an incomplete monetary union, have caused widening inter-union inequality, exacerbating fault lines among member economies (Dallago 2016b). The economic fault between Northern countries and Southern countries continues to be significant, and political fault lines are deepening too between older member countries and the four Visegrád countries (Poland, the Czech Republic, Slovakia, and Hungary). These fault lines were invisible until the international crisis, thanks to the internal flow of private resources from financially strong countries to some of the unbalanced countries. The asymmetric financial shock of the crisis, austerity policies and internal devaluation forced upon distressed member countries in order to fix their fiscal and financial imbalances, caused a reversal of financial flows and put financial and political pressure on them. Their distance from the Union’s resilient core increased rapidly. The adverse distancing was particularly evident in the case of Greece, but remarkable also in other Southern European countries and Ireland.

The UK sidestepped the problem thanks to its monetary and fiscal sovereignty by fighting the global financial crisis of 2008 with expansionary monetary and fiscal policy. Its economy swiftly recovered, while continental economies, in particular in the South of the continent, languished. However, things changed following the referendum and since then the UK economy languished compared to the EU average (Chart 1).

The UK relations to the EU were traditionally complex (Gowland 2016). The country adopted an opportunistic policy approach to the EU from the beginning. It was interested in the unified market and in syphoning continental financial resources and activities to strengthen the role of the City of London as a world financial center. Moreover, it also had the expertise and structures to succeed. The UK was also interested in attracting foreign investment to develop its manufacturing industry while exporting its production to the continent. Overall, the strategy was successful, aided by its close alliance to the United States and its first-class role in globalization. In the process, the UK obstructed changes in the European integration that might diminish its benefits. The UK opposed progress towards unified financial and capital markets, and fiscal unification. It obtained favorable institutional treatment, most importantly the euro opt-out. The UK was a privileged insider from the beginning, a position underscored by Brexit.

The EU had a clear interest in having the UK as a member country. The political, geostrategic and military role of the UK buttressed by its close relationship with the USA was important. The EU hoped that British membership would give it a broader political dimension beyond the Union’s economic core that it found difficult
Chart 1  Quarterly GDP at market prices, percentage change over previous period (2005 = 100) (Chain linked volumes (2015 = 100), seasonally and calendar adjusted data. EZ variable includes the actual member countries of the Eurozone in each relevant quarter). Source Own elaboration on Eurostat database

to accomplish on its own. Similarly, it was hoped that UK membership would support the development of a strong and sophisticated European financial sector, which in turn would strengthen EU’s international role and support the common currency and its role as an international currency. These hopes were largely unfulfilled. The EU’s acceptance of Brexit reflects the disappointment. The UK’s departure is no longer viewed as a tragedy. It is more a hindrance that has to be fixed swiftly and may have important potential advantages.

4 Brexit and the Economy

Brexit is a reality since 31 January 2020. All the involved parties, the UK and the EU, and their deputed organs had approved the deal and the decision entered into force. Yet the particulars remained to be settled: a host of agreements have still to be worked out, let alone agreed on. The future will depend on the type of relations the two parties will agree on, perhaps in 2020. The alternatives are (1) a full UK participation in the single European market with conditions and (2) no deal, which means governing bilateral trade relations with WTO rules. At the time of writing (April 2020), the decision is in limbo due to the health pandemic.

In the interim, Great Britain has to follow EU rules, including paying a fee for the financial settlement foreseen in the Withdrawal Agreement, and get permissions in case of extraordinary policy measures such as those needed to fight the economic consequences of Covid-19. In exchange, the UK continues to enjoy EU support—although it is a net contributor to the EU budget. Hard times occasioned by Brexit itself have complicated smooth transitions in trade and labor relations, and allow the United States to fish in troubled waters. The Covid-19 pandemic which hit the UK
and various EU member countries hard is exacerbating the situation. The pandemic slowed down the ongoing EU–UK negotiations and added uncertainty to an already blurred future. Economic forecasts are worsening, and financial strain is growing (Chart 2 and Table 1).

Ameliorating these difficulties requires progress on two fronts: fast and positive conclusion of bilateral negotiations and a new perspective for the European integration in the direction of an explicit and orderly multispeed, multitrack, multilevel (MSTL) union.

**Chart 2** OECD interim economic outlook forecasts, 2 March 2020, real GDP growth, year-on-year % change. *Source* Own elaboration based on OECD interim economic assessment, *Coronavirus: The world economy at risk*, 2 March 2020, p. 2 (https://www.oecd-ilibrary.org/economics/oecd-economic-outlook/volume-2019/issue-2_7969896b-en)

**Table 1** Real GDP growth in selected areas (percent change)

| Area          | 2018 | 2019 | 2020 | 2021 | 2020 Projections (April 2020) | Deviations (from January 2020) | 2021 |
|---------------|------|------|------|------|-------------------------------|-------------------------------|------|
| World         | 3.6  | 2.9  | −3.0 | 5.8  | −6.3                          | 2.4                           |      |
| European Union| 2.3  | 1.7  | −7.1 | 4.8  | −8.7                          | 3.2                           |      |
| Euro area     | 1.9  | 1.2  | −7.5 | 4.7  | −8.8                          | 3.3                           |      |
| UK            | 1.3  | 1.4  | −6.5 | 4.0  | −7.9                          | 2.5                           |      |
| Japan         | 0.3  | 0.7  | −5.2 | 3.0  | −5.9                          | 2.5                           |      |
| USA           | 2.9  | 2.3  | −5.9 | 4.7  | −7.9                          | 3.0                           |      |
| China         | 6.7  | 6.1  | 1.2  | 9.2  | −4.8                          | 3.4                           |      |
| Russia        | 2.5  | 1.3  | −5.5 | 3.5  | −7.4                          | 1.5                           |      |

*Source* Elaboration on data from IMF, World Economic Outlook, April 2020, p. 15 (https://www.imf.org/external/np/g20/pdf/2020/041520.pdf)
5 The Fading of the Original EU Project and the UK

The process of European integration started with a small group of six countries primarily to reestablish and strengthen peace and democracy in war-torn Europe. With time priority moved from production and trade integration for deterring armed conflicts to reduce transaction costs and strengthen scale and scope economies for improving enterprise competitiveness and increasing market size. All this also served to make the integrated economy more resilient to crises and improve Europe’s standing in international markets. The monetary union subsequently sought additional micro and macroeconomic management efficiencies.

This initial unitary vision and strategy, however politically ambitious, were technically feasible since member countries were in similar situations. The post-war reconstruction period, rapidly growing openness of economies in a globalizing international context and strong willingness to cooperate created opportunities for rapid growth free of major negative shocks. The original unitary vision led to the single market and the Economic and Monetary Union (EMU). It yielded high initial dividends by focusing on Pareto superior common market building, allowing everyone to gain without compelling any member to lose. Widened rational utilitarian choice outweighed conflicts over monetary and fiscal policy and social values. There were two major events that jeopardized this harmonious progress: membership of Great Britain on 1 January 1973 and the financial crisis of 2008.

The UK membership introduced a previously unknown institutional and policy diversity in the Union. Great Britain has an Anglo-Saxon or liberal market system, from which important institutional and policy idiosyncrasies follow, and an internationally and militarily powerful country. Great Britain was a critically important member since the beginning, quite aware of its own strength and interests and determined to push them through within the EU. The exceptional nature of the UK membership appeared soon.

A first referendum on the UK membership was held as soon as 5 June 1975 which obtained two-thirds support to continuing membership. In 1979, the UK opted out of the newly established European Monetary System (EMS), the first fundamental step toward the common currency. However, in 1985, the UK ratified the Single European Act (SEA) which created, among others, the single market and in October 1990 joined the European Exchange Rate Mechanism (ERM) which pegged European currencies to cross-parities. UK membership in ERM lasted until September 1992 when international speculation against the overvalued pound compelled the country to leave ERM and refuse to reenter afterward. During the concomitant negotiations for the Maastricht Treaty, the UK successfully negotiated an opt-out that freed the UK from the need to join the monetary union. The UK had four opt-outs overall during its EU membership, more than any other member country. The UK thus remained the institutionally least integrated member country until Brexit took over and played an important political role, albeit indirectly, to encourage other unruly member countries.
Other opt-outs jeopardized the original unitary vision. As more and more diverse countries joined the EU, following the same track at the same speed became difficult and sometimes impossible. Opt-outs were mostly in noncore issues. Some member countries negotiated particular opt-outs from legislation or treaties of the European Union that in principle apply to all member countries. There are currently five opt-out areas involving four countries: (1) Ireland and the UK relieved from implementing the Schengen agreement; (2) permission for the UK to exclude itself from the monetary union, while Denmark has the right to decide if and when to join the euro; (3) Poland and the UK have partial opt-out from the Charter of Fundamental Rights of the European Union; (4) Denmark, Ireland, and the UK have opt-outs on issues regarding freedom, security and justice. To overcome the opposition of particular member countries to progress in certain areas, possibly including a tax on international short-term financial transaction, the EU foresees an enhanced cooperation among interested and willing member countries.

As the Union enlarged, integration became less and less unitary and the EU became increasingly loosely coordinated, although the core monetary union among a subset of member countries proved to be successful and overall, consistently managed. The financial crisis of 2008 shattered the euphoria. The game ceased being unambiguously Pareto superior, morphing into an asymmetric power and social order game that paved the way of the monetary union (Dallago and Rosefielde 2020; Stiglitz 2016). The Eurozone itself is an inconsistent MSTL. Countries pursue the same goal (the same currency with the same monetary policy and macroeconomic and fiscal equilibrium in order not to jeopardize the stability of the currency) at different speeds, through different tracks (some countries have to stabilize and others not, some grow and others stagnate, some decrease their debt and others increase it).

The EU has chosen to distort its de facto institutions rather than engage in the difficult revision of the treaties. Ultimate economic sovereignty still reposes in national governments, as Brexit showed, albeit with the exception of the monetary sovereignty. While joint sovereignty encourages cooperation, it disregards the growing disparity among and different preferences of member countries. Pressed by a prolonged economic and financial crisis and growing domestic social and political pressure, aggravated by the 2020 pandemic, various countries are increasingly resisting common rules and enforcement and demanding change. An explicitly well-ordered MSTL EU based on transparent institutions and processes would be better.

6 Toward a Post-Brexit MSTL Union

The founding principle of the EU is the cohabitation of supranationality in selected fields based on the principle of subsidiarity and national coordinated sovereignty, that is, the creation of a multitier governance regime that reserves some powers to nation states and simultaneously facilitates transnational coordination. The concept is
compatible with strong, moderate, or weak supranational authority and can accommodate multiple degrees of participation if members desire. The core EU group (France, West Germany, Italy, Belgium, Luxembourg, and the Netherlands), signatories to the Treaty of Rome (March 1957) have long favored increasing coordination and the gradual construction of supranationality (“more Europe”) achieved by deepening the power of common supranational institutions and holding members to strict convergence criteria in order to ameliorate problems caused by the monetary union’s incompleteness. The UK and some other members prefer softer central power in varying degrees including different classes of supranational participation. The debate on the merit of these alternatives has clarified some issues but has not settled matters because the merit of any institution depends fundamentally on its goals, not just its architecture.

The EU project revolved around the idea of an increasingly deep integration since its beginning and in spite of occasional difficulties. Pressure for “more Europe” and promotion of one-track integration reached its climax with the Maastricht Treaty of 1992 and the launch of the process of monetary union. However, intraunion disagreements and divergences were ever present (Brunnermeier et al. 2016; Mody 2018). Brexit represents the culmination of conflicts of interests and divergent views and strategies within the process of European integration and raises the warning that the EU should start considering and implementing a reform capable of accommodating such differences in a constructive way. We contend that an orderly multispeed, multitrack, and multilevel (MSTL) order is sufficient to significantly mitigate strife and promote better outcomes in a Union made of countries with many institutional and structural differences and need to solve different problems (Dallago and Rosefielde 2020).

Multispeed integration means that member countries go in the same direction and pursue common goals, but do so at different speeds, as in the case of fiscal balance. In a multitrack integration, some countries pursue more integration, others less, as in the case of the monetary union. Multilevel integration means that member countries pursue similar goals, but do this in different ways in accordance with their circumstances, as in the case of reforms to comply with EU requirements. Members may also seek objectives other partners dislike, but are willing to tolerate, as in the case of immigration or participation in the Schengen area.

The main challenge of MSTL integration is the management of onerous macroeconomic spillovers and the danger of moral hazard that may transform win–win into win–lose situations. The challenge may be solved by means of proper measurement, assessment and enforcement. MSTL’s primary virtue is more national freedom combined with joint responsibility based on transparent rules and procedures. This solution promises superior results and political stability, thus making the EU stronger because cooperation will be upgraded, internal conflicts softened and decision-making concentrated on solving the most demanding problems. The proposed solution would be akin to, but more general than an upgraded version of the existing enhanced cooperation.

The MSTL solution allows members to maximize utility without jointly optimizing wellbeing, subject to critical benevolent constraints according to a single
Bergsonian social welfare standard (Bergson 1938, 1954, 1976). Paretian and Bergsonian metrics are identical if members have common preferences and values. If members do not agree, some will necessarily be displeased and may try to harm others deliberately or inadvertently by exerting de facto regulatory power and imposing paternalistic values.

7 Brexit and the MSTL Perspective

Following the crisis and Brexit, the debate is de facto moving in the direction of the fundamental distinction between Eurozone countries, where more coordination is necessary and inevitable, and those countries among the others which want to remain outside. The new imperative is to reconceptualize the EU as an adaptive socially and politically inclusive, Pareto improving satisficing project with a flexible internal structure. While the problem is increasingly clear, a shared solution is still distant.

The EU has taken some important steps to increase flexibility. The Euro Plus Pact (E + P), adopted in March 2011 redefined the primary deficit to lighten the compliance burden. The new rule excluded the zero-output gap (the gap between current GDP and potential GDP) from the deficit calculation, a measure that implicitly favored the most indebted countries. The suspension of the Stability and Growth Pact during the 2020 pandemic gave members additional degrees of freedom on an emergency basis. The 2010 European Semester, a series of regularly scheduled fora created to foster national fiscal policy coordination, structural reforms and macroeconomic imbalances discussions, based on commonly agreed treaties and standards, serves a similar eclectic purpose. The consultation process is not joint sovereignty and has a limited short-term perspective, but is a step in the right direction. The key objectives of the European Semester are of ensuring sound public finances and convergence and stability in the EU and thus preventing excessive macroeconomic imbalances.

Following the international crisis, the EU decided in the “more Europe” spirit to implement stronger economic governance and better policy coordination, synchronization and monitoring among member states to improve convergence, stability and other EU objectives, pushing the growth agenda into the background. The ongoing debate on the introduction of common Recovery Bonds—apparently jointly emitted by the European Commission and then given to member countries in need, in part as a contribution and in part as a long-term debt—and accession to the European Stability Mechanism (ESM)—without conditionality for managing the health emergency and up to 2% of each country’s GDP—are fundamental advances that were unimaginable before April 2020. Making fundamental progress under the push of extreme difficulties has been a standard for the EU through its life and the present time is perhaps not an exception. Having to deal on two difficult fronts at the same time—Covid-19 and Brexit—is perhaps leading the EU in the right direction.
The problem is that all these changes are ad hoc and not yet a coherent part of a new visionary EU integration strategy. In November 2018, the European Commission prepared an analysis of the Eurozone economy including an EU Reform Support Programme, a European Investment Stabilization Function and a European Monetary Fund (EC 2018). A subsequent Council of the European Union document on the Eurozone (CEU 2019) and a Commission document on the 2019 European Semester (EC 2019) supplemented these initiatives without reaching an operational agreement. Further progress has been held in abeyance until the Covid-19 problem resolves itself.

The basic principle guiding the construction of a well-ordered MSTL union is that everything not explicitly prohibited in EU treaties should be allowed, if policies do not create negative macroeconomic spillovers. If there are spillovers, compensation should be given according to preestablished and verifiable rules and parameters, guided with a long-term perspective. Alternatively, a joint management of the spillovers should be explicitly part of a long-term management of the common future. If properly defined and managed, these steps could with time evolve in a true MSTL solution. Political debate will be inevitable, but the well-ordered MSTL approach lubricates the integration process, making it more flexible and effective.

Brexit and the health pandemic offer good examples of the method, while the management of the financial crisis offers a mixed perspective. In the former case, the EU was consistently capable of jointly managing a complex process. In the pandemic case, the EU is apparently moving to partially mutualize the negative effects without formally revising treaties. It merely invoked Article 122 of the consolidated version of the Treaty on the Functioning of the European Union stipulating that “Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned.” This is exactly an MSTL approach in the making, waiting for consistent drafting and institutionalization.

The advantages of the orderly MSTL approach are manifold. First, each country would be assigned a clear track, which would give transparency to the process and facilitate compliance. Second, national preferences would be clarified speeding conflict resolution. Third, ailing members would have more time to correct structural problems. Fourth, solidarity would be enhanced. In short, orderly MSTL provide the EU and Eurozone with both sticks and carrots for promoting compliance and cooperation.

8 Conclusions

In spite of its many complexities and negative consequences for both the EU and the UK, Brexit had the merit of warning the EU of its fading appeal and mounting problems. The EU management of the financial crisis was costly and ineffective, although it succeeded in keeping moral hazard at bay. Brexit confronted the EU with the need for changing track and the political possibility to do so. The UK was
for years a powerful and consistent opponent of fundamental reforms, such as the fiscal and capital markets union. Without this internal opposition, it is now easier to proceed with institutional completion of the EU. Other internal opponents, deprived of the UK key role, are now weaker, although not powerless. The Covid-19 pandemic is apparently offering a grand opportunity to proceed.

The essence of the MSTL proposal is that, lacking a political union, the member countries’ institutional and structural idiosyncrasies become part of a new deal in a sustainable win–win perspective. This is particularly important and urgent in the Eurozone, where policy and institutionally based negative spillovers threaten financial stability, depress growth and make intercountry divergences permanent. The way for solving such dangers is to prolong the time horizon of both the EU and member countries and set up credible assessments, guarantees and enforcement against moral hazard through the MSTL cooperative perspective.

Although in the long run, the MSTL perspective would gain from a revision of the treaties, its experimentation and practical use easily fit the present treaties if longer term and learning by doing perspectives prevail. Moving in this direction, also serves to build trust among member countries, an essential ingredient for the success of the perspective.

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