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Phedon A. Nicolaides and Joanna Hornik

The Political Limits of Economic Integration

Economic integration can be beneficial for all participating countries. But after a point, further gains from integration can be achieved only by trading off costs in one policy or sector against benefits in another. In this article we explore the relationship between these trade-offs and their political sustainability. We conjecture that a viable policy is politically sustainable when its benefits to citizens are visible to them. In the longer term, the trade-offs which are required to deepen integration become invisible, at which point reversing the process of integration appears to be in the national interest. We conclude that integration needs to be supported with domestic policies that mitigate the costs of integration borne by some groups or sectors.

The European Union has recently suffered several setbacks, many of them severe: financial instability and the institutional incompleteness of the euro, the UK referendum vote in favour of leaving the EU, deep disagreements on the appropriate response to migration, and the popular opposition to international trade agreements such as the Comprehensive Economic Trade Agreement (CETA) with Canada, the EU-Ukraine Association Agreement and the Transatlantic Trade and Investment Partnership (TTIP) with the United States.

Many explanations have been offered, ranging from voter alienation caused by political elitism to income inequality caused by the negative effects of globalisation. Undoubtedly, these factors have contributed to popular disaffection. In this article, however, we explore a different explanation that goes to the core of the integration process and suggests that there is a limit to the extent to which the economies of independent countries can be integrated.

We argue that in order for economic integration to proceed beyond a certain point, this integration must be based on arrangements which turn out to be politically controversial. It is not just that the achievement of consensus becomes progressively more difficult as integration encroaches into politically sensitive policy areas and challenges entrenched beliefs of national sovereignty. We present a different description of what may actually happen. Accordingly, the bargains that enable countries to cooperate on new policies necessarily involve the packaging of issues and depend on a delicate balancing of negative and positive effects. This packaging creates po-

litical opposition, which over time overwhelms the forces in favour of integration.

The slogan of Brexiters in the run-up to the June 2016 referendum was disarmingly simple and powerful: “Take back control”. How can anyone disagree with such an apparently reasonable exhortation? Yet this slogan begged the question as to why the UK joined the EU in the first place if there was a chance that it could lose control over its own affairs. Many answers have been given over the years, covering a wide range of plausible explanations: the UK was not really aware of the implications of what it signed, the EU has changed significantly since the UK agreed to join in 1972 and has become more centralised, the EU is now dominated by the eurozone, the EU’s economy is overregulated and no longer dynamic, or the rest of the world is now growing faster and offers more trade opportunities. Indeed, the EU may have become a less attractive place to do business.

However, Brexiters appear to have given little thought to how the EU can still impact on the UK even when it formally ceases to be a member. It is not surprising that proposals regarding the relationship that the UK could or should have with the EU in the future have multiplied like mushrooms after the first autumn rain. These scenarios reflect the different expectations of what would happen in the absence of the EU – or in other words, the counterfactual situation of not having common European rules.

Speculation on how the exit of the UK may affect the EU has also been rife. There is no doubt that the future direction of the EU is now less certain. But the impending withdrawal of the UK also poses a deeper and more fundamental question: is the theory of integration in need of substantial revision? The theory has been predicated on models that presuppose mutual benefits. The Brexiters, instead, see costs, stifling regulation, missed opportunities, democratic unaccountability and loss of control over their own affairs.

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Integration, by definition, implies some loss of control and some loss of decision-making discretion. However, this is the *sine qua non* of gaining control over the actions and policies of other countries that affect you. Hence, by itself, loss of control is only one side of the coin and does not tell the whole story. Loss of control is the price that has to be paid for gaining control over the policies of others. Loss of control is a pure cost only when the counterbalancing benefits of the other side of the coin are ignored. We explain in this article that in order to advance economic integration and to benefit from closer policy coordination, it may be necessary to incur such costs. However, the political process that makes such bargains possible also tends over time to obscure or ignore the benefits from integration and focus instead on the cost side.

Therefore, the purpose of this article is to present a model of how policy integration is achieved and then argue that economic and political processes and principles eventually collide. The very process by which countries become better off through integration sets off a political reaction. The model explains why the compromises and trade-offs which are required in order to advance mutually beneficial integration also trigger political opposition. The article concludes by considering a possible resolution of this intrinsic conflict between the economics and politics of integration.

The process of integration: from agreement to implementation to non-compliance

Economic literature describes the stages and necessary components of integration: from free trade areas, customs unions and trade liberalisation to common markets, in which factors of production move freely; this is followed by the harmonisation of specific policies, such as competition, agriculture, trade, and regional development; the final stages are to optimum currency areas and, in the context of the European Union, the evolution of monetary cooperation and integration in Europe.¹ No textbook on economic integration that we are aware of goes into any formal analysis of the counter-forces that may be unleashed by the very process of integration. Nor is there any systematic attempt, apart from indirect or incidental mentions, to consider how politics interacts with economics, with the exception of textbooks which focus on the politics of integration and supranationalism.

¹ See, for example, R. Baldwin, C.R. Wyplosz: *The Economics of European Integration*, London 2015, McGraw-Hill Education; W. Molle: *The Economics of European Integration: Theory, Practice, Policy*, Aldershot 2006, Ashgate Publishing; J. Pelkmans: *European Integration: Methods and Economic Analysis*, Harlow 2006, Pearson Education.

While the various economic models of integration explain why and how countries might decide to cooperate, they rarely explore what happens after an agreement is sealed. They implicitly assume that countries just comply with the agreement.

In fact, the explanation of why cooperation continues, after it is first agreed, is difficult, because in some situations a country may be able to become better off by ceasing to cooperate. Several important elements affect the compliance of member states with common rules: the costs and benefits associated with implementation, the design of the rule itself, the capacity of national administrations to apply the rules, and progressive internalisation of shared preferences. From a theoretical perspective, it is possible that member states agree initially yet later deviate from what is agreed. It is also conceivable that the initial agreement to adopt common rules may contain the seeds of its own self-destruction, as countries realise they can become better off afterwards by breaking the rules while everyone else complies.²

As recent events have shown, neither the existence of enforcement procedures and institutions nor the possibility of penalties will eliminate non-compliance. Scholars, mostly in political science and law, have been trying to identify the underlying causes of the EU's failure to achieve perfect compliance.³ The extreme manifestation of non-compliance is *disintegration*, such as the imminent exit of the UK from the EU. A small but growing literature on disintegration analyses the conditions under which agreements on common markets or policy cooperation collapse.⁴ The fundamental assumption of these studies is that there is a change in the conditions that underpin the initial cooperation agreements. This could mean, for example, changes in market conditions, policy prefer-

² P. Nicolaidis: *The Political Economy of Multi-tiered Regulation in Europe*, in: *Journal of Common Market Studies*, Vol. 42, No. 3, 2004, pp. 599-618, for example, provides an economic explanation of cheating by member states after they agree on common rules.

³ See M. Cremona (ed.): *Compliance and the Enforcement of EU Law*, Oxford 2012, Oxford University Press; E. Versluis: *Compliance Problems in the EU: What potential role for agencies in securing compliance?*, Working paper for the 3rd ECPR General Conference, Budapest, 8-10 September 2005; T.A. Börzel: *Why Do States not Obey the Law?*, paper presented at ARENA, University of Oslo, 6 June 2002; R.B. Mitchell: *Compliance Theory: An Overview*, in: J. Cameron (ed.): *Improving Compliance with International Environmental Law*, London 1996, Earthscan, pp. 3-28.

⁴ See, for example, A. Alesina, E. Spolaore, R. Wacziarg: *Economic Integration and Political Disintegration*, in: *American Economic Review*, Vol. 90, No. 5, 2000, pp. 1276-1296; A. Alesina, E. Spolaore: *The Size of Nations*, Cambridge MA 2003, MIT Press; E. Campanella: *Smaller is Better: Disintegrated Nations in an Integrated Europe*, VoxEU.org, 12 June 2014; M. Schiff: *Multilateral Trade Liberalization and Political Disintegration: Implications for the Evolution of Free Trade Areas and Customs Unions*, Policy Research Working Paper, No. 2350, World Bank, 2000.

ences or public opinion. Consequently, member countries no longer benefit or perceive benefits and, therefore, gain by exiting the agreements. In the model that we develop in the next section, agreements become unhinged not because of any change in underlying conditions but because the very mechanism that makes such agreements possible provokes political opposition. We argue that co-operation cannot simultaneously satisfy certain fundamental principles.

However, the different theories of (dis)integration offer little insight into recent developments. Opinion polls indicate that the public perceives the process of European integration as driven by elites.⁵ The “permissive consensus” has morphed into “constraining dissensus”, where both the decision-making process and policy content are shaped by Eurosceptic public opinion.⁶ The European system of multi-level governance created a gap between the elites and the public, which consequently undermined national sovereignty and identity and ignited a popular backlash. The options for consensus at the EU level have in turn shrunk significantly.

It seems, therefore, that the reversal of the process of European integration is caused by factors which are linked to popular disaffection and reaction to economic upheaval resulting from macroeconomic imbalances in the eurozone and the flawed initial design of the common currency.⁷ Clemm emphasises the importance of social factors that are relevant to explaining disintegration, highlighting the role of “sense of community” in making political integration work.⁸ In this context, disintegration is understood as a failure of the EU to build a democratic socio-political identity similar to that of a nation state. The complex system of “polycentric authority” complicates collective bargaining at European institutions.⁹

In many ways, integration and disintegration are two sides of the same coin – meaning we can view disintegration as a process of erosion of various aspects of European cooperation, be it legal, economic, territorial or socio-cultural.¹⁰ In fact, it has been suggested that trade openness might go hand in hand with political disintegration as markets become more globalised.¹¹ Our goal in this article is to explore in more detail this fundamental conflict between the economics and politics of integration, with specific reference to the European Union. Is there a point after which political opposition overwhelms support for further integration?

To investigate this, we ask two specific questions to explore this apparent conflict. First, under which conditions can member states voluntarily agree on common rules – and continue to respect those rules – especially when the purpose of the rules is to prevent them from harming each other? The answer seems obvious that it is in their self-interest to abide by the rules. Therefore, the second question is why a country that initially agrees with the rules would then decide to withdraw from the framework? The answer is that withdrawal depends critically on the perceived consequences. The likely or imagined counterfactual is decisive. The theoretical framework that is developed below in essence explores the role of the counterfactual – what happens when a common rule or policy is abandoned.

A theoretical framework of integration through policy cooperation

Our model is based on the axiomatic requirement that integration must satisfy three principles – it must lead to economic improvement, it must be politically sustainable and it must be procedurally feasible.

First, the economic principle is that each country must become better off from any agreement to adopt a common rule or policy or to adjust its rules or policies in response to a request from a partner country. Countries are presumed to be selfishly seeking to raise their welfare. Second, the political principle is that the net benefits to each country must be demonstrable, in the sense that they must be visible to citizens. This is what we term “political sustainability”. The third principle is that integration progresses when the first two principles both hold. We will show that in certain situations the first two principles can-

5 H. Best, G. Lengye, L. Verzichelli: *The Europe of Elites: A Study into the Europeanness of Europe's Political and Economic Elites*, Oxford 2012, Oxford University Press.

6 L. Hooghe, G. Marks: *A Postfunctional Theory of European Integration: From Permissive Consensus to Constraining Dissensus*, in: *British Journal of Political Science*, Vol. 39, No. 1, 2009, pp. 1-23.

7 H. Scheller, A. Eppler: *European Disintegration: non-existing Phenomenon or a Blind Spot of European Integration Research? Preliminary thoughts for a Research Agenda*, Working Paper 02/2014, Institute for European Integration Research, Vienna 2014.

8 B. Clemm: *Integration on Trial: EU disintegration is still possible and the theories behind supranational governance offer little guidance*, Oxppl, The Oxford University Politics Blog, 7 January 2013, available at <http://blog.politics.ox.ac.uk/integration-theory-on-trial-eu-disintegration-is-still-possible-and-the-theory-behind-supranational-governance-offer-little-guidance/>. See also K.W. Deutsch et al.: *Political Community and the North Atlantic Area*, New York 1957, Greenwood.

9 J. Zielonka: *Disintegration Theory: International Implications of Europe's Crisis*, in: *Georgetown Journal of International Affairs*, Vol. 13, No. 1, 2012, pp. 51-59.

10 H. Scheller: *We've studied European integration. It's time to examine its flipside – disintegration*, BrexitVote blog, London School of Economics, 12 January 2016, available at <http://blogs.lse.ac.uk/brexit/2016/01/12/weve-studied-european-integration-its-time-to-examine-its-flipside-disintegration/>.

11 A. Alesina, E. Spolaore, R. Wacziarg, op. cit.

not hold at the same time and, therefore, integration cannot proceed or the integration process will be reversed.

Symmetrical cooperation

Assume that we have a two-country world that is made up of country i and country j . Each country decides autonomously on a certain public policy, and each country chooses the nationally optimal level of the policy instrument, X , that is used to achieve the objectives of that particular public policy. Assume that the net benefits (i.e. after total costs are subtracted) from the policy in terms of variable X are given by the function $B = f(X)$. If this function is concave (i.e. $\frac{dB}{dX} > 0$ and $\frac{d^2B}{dX^2} < 0$), the optimum level of X^* is given at the point where the function reaches its local maximum, i.e. when $\frac{dB}{dX} = 0$. At this point, net benefits are maximised.

Further assume that each country ignores the negative effects of its policy on the other country. Let these negative effects be indicated by the function $E = g(X)$, which is convex (i.e. $\frac{dE}{dX} > 0$ and $\frac{d^2E}{dX^2} < 0$). Had each country taken into account these negative externalities, it would have maximised instead the difference between B and E . In this case, the optimum value of X is given by X' , which is at the point where the slopes of the benefit and externality functions are the same, i.e. when $\frac{dB}{dX'} - \frac{dE}{dX'} = 0$ or $\frac{dB}{dX'} = \frac{dE}{dX'}$.

Since E is an increasing function of X (i.e. $\frac{dE}{dX} > 0$), it follows that the benefits at point X' will be smaller than at the local maximum X^* , namely that $\frac{dB}{dX'} > \frac{dB}{dX^*}$ so that $X' < X^*$. This means that if each country is to take into account the impact of its own decisions on the other country, it has to restrain itself and keep its policy instrument below the nationally optimum level.

This implication raises a fundamental question. Why would a country do something which is not in its best self-interests? Benevolence and generosity are not good answers, not just because they arbitrarily close the argument without adding any substance, but more importantly because they contradict the assumption that each country acts to maximise its own benefits. A more credible answer that has often been given in the literature is that there can be reciprocal benefits.¹² An example of this could be that each country agrees to refrain from decisions that harm the other country. Reciprocal self-restraint can therefore benefit both countries.

We now need to derive the conditions that make it possible for countries to agree to cooperate. Let the maximum net benefits before cooperation be indicated by B_i^* and B_j^* , where subscripts i and j denote the two countries. The maximum net benefits when each country takes into account the negative effects of its policy on the other are given by B_i' and B_j' . The net benefits before cooperation are higher for each country than those when the negative effects of one's own actions are taken into account, thus $B_i^* > B_i'$ and $B_j^* > B_j'$. Hence, policy restraint is neither spontaneous nor unilateral. Because it makes each country worse off, cooperation or reciprocal policy restraint has to be agreed, so that each country can be compensated through the policy restraint of the other country, which leads to a reduction in the harmful effects on the first country.

The adjustment of the policy of each country reduces the external harmful effects on the other country from E^* to E' , so that $E_{ij}^* > E_{ij}'$ and $E_{ji}^* > E_{ji}'$, where E_{ij} means the impact of the policy of country i on country j , and E_{ji} means the impact of the policy of j on i .

Therefore, after the agreement to cooperate, the net impact on country i is the difference of the effect from its own policy adjustment (which is negative for country i) and the effect from the policy adjustment of country j (which is positive for country i), which can be expressed as $|E_{ji}^* - E_{ji}'| - |B_i^* - B_i'|$.¹³

Consequently, country i will agree to cooperate only if the net impact is positive, that is, only when $|E_{ji}^* - E_{ji}'| > |B_i^* - B_i'|$. This means that the benefit for country i from the reduction in externalities caused by country j exceeds the loss to country i from adjusting its own policy. In turn, the adjustment by country i benefits country j . Since the same conditions apply to country j , it will cooperate only when $|E_{ij}^* - E_{ij}'| > |B_j^* - B_j'|$.

Under these conditions of a symmetrical net positive impact, it is rather easy to see how cooperation can emerge. This does not mean that net gains must be equal. Equality of gains is not required for cooperation to be mutually beneficial. In fact, cooperation is possible even if gains are unequal in size, as long as the condition of positive net impact for each country is satisfied. In reality, of course, opponents of any deal may use an apparent inequality of benefits to derail a cooperation agreement. But even if benefits are unequal, in principle, it is still in the self-interest of both countries to cooperate.

¹² See, for example, H.G. Johnson: An Economic Theory of Protectionism, Tariff Bargaining, and the Formation of Customs Unions, in: Journal of Political Economy, Vol. 73, No. 3, 1965, pp. 256-283; or E. Fehr, S. Gächter: Fairness and Retaliation: The economics of reciprocity, in: Journal of Economic Perspectives, Vol. 14, No. 3, 2000, pp. 159-181.

¹³ We take the absolute values of the two effects to deduce the absolute net impact of cooperation.

Asymmetrical cooperation

Let us consider now the possibility that only one country gains from cooperation, so that the impact is asymmetric. It follows from the previous section that we define “symmetry” to mean that both countries experience gains in the same policy area which, however, are not necessarily equal. Consequently, “asymmetry” means that gains occur in different policy areas (such gains must occur, however; otherwise we violate the principle of economic improvement).

In order to make the argument more complex, it is useful to simplify the notation. For country i , let $\Delta Ei = |E_{ji}^* - E_{ji}'|$ (i.e. the benefit to i from a reduction of externalities caused by j) and $\Delta Bi = |B_i^* - B_i'|$ (i.e. the reductions in i 's benefits from its own policy adjustment). For country j , let $\Delta Ej = |E_{ij}^* - E_{ij}'|$ (i.e. the benefit to j from a reduction of externalities caused by i) and $\Delta Bj = |B_j^* - B_j'|$ (i.e. the reduction in j 's benefits from its own policy adjustment).

Consider a situation where the positive effect of reduced externalities on country i from the adjustment by country j outweighs the reduction in benefits from the adjustment of country i . This means that country i becomes better off. However, assume that the opposite is true for country j , implying that $\Delta Ei > \Delta Bi$, while $\Delta Ej < \Delta Bj$. In this scenario, country j is not willing to change its policy. This possibility reveals a politically awkward aspect of cooperation in such situations. A country should be more willing to cooperate, the more it is harmed by the actions of the other country. But in reality, country i may not be willing to cooperate with a country like j , which pursues harmful policies.

However, in our model, mutually beneficial cooperation may still be possible. Let the gains of country i from an agreement be $G_i = \Delta Ei - \Delta Bi$ and the losses of country j from the agreement be $L_j = \Delta Ej - \Delta Bj$. If the gains of country i are larger than the losses of country j , i.e. $G_i > L_j$, country i can in principle fully compensate country j through side payments, and both countries can become better off. But this also means that country i compensates country j for the loss the latter suffers when it stops harming country i ! From a political standpoint, one can see how this might prove controversial and may be perceived as encouraging internationally harmful policies.

There is of course the possibility that $G_i < L_j$. In this case, country i cannot afford to compensate country j . Once this limit is reached, where the possibilities for symmetrical benefits are exhausted, cooperation becomes impossible.

Cooperation through policy packaging

This, however, is not necessarily the end of the story. Country i may be able to identify another policy or issue where it creates large external costs for country j . It can then offer to adjust the second policy if country j agrees to adjust the first policy. It can convert the large external costs into large gains for country j . This is what is often called a “package” agreement. A package makes integration possible where benefits are asymmetrical.

“Packaging” of policy adjustments or compromises has two important features. First, the policies which are put in the same package are not necessarily related. For example, the EU Cohesion Fund was established in 1993 in response to Spanish concerns that the creation of the euro would disadvantage peripheral countries. Although formally the Cohesion Fund aims at improving environmental conditions and strengthening connectivity across European regions, the motivation behind it was to alleviate possible negative externalities from the monetary union, which was an altogether different issue. Second, policy packaging is a “compensatory” deal, in the sense that it includes policies which cause harm to the other country, rather than policies from which both countries can reap benefits by cooperating.

Policy packaging is the bread and butter of any negotiation. For example, a version of this packaging approach was hailed as the ingenious solution that facilitated the adoption of the single market programme in 1985-87, involving more than 280 distinct measures.

We argue that the packaging approach works in the short run but creates other problems in the longer run. Let us define the package as containing two policies, indicated by superscripts $''$ and $^{\wedge}$. The reason the two policies are lumped together is that agreement could not be found for at least one of the policies, say the policy that is indicated by $''$. This must mean that the gains from this policy for country i are less than the losses for country j , that is $G_i < L_j$. Country i cannot compensate country j for these losses. However, country i can reduce the losses (or increase the gains) of country j by adjusting policy $^{\wedge}$. For country i to be willing to do that, any losses it suffers from adjusting policy $^{\wedge}$ must be smaller than the gains it can reap from policy $''$, i.e. $L_i^{\wedge} < G_i''$. Similarly, country j would be willing to agree to adjust its policy $''$ only if the gains it can reap from policy $^{\wedge}$ are larger than the losses in policy $''$, i.e. $L_j'' < G_j^{\wedge}$.

If we put these inequalities together, we can see that $L_i^{\wedge} < G_i'' < L_j'' < G_j^{\wedge}$. Although the package deal enables each country to become better off, as they both gain more than

they lose, it also results in an uneven distribution of gains and losses across policies and countries in the same policy area ($L_i^\wedge < G_j^\wedge$ and $G_i^\wedge < L_j^\wedge$). Moreover, since $L_i^\wedge < L_j^\wedge$ and $G_i^\wedge < G_j^\wedge$, losses and gains are also unequal across countries. The next section explores the implications of these kinds of uneven distribution.

The simple model that we developed in this section demonstrates that mutually beneficial symmetrical cooperation reaches a limit at the point where a country can gain from policy cooperation only when it is compensated with adjustments in other policy areas or through side payments. The limit can be overcome through package deals that enable asymmetrical cooperation. But package deals, which break the cooperation deadlock and enable each country as a whole to become better off, necessarily result in an uneven distribution of gains and losses. This uneven distribution can unravel the process of integration because it can violate the principle of political sustainability. The next section explores how asymmetrical benefits may fail to be visible to citizens.

The role of the counterfactual

If one or both of the countries break the above agreement and the package deal falls apart, both countries lose out. When the effects of the whole agreement are taken into account, each country benefits and should therefore stick to it. However, this may not be a robust conclusion if, after the agreement is concluded and implemented, there is pressure to dismantle it from those who perceive that they are on the losing side. It should be recalled that a package agreement necessarily implies losses for some policy sectors. Hence, the demise of the agreement eliminates those losses. For example, those in country i who are affected by policy $^\wedge$ see only gains in the absence of the agreement. The gains in country i are reaped by those affected by policy $^\wedge$. In policy area $^\wedge$, it is those who are in country j who are the net beneficiaries.

Hence, the important question that arises is under which conditions the counterfactual scenario (i.e. the absence of the agreement) would ignore that the country as a whole loses out. To put it differently, under what conditions is the principle of political sustainability violated? As defined earlier, the principle of political sustainability requires that the net benefits of each country must be demonstrable, in the sense that they are visible to citizens.

These benefits may become obscure or invisible over time. Consequently, those who lose out have no reason to believe or expect that a change in their policy or sector would cause a change in another policy or sector. For example, no member state has ever disputed the agree-

ment in the Council to approve the 280 or so single market measures as a package simply because some other member state infringed or misapplied one of those measures in the 30 years since their adoption.

Another example is the Cohesion Fund to which we referred in the previous section. Would abolition of the Cohesion Fund lead to abolition of the euro, even though the former was the condition for the establishment of the latter? The answer is unlikely to be in the affirmative.

This example also highlights the issue of the “irreversibility” of rules. If agreement can be reached only when the “package” contains a sufficient number of diverse policies, some of which are reversible while others are not, then after enough time elapses those who lose out may seek abolition of the reversible rule, safe in the belief that there will be no opposition by those who would be harmed by the abolition of other rules, because such rules are irreversible.

This belief in the stability of the “package” has also been one of the main planks (and an article of faith) of Brexiters who claimed that a UK withdrawal would not cause the EU to change its internal market rules. In addition, the Brexiters have argued that if the EU tried to shut UK products out of the internal market, it would harm itself. Indeed, we saw above that there is always an uneven distribution of losses and gains as, for example, $L_i^\wedge < G_j^\wedge$. If the UK is country i and the EU is country j , then the losses suffered by the UK in policy $^\wedge$ (which are the gains it can reap after it exits and sets its own independent policy) are smaller than the gains of the EU from common rules.

Lastly, and perhaps more importantly in political terms, for those affected by policy $^\wedge$, respecting the agreement because otherwise country j would change its policy “ sounds like blackmail. Country i consents to the agreement because i ’s losses in policy $^\wedge$ are smaller than its gains in policy $^\wedge$. Once country j changes its policy $^\wedge$, the gains of country i will be converted into losses. The agreement must be respected because of fear of the harm that country j can inflict on country i . Politically, this never galvanises popular support.

Impossible conditions: the bargains that make economic integration possible are politically unstable

The last paragraph of the previous section alludes to the fact that there are several other reasons why the arrangements that enable countries to benefit from integration of their economies or policies beyond the limit of reciprocal benefits in the same policy area may be politically untenable. First, the bundling of policies in the same package

in order to compensate for losses can be perceived as blackmail. Indeed, if a country is seen as pursuing harmful policies towards its neighbours, it can be difficult for others to sit with it at the negotiating table and agree to cooperate. Not only will there be concern that the agreement may not be honoured, but there could also be suspicion that the country actively seeks to harm others in order to extract concessions. Giving in to a bully neighbour never goes down well in domestic politics.

Second, the package deals or bargains identified in the previous section make both countries better off. However, although gains outweigh losses for each country as a whole, in some policy areas there are net losses. Whether everybody becomes better off depends on the internal redistribution policies of each country.

If redistribution does not occur, then it is rather obvious that those who lose out will constantly lobby for either compensation or change in policy. But even where it actually occurs, it may not last for long. In practice, a redistribution policy is linked to both taxes on those who gain and subsidies for those who lose out. Because such policies are part of the government budget, they need to be approved every year by parliament, and every year those who pay these taxes will oppose them and those who receive these subsidies will support them. There can be no guarantee that the government of the day will be able to maintain the redistribution policies. As time passes, it may become increasingly difficult to defend old compensatory arrangements.

Third, as also explained in the previous section, the envisaged or imagined counterfactual situation also plays an important role. An opposing group will try to decouple issues in order to minimise resistance to its demands. It will pretend, and it may even come to truly believe, that changing policy to minimise or eliminate the losses it suffers will not undermine the package deal and, by implication, the rest of the country. The counterfactual they present will contain no changes to any other component of the larger bargain. Why, for example, would a Scottish fisherman who supports Brexit in order to get rid of fishing quotas consider that such a move would jeopardise the unimpeded access of the UK's financial services to the internal market?¹⁴

¹⁴ See M. McGrath: UK fishing industry 'will need EU market access' post Brexit, BBC News, 17 December 2016, available at <http://www.bbc.com/news/science-environment-38345826> for a report on the views of Scottish fishermen; and House of Lords, European Union Committee: Brexit: fisheries, 8th Report of Session 2016-17, HL Paper 78, 17 December 2016, available at <http://www.publications.parliament.uk/pa/ld201617/ldselect/ldcom/78/7802.htm> on the impact of Brexit.

A fourth reason is the focus of political discourse, at least in democracies, on equal treatment of all citizens. The essence of the package deal is that in order to reduce the losses in a certain policy area or sector, some of the gains in some other policy area or sector are sacrificed. There is a trade-off. By definition, this trade-off results in unequal treatment. Some are penalised while others are advantaged. Even though society as a whole becomes better off and the welfare increases of some people exceed the welfare decreases of others, this cannot hide the fact that the treatment is unequal and therefore provokes political resistance.

These four reasons suggest that there is a fundamental and probably irreconcilable conflict between, on the one hand, the trade-offs and package deals that enable deeper economic integration and, on the other, political processes and principles. There is a limit to the extent or depth of integration.

There appears to be no perfect method to resolve this conflict. While compensation may be initially necessary, it becomes irrelevant with the passage of time. This is because it cannot be credibly argued that, had the policy not changed, those who lost out would not have suffered any losses due to other changes in the economy. Any compensation must therefore be temporary. Determining the optimum duration of such a temporary arrangement is beyond the scope of this article.

In this connection, a question that arises is whether each country should set up its own compensation fund or whether the fund should be supranational. We saw previously that gains and losses are unevenly distributed across policies and countries because $L_i^\wedge < G_i''$ and $L_j'' < G_j^\wedge$ across policies and $L_i^\wedge < G_j^\wedge$ and $G_i'' < L_j''$ across countries. Should the two countries contribute their net gains $-(G_i'' - L_i^\wedge) + (G_j^\wedge - L_j'')$ to a common fund to help each other?

It makes sense for each country individually to set up its own compensation fund, and it also makes sense for both countries collectively to agree to set up a common fund, because it is in their individual interest to ensure that their partner also take measures that reduce the political vulnerability of whatever agreement is reached. Some member states complain that they pay too much into the EU budget, but their gains from integration far outweigh their net contributions and, if anything, incentivise net recipients to stick with the grand bargain.

However, a collective fund explicitly set up for the purpose of compensation will be subject to moral hazard. How can it be ensured that one or both countries will not try to ex-

aggrate their losses in order to maximise the amount of money they receive from the common fund? Establishing a supranational authority to manage the fund does not resolve the problem. In fact, it creates other problems. As the euro crisis has shown, rules agreed in Brussels are not necessarily respected by national parliaments and any attempt by EU authorities to interfere in national politics has the potential to backfire.

Conclusions

There is a vast literature on integration but not many contributions on disintegration. The analysis in the few contributions that exist is based on the assumption that underlying economic conditions or policy preferences change. If they change to a large enough degree, then exiting a customs union, common market or policy area generates net benefits.

This article has argued, instead, that policy disintegration may paradoxically be caused by factors which are intrinsic to the arrangements that facilitate integration in the first place. It is reasonable to expect that cooperation emerges first where there are large benefits and little or no costs – i.e. the low-hanging fruit of integration is picked first. But a limit is soon reached when gains cease to be symmetrical. Beyond this limit, deeper policy cooperation, especially where national interests are asymmetrical, can proceed only through package deals which bundle disparate policies so that overall gains can outweigh overall costs.

However, package deals are vulnerable to politics. This article has identified several reasons why such package deals may be undermined and agreements may be unravelled by political opposition from the groups that lose out. Packages can violate the principle of political sustainability. The very arrangements that enable deeper policy integration also unleash opposition and make it easier for opponents to scupper agreements. This political opposition presents a barrier to what can be achieved through economic integration that seeks to maximise net benefits for the country as a whole.

There are no perfect solutions to this conflict between the economics and politics of integration. Having national compensation funds can help. But compensation can only be temporary. Another solution is the establishment of a supranational fund that can even out benefits and costs across countries. But a fund of this kind would also be vulnerable to moral hazard and prone to disagreements between those who manage the fund and those who contribute to the fund or receive assistance from the fund. Nonetheless, the inevitable conclusion is that economic and political integration should be coupled.