CER **Bulletin**

Issue 99 | December 2014/January 2015

Ukraine after the elections: Democracy and the barrel of a gun

By Ian Bond

What should an energy union cover?

By Nick Butler

Free movement: Why Britain does not need to change the rules

By Camino Mortera-Martinez

CENTRE FOR EUROPEAN REFORM

Ukraine after the elections: Democracy and the barrel of a gun

by Ian Bond

Ukraine has lost control of parts of its industrial heartland, as well as Crimea. The question is whether there will now be a government in Kyiv that can make a success of the rest of the country. There are reasons for concern.

The good news is that most of Ukraine voted for a new parliament on October 26th. Pro-European parties backing President Petro Poroshenko and Prime Minister Arseniy Yatsenyuk won a majority of the 423 seats contested (which excluded occupied areas). More than 900 international observers monitored voting; they described it as "an amply contested election that offered voters real choice". The Russian Foreign Minister, Sergey Lavrov, said grudgingly that the elections seemed to be valid, though not in every part of Ukraine.

The first piece of bad news is that Russian forces and their local proxies did not give Ukrainians in the occupied parts of Donetsk and Luhansk regions the chance to cast a ballot. Instead, on November 2nd the separatists organised sham elections in the self-proclaimed statelets. These polls were criticised by the EU, the US and the Organisation for Security and Co-operation in Europe. The Russian foreign ministry, however, said that Russia respected "the declaration of the will of people in south-eastern Ukraine".

About 15 per cent of the Ukrainian population lives in the areas Russia controls (or used to live there – the UN estimates that the conflict has created over 900,000 refugees or internally-displaced persons). Ukraine, while asserting its territorial integrity *de jure*, is effectively challenging Russia to take responsibility for these areas: on November 15th, Poroshenko ordered state institutions in the occupied territories, including schools and hospitals, to close, and banks to cease operations. Poroshenko's action is understandable: he could not control what was happening in the area. But he risks consolidating the division between the self-proclaimed Donetsk and Luhansk 'People's Republics' and the rest of Ukraine.

The second piece of bad news is that the potential coalition partners are wrangling over the composition of the government, including which party should fill the important posts of interior minister and finance minister. The president's 'Petro Poroshenko Bloc' has the most MPs, with the prime minister's 'People's Front' as runner up. Between them they have 214 seats, a narrow parliamentary majority. Important reforms such as devolving powers to the regions will require constitutional changes, for which 300 votes are needed. So coalition talks include three smaller parties (including the far-right 'Radical Party', which argues for Ukraine to have nuclear weapons).

What Ukraine needs, immediately, is a competent government with honest ministers, rather than one designed to divide the spoils among its constituent parties. The coalition parties should sink their differences and install a government based on ability and integrity rather than party affiliation. For most of the last two decades Ukraine was a case study in post-Soviet poor governance. The new government must do better. Fighting the corruption for which Ukraine has been famous will demand both government transparency and effective law enforcement. An EU mission will start work on December 1st on police and judicial reform; the EU should also attach advisers to ministries and agencies to help them combat corruption.

The third problem is a collapsing economy. The European Bank for Reconstruction and Development forecast in September that Ukrainian GDP would fall by 9 per cent this year and a further 3 per cent in 2015; meanwhile inflation will rise from minus 0.3 per cent in 2013 to 11.8 per cent this year. The current account deficit is undergoing a forced correction, from 9.2 per cent of GDP last year to 2.5 per cent in 2014, through a painful contraction in imports. The value of the hryvnia has fallen by almost 50 per cent this year, making imports impossibly expensive.

In theory, the devaluation of the currency should help Ukrainian exporters. Unfortunately, the Russian market, which absorbed around a quarter of Ukraine's exports in 2013, is now effectively closed; and as long as much of Ukraine's heavy industry in the east cannot operate, Ukraine's export potential will be limited.

The Ukrainian government cannot cope without international help. The $17 billion (€14 billion) IMF package and the €11 billion mixture of EU grants and loans agreed earlier in the year are insufficient. Yields on Ukrainian government bonds are over 18 per cent, with investors assuming a high probability of default. A senior American official suggested recently that Ukraine would need an extra $10-15 billion in 2015 alone. The US itself has been niggardly, giving around $1.3 billion in loan guarantees and grants; both Washington and its international partners need to do more for Ukraine to have a chance of succeeding. The EU should not have delayed implementation of its association agreement with Ukraine under Russian pressure. It should now do everything possible to accelerate Ukraine's convergence with EU standards and regulations. Then Ukraine can re-orient its economic ties westwards (as Georgia did, successfully, after its war with Russia in 2008).

Finally, the ceasefire agreed in September has broken down. According to NATO, Russian forces and equipment are again crossing Ukraine's border. The Russians' aim may only be to consolidate their hold, and perhaps straighten out some 'kinks' in the front line (for example by taking the town of Shchastya, home to a power plant supplying almost all the Luhansk region's electricity, or they may intend something more ambitious, such as capturing the port city of Mariupol and the rest of the coastline between there and Crimea (which is proving hard to supply by ship from Russia). Poroshenko has said that Ukraine is prepared for a "scenario of total war" with Russia; but in reality, while Ukrainian forces could certainly inflict large-scale casualties on attacking forces, they could not resist an all-out invasion from better equipped and more numerous Russian forces.

> *"What Ukraine needs is a competent government with honest ministers, not one designed to divide the spoils."*

So far, Western leaders have refused to do much to increase Ukraine's military capability, hiding behind the mantra that "there is no military solution" to the conflict, and suggesting that arms supplies might encourage Kyiv to think that there is. But as long as Ukrainian forces are so much weaker than Russian forces, there is indeed a military solution: outright Russian victory. The best way to deter further Russian advances is to help Ukraine with equipment, training and intelligence, so that the domestic political cost of victory for Russia, in casualties incurred, becomes prohibitively high.

'Realist' commentators like Henry Kissinger often assert that Ukraine matters more to Russia than to Europe or the United States. A strong case could be made, however, that the success of Ukraine matters more to the West than it does to Russia. The EU and NATO would be better off with a prosperous, stable nation of 45 million people next door, rather than a corrupt, unstable economic basket-case. The West should be prepared to invest in achieving the right outcomes by both strengthening the government-controlled parts of Ukraine and preventing Russia from further demolishing the country.

Ian Bond
Director of foreign policy, CER

What should an energy union cover?

by Nick Butler

The events of the last year, and in particular the risk that the fighting in Ukraine could jeopardise Russian energy supplies to Europe, have highlighted the absence of a co-ordinated European energy policy. Donald Tusk, the incoming president of the European Council, has talked of the need for an 'energy union'. What kind of policy co-ordination should European leaders undertake?

The basic facts are clear. The European Union is importing an increasing proportion of its energy, as output from mature oil and gas fields in the North Sea declines. Oil can be bought on the international market, but the Union has become dependent on imports of Russian gas, which now meet a quarter of our daily consumption. The gas reaches Europe through a series of pipelines, two of which run through Ukraine.

> *"Attitudes to one form of supply or another can owe more to emotion and history than to economics."*

Securing gas supplies is not, of course, the only issue at stake in the European energy market. There are Europe-wide targets to reduce emissions, improve efficiency and increase the share of renewables, which were recently extended to 2030. The European Union also aims to keep energy affordable. However, European competence in the area of energy is limited. There is no common energy policy and the pattern of supply and demand is the product of 28 distinct national policies. So what might an energy union mean and how might it advance the three goals of security, cost competitiveness and environmental protection?

It is important to start with a dose of realism. Countries' choices about energy supply often transcend rational economic calculations. Attitudes to one form of supply or another can owe more to emotion and history than to economics. No European directive is going to make Germany reverse its decision to close its nuclear power stations by 2022, or remove the overwhelming opposition to the technology of 'fracking', which can produce oil and gas from shale rocks, in France and Bulgaria. Nor are we likely to see common European energy prices, not least because energy taxation is such an important source of national government revenue. In the UK 80 per cent of the price of every litre of petrol goes to the government in taxes.

In addition, different countries hold different natural resources, and widely varying requirements for imports. The United Kingdom is still a significant producer of oil and gas, even if the volumes have fallen. Poland is still a major coal producer. Many of the other countries in Central and Eastern Europe have limited local energy supplies and rely on imports, often imports of gas and electricity from Russia. Donald Tusk, when Polish prime minister, argued that Europe should create a single buyer to match the market power of Russian exporters. But the pattern of trade across Europe is too complex for that. If the European Union created another centralised structure, it would not change that reality.

An energy union will therefore have limitations but could still be valuable. In at least three ways, a rational co-ordination of policy could give us all a more secure, cleaner and lower-cost energy supply system.

The first role is to link what we have already. Most of the energy systems across Europe, along with patterns of ownership and regulation, remain strictly national in scope. The most recent European Council set an objective that, by 2030, 15 per cent of the installed electricity production should be linked across borders. The scale of the aspiration seems limited compared to the potential. Last May the European Commission published a long list of potential projects that could usefully develop cross-border links. These included physical projects such as linking the southern Italian grid to the north of the country and onward, or a link over the Pyrenees between Spain and France. Under a working energy union, such links should be the norm rather than the exception.

An integrated distribution network, combined with a diversity of sources of supply, is clearly the most effective means of achieving energy security. If we had that, European countries could continue to trade with Russia – if it made economic and political sense – but would know that, if things did go wrong, alternative sources of gas and alternative pipeline networks were always available.

The second role is to establish a new pan-European grid with the capacity to transmit power across the continent from multiple sources. A so-called 'super grid' would enhance security but also enable us to better use power from areas in surplus. It cannot be efficient or cost effective for every one of the 28 member-states to maintain their capacity at the level necessary to meet peak demand. A super grid, which has in the past been backed by the German government, could be built step by step, starting with the plans for a new grid around the North Sea. A super grid would help to open markets to competition and to keep prices down. If European leaders are really serious about the notion of using infrastructure investment to drive economic recovery, a modernised grid would be a good place to start.

The third role for an energy union is to invest in the research necessary to transform the system as a whole. The EU's plans for reducing emissions by means of carbon pricing and emissions trading, conceived six years ago, have not succeeded. The carbon price (the cost of having the right to emit one tonne of carbon dioxide) is proving insufficient to prevent a resurgence of – low cost, but high carbon – coal use. Renewables may be growing in scale – at a high cost – but their benefit in terms of reducing emissions is being offset by increasing use of coal.

> *"A rational co-ordination of policy could give us all a more secure, cleaner and lower-cost energy supply system."*

An energy union could be a very useful way of focusing collective funds on the important research objective of finding a source of power which is both low cost and low carbon. One option, on which some initial work is being done in the United States, is to find a way of storing electricity efficiently. If successful, that would transform the economics of renewables – allowing much more power generated from the sun and the winds to be captured and used. Effective storage would also remove the problem of intermittency, which at the moment means that expensive back-up systems have to be in place to provide cover when wind and solar are unavailable. Why should Europe, with its extensive scientific base, wait for the US to find the answer?

An energy union should not mean centralisation and uniformity. Different countries will continue to pursue various policies. Such diversity is a good thing, not a problem. The EU's role should be to enhance security, cost competitiveness and emissions reductions in ways which individual countries cannot achieve on their own.

Nick Butler
Visiting professor and chair
King's Policy Institute, King's College London

Free movement: Why Britain does not need to change the rules

by Camino Mortera-Martinez

Now that the European Commission, Germany and other member-states have made clear that they will not accept quotas or 'emergency brakes' on EU migrants, British Conservatives are looking again at limiting their access to benefits. As this bulletin went to press, David Cameron was preparing a major speech on the issue. But he will find it very hard to achieve significant changes to the rules on benefits.

A recent ruling of the European Court of Justice (ECJ) in the *Dano* case seemed to offer encouragement to Britain. The ECJ confirmed the right of the German authorities to refuse unemployment benefits to a Romanian citizen who had no history of work in either country. Many Conservatives hope this means that the EU institutions will not block reforms to reduce EU migrants' access to welfare. They are probably wrong: the court merely upheld a 2004 directive (the 'citizens directive') that already limited migrants' access to benefits.

Free movement has never been an unconditional right. EU law offers a number of tools to control intra-EU migration and prevent abuse of welfare systems. In the past, the ECJ has tended to expand the scope of free movement rights, particularly for non-active migrants. The *Dano* ruling may be a sign that the Court is reacting to growing national concerns over free movement and national welfare systems.

The 'citizens directive' gives EU citizens the right to live in another member-state for more than three months, but only if they are employed, studying or economically self-sufficient. In the latter two cases, they must have health insurance. Once these conditions are met, EU citizens have the same rights as nationals of the host country. In turn, those migrants who become an "unreasonable burden" (a term undefined in the directive) on the welfare system of the host country can be denied benefits. Member-states are allowed to expel those EU citizens who do not fulfil the conditions for legal residence.

EU law prohibits flagrant abuses of social security systems. These abuses are, in any case, vanishingly small in number. Neither the CER nor the European Commission can find much evidence of 'benefit tourism' in the UK – the idea that migrants head for the UK because of its welfare system. And a new study from University College London has found that immigrants from the EU – including from Central and Eastern Europe – were net contributors to the public purse, a finding that has been replicated in other member-states.

Various Conservative MPs and think-tanks have suggested that benefits should not be granted to EU migrants for a period of two to three years, either by amending existing EU laws or by proposing new ones. But the chances of other member-states and the EU institutions agreeing to such a reform are very low. It might require treaty change, if the denial of in-work benefits were to amount to discrimination between workers from different member-states, which is prohibited by the treaties. If that were the case, such a change would require the unanimous agreement of all 28 member-states.

Even if the UK could find reforms that would not require treaty change, the reform would still need to go through the EU's legislative procedure. The new or amended legislation would need to be proposed by the Commission and approved by a qualified majority in the Council (at least 15 member-states representing 65 per cent of the European population) and by the European Parliament. In the unlikely event that the UK convinced 14 other member-states to support reform, it would still need to persuade both the European Commission and the Parliament that such a change was needed. Given the lack of evidence supporting the claim that EU migrants are bad for the UK's economy, and the strong stance taken by the EU institutions in defence of free movement, this would be difficult. Existing EU legal safeguards against the abuse of welfare systems would also weaken the case for reform.

Further limitations to the rights of EU migrants are unnecessary and may well be politically unfeasible at the European level, however popular they would be with some Britons. They are also not in Britain's interest. There are many retired British citizens living in Spain or France who enjoy free access to healthcare, paid for by their host member-state. If Britain were to push for measures to delay or limit benefits to EU migrants, the UK taxpayer would probably end up bearing the cost of healthcare for British pensioners abroad.

The UK should learn the right lesson from the *Dano* ruling, and stop blaming Brussels for problems which can and should be solved at the national level. EU laws, which the UK agreed to adopt, allow member-states to prevent abuse of the benefits system. Britain could exercise closer oversight of EU migrants by, for example, establishing a compulsory register for EU citizens. The majority of member-states use such registers to check that EU migrants fulfil the necessary conditions and that they are not a burden on the welfare state. Those not meeting the requirements could be expelled.

Free movement is a cornerstone of the internal market, which the UK has traditionally championed. Hostility to EU migration has become the most salient issue in British politics, despite evidence of its positive economic impact. But ultimately, Britain has to face up to reality: the only way to stop EU migrants entering the country is to leave the EU, with all the economic and geopolitical damage that entails

Camino Mortera-Martinez
Research fellow, CER

CER in the press

Financial Times
19th November 2014
"Sweden has done an experiment the whole world is interested in," Christian Odendahl, chief economist at the **CER** says. "What should we do when monetary policy should be accommodative but there are financial risks? The Swedish lesson is that tightening policy prematurely isn't the answer."

Wall Street Journal
11th November 2014
The [ECJ's] judgment is "a good thing for the UK and northern European countries who have been pressing for more action on the benefits question," said John Springford, senior research fellow at the **CER**.

The Telegraph
25th October 2014
The **CER** has estimated that membership of the EU increases Britain's trade in goods by around 30 per cent and has also warned that an exit would endanger exports. Europe currently accounts for around 54 per cent of Britain's total trade.

The Guardian
24th October 2014
Charles Grant of the **CER** says Britain's former allies are "in despair. They want to help us, they want us to stay in [the EU] – but the [British] brand is increasingly toxic."

Bucharest Forum
24th October 2014
Ian Bond, director of foreign policy at the **CER** said that "Russia has tried to block the open regional approach that the EU has taken through the Eastern Partnership".

The Guardian
17th October 2014
Stephen Tindale, associate fellow at the **CER,** argued in a September report that "inefficient fossil fuel subsidies" needed to be stopped in Europe, in line with a G20 commitment made in 2009.

The New York Times
7th October 2014
"After going along with the damaging strategy of austerity in the hopes that Germany would eventually moderate its position, countries are now saying, 'Enough is enough. We're going to have to act to arrest the downward spiral in the economy,'" said Simon Tilford, the deputy director of the **CER**.

Financial Times
30th September 2014
"I have never known Berlin more annoyed with France," says Charles Grant, the director of the **CER**. "Seen from Berlin, Hollande has wasted two years achieving virtually no structural reform and failing to rein in spending."

Recent events

László Andor and Simon Tilford

3rd – 4th October
CER conference on 'Is Europe's economic stagnation inevitable or policy-driven?', Ditchley
Speakers included: Joaquín Almunia, László Andor, Paul Tucker, Richard Portes, Jean Pisani-Ferry, Andrea Enria and Charles Goodhart

8th October
Keynote speech on 'Smart climate and energy policy', London
With Alexander Stubb, prime minister of Finland

Alexander Stubb

Carl Bildt and Kemal Derviş

17th – 19th October
CER-EDAM conference 'The 10th Bodrum Roundtable', Turkey
Speakers included: Carl Bildt, Enrico Letta, Ghassan Salamé, Klaus Welle and Kemal Derviş

11th November
Breakfast on 'The UK's place within the European Union', London
With David Lidington, minister of state for Europe

David Lidington

Forthcoming publications

State aid and energy
Stephen Tindale

The EU, Russia and sanctions
Jennifer Rankin, Christian Odendahl and Ian Bond

The strategic implications of a deal with Iran
Rem Korteweg

Can Cameron keep Britain in the EU?
Charles Grant

To read all of our recent publications please visit our website.

For further information please visit
www.cer.org.uk