Giuseppe Bertola

The Single Market and Common Policies in Uncommon Circumstances

KEY MESSAGES

- **Markets can deliver growth but need help from government provision of infrastructure, regulation, stabilization, and redistribution**
- **In the 20 years since the 10th anniversary of the Single Market, growth in Europe has remained relatively slow**
- **Two deep crises revealed underlying problems and prompted the introduction of new instruments in the European policy framework**
- **The market currently faces dramatic challenges from war and international tensions and suffers from the effects of subsidy-and-debt policies that persist after the Covid-19 pandemic**
- **Deep divisions across and within member countries and between Europe and the rest of the world unfortunately hamper efforts to coherently configure European policies**

In the midst of the turmoil spurred by the aftermath of the Covid-19 pandemic, the Russian invasion of Ukraine, and worries about climate change, January 1, 2023, marked the 30^{th} anniversary of the elimination of border controls within a large economically integrated area.

The anniversary of this key step in the implementation of the European Single Market program is an opportunity to look back as well as forward – to take a step back from the confusion of the current, disconcerting situation and to discuss more generally what the Single Market was supposed to do, what actually happened, and how policy may help it function. To organize these thoughts, the developments over the intervening 20 years will be compared to the analysis and recommendations of a voluminous and widely cited report published on the occasion of the Single Market's 10^{th} anniversary by request of European Commission President Romano Prodi (Sapir et al. 2004, accessibly summarized in Sapir Group 2005).

LOOKING FORWARD FROM THE PAST

That report, issued in July 2003, argued that a well-regulated European market is crucial for achieving the European Union's objectives of cohesion, stability, and especially growth, since improvements in living standards are key to preventing a political backlash against economic integration.

The voluntary exchange of goods, services, and production factors benefit all parties involved. It lets the market deliver efficiency and economic welfare. Europe's market integration since the 1950s was also meant to foster ties between nation states so as to prevent continental wars of the kind that broke out twice in a century since the Treaty of Westphalia.

The market is in fact a social and political construct that relies on communication and trust as well as on governments that view it as a common good for all and do not try to distort it for the benefit of some. Governments must provide a public infrastructure consisting not only of physical roads and marketplaces but also of product standards, legal enforcement, and payment systems, and they must implement policies that control the instability and inequality that an imperfect market inevitably generates.

This is unusually difficult in the European Union (EU), with its many national and supranational public decision-makers and their different objectives and time horizons. The most obvious aspects of this problem are addressed by the EU's policy framework, which assigns most fiscal policy choices to member states but prohibits state aid that, by tilting the playing field, would prevent the market from delivering growth efficiently.

The Sapir report proceeded to outline whether and how the EU policy framework could deliver growth. The need to do so was then evident as per capita GDP had stagnated since the mid-1970s at about 70 percent of that of the United States, an integrated economy comparable in size and development level. This stagnation followed 30 years of gloriously fast growth in Europe after World War II and had not ended upon implementation of the Single Market. It was reasonable to wonder whether this was the result of a failure to adapt the national welfare and labor market policies implemented in the 1970s to new circumstances, where growth would have to derive from innovation and market dynamics rather than from the adoption of techniques developed in the United States. There was a hope that stagnation in times of economic integration could end in the aftermath of the then-recent adoption of the euro by many member countries, addressing obvious and long-standing "one market, many monies" coherency issues (Padoa-Schioppa et al. 1987).

Giuseppe Bertola

is Professore di Economia Politica, Università di Torino, and Socio Corrispondente, Accademia delle Scienze di Torino.

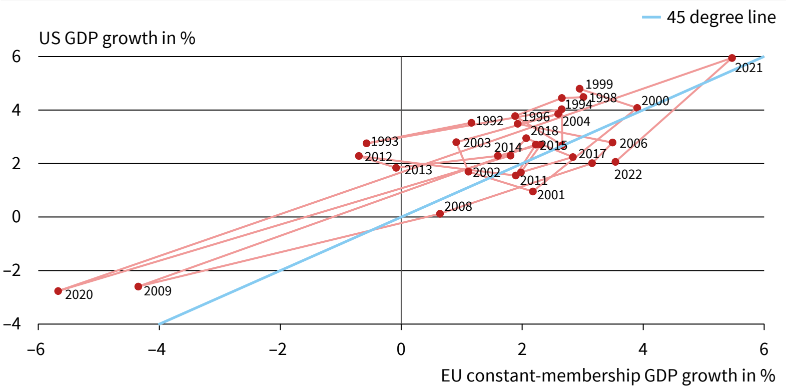
However, it would have been naïve to expect this to happen automatically.

The Sapir report argued that to facilitate adoption and implementation of growth-enhancing policies the EU policymaking framework should itself be reformed. Its suggestions were many and detailed, but the main recommendation was to refocus the EU budget on common challenges and implement an effective growth-oriented policy package, conditioning disbursement of EU funds on a suitable administrative capacity and the fulfilment of specific objectives.

GROWTH?

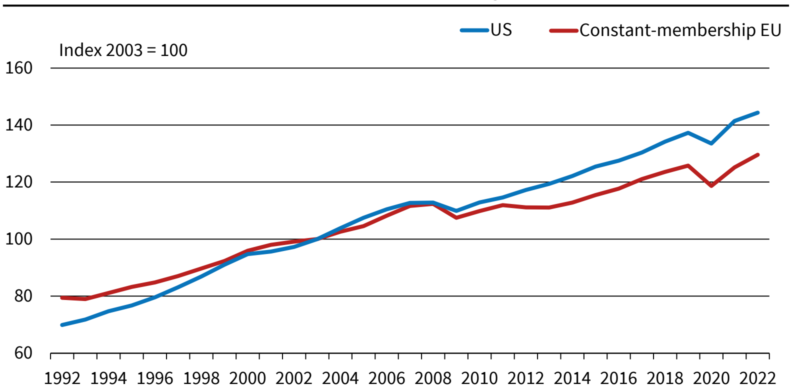
Before comparing those recommendations to what the member countries and the EU chose to do in the two decades that followed, it will be interesting to see whether their motivation is still valid by assessing the growth performance of the EU against the same American yardstick. Since 2003, thirteen countries joined the EU and one left it (the United Kingdom in 2020). What is interesting is the EU's growth rate at constant membership, computed as the weighted average of growth rates between year t-1 and t of countries that are in the EU in year t. No such adjustment is necessary for the US, which did not experience any accession or secession during this period.

Figure 1
Annual Real GDP Growth Rates in the EU Compared to Those in the US



Source: World Bank. © ifo Institute

Figure 2
Cumulative Real GDP Growth from Growth Rates in Figure 1



Source: World Bank. © ifo Institute

Figure 1 plots annual growth rates of real GDP in the EU against those in the US. Most observations are above the 45˚ line, indicating that – much more often than not – growth was faster in the US than in the EU. Figure 2 shows that from 2003 to 2022, the EU's constant-membership growth cumulates to about 30 percent, while the US GDP grew by 44 percent. Much of this is due to population growth, which in the US is always faster than in its EU constant-membership counterpart, and in the last 20 years has cumulated to about 10 percent for demographic reasons and because of net immigration (it is worth noting that the Covid-19 pandemic caused a small population decline in the EU but not in the US, where many more deaths were quickly made up for by immigration). But per capita GDP relative to that of the US declined to about 4 percentage points below the 70 percent plateau it had reached in the 1970s. The growth deficit that motivated the Sapir report's analysis and recommendations not only persisted but deepened.

UPS AND DOWNS

It is sobering to consider how much has happened in the past two or three decades. In 1993, we did not have the internet or cell phones. In 2003, we had cell phones and knew EU enlargement to the East was coming soon, but neither smartphones nor social media had arrived yet, and we certainly did not expect that unprecedented crises would hit Europe every ten years or so.

Those events interacted with the Single Market and with the more or less common policies that can help it function. Europe did well with cell phones, aiming since 1987 to reach a common standard: the GSM cellular network introduced in Finland in December 1991 strengthened competition on an integrated and level playing field and was adopted worldwide (Pelkmans 2001). The Single Market has also helped European citizens in many other ways, but here it is instructive to discuss briefly how the EU policy framework dealt with the two deep crises, visible as sharp spikes in Figure 1.

THE EU AND THE GREAT RECESSION

The Great Recession of 2008–09, when GDP fell by about 3 percent in the US and by more than 4 percent in the EU, highlighted problematic aspects of the EU policymaking framework and brought some changes to it. A demand-driven recession called for classic Keynesian macroeconomic stabilization policies. The US was able to deploy a market-wide federal fiscal policy against the Great Recession in the US and enjoyed a quicker recovery, while the EU experienced national public debt crises that prolonged the slump. The crisis could have been worse if the EU economy had not been as integrated as it was in 2008: even though free capital mobility sowed the seeds of instability and of a prolonged financial crisis during and after the Great Recession, reversible exchange rates would have triggered much more dramatic instability. Things could have been better, however, and the experience led to the creation of the European Stability Mechanism and stimulated innovative ideas, at least on paper, such as the "Convergence and Competitiveness Instrument" for supranational funding of reforms proposed by the European Commission (2012).

PANDEMIC EVOLUTION OF THE EU

The EU policy framework also evolved very significantly during the Covid-19 pandemic recession of 2020, which triggered even deeper falls of GDP and called for a different type of policy responses, aimed at redistributing the negative aggregate shock rather than at sustaining an aggregate demand that supply restricted by lockdowns could not satisfy. Financial markets and banks could not directly channel the savings of individuals who continued to work but did not have opportunities to spend to support consumption by individuals who could not perform in-person services. Fiscal and monetary policies were necessary to mediate that resource transfer: government deficits subsidized consumption by out-of-work individuals with the savings of those who purchased public debt, or accumulated deposits that in the banking system's balance sheet was the counterpart of public debt.

Crises make the pros and cons of policies much clearer, and the European policymaking framework adapted quickly to introduce a set of new common policy instruments intended to help rather than constrain the member countries' policies. The Support to mitigate Unemployment Risks in an Emergency (SURE) low-interest EU loans that fund member countries' schemes aimed at preserving employment, and the vast Next Generation EU (NGEU) program for recovery, resilience, and climate and digital transition expenditures are broadly consistent with key recommendations of the Sapir report.

In some respects, however, they are less germane to those recommendations. One is that EU spending relies on off-budget borrowed funds (Begg 2023). Another is that they tend to shape economic choice with off-market mechanisms. Many markets of course ceased to function during the pandemic, which however damaged the Single Market also through the Temporary Framework's suspension of state aid rules. The damage is perhaps more permanent because policymakers and electorates became addicted to nonstandard policies that were appropriate in the emergency situation, but persisted in the aftermath of the pandemic. Peculiar fiscal and monetary policies provided useful redistribution and relief in exceptional pandemic circumstances, and it is tempting to continue using them when, as is normal, guaranteed minimum incomes reduce labor supply, and monetary expansion cannot generate demand for underutilized production factors without increasing prices. Deficits feed public debt, which has to pay high interest rates when unexpected inflation has eroded its real value and the wealth of individuals who saved during the pandemic. Short-time wage subsidies like those funded by SURE fostered stability during the pandemic, but hamper reallocation and adjustment in less dramatic circumstances, and the debt-financed subsidies deployed to pursue worthy NGEU goals reduce the growth of market incomes.

AFTER THE PANDEMIC, WAR

An unfortunate victim of the latest crisis is one of the cornerstones of Europe's post-war project: the idea that market connections could replace royal marriages as the way to integrate diverse economies and complicated decision-making processes without conquest by blood and steel. Russia was well integrated into world markets, but was not deterred by the threat of sanctions, and feared that its trade with Ukraine would decrease if it had to cross the enlarged EU's borders. Economic integration can at most move the boundaries of war to those of well-integrated economies rather than of nations, and war can be prevented only by the expectation that trade will continue (Copeland 1996).

Trust in markets prevents war, but loss of faith in markets triggers both military and economic war. In 2023, Europe and the world find themselves in that unfortunate equilibrium and an unusually turbulent and precarious situation. Interest rates are no longer near zero, and economies face real resource constraints. To cool the environment of future generations and produce missiles that replace those sent to Ukraine, citizens must consume less now, as they will if inflation erodes the purchasing power of their wages. The real cost of transitions and military buildup would be large if funded by efficient taxation of free market exchanges. It must be huge when the market resembles a battlefield more than a playing field, and dirigiste and protectionist inefficiency reduce the welfare of the average citizen, if not that of subsidy recipients. War is highly profitable for a select few, and the same is true of industrial policy.

POLICY CONCLUSION

Looking ahead from 2003, the key policy issue for Europe was "how to enjoy the benefits of [further] globalization while continuing to mitigate its costs" (Sapir et al. 2004). Looking ahead from 2023, Europe will need to manage the decline of globalization without forsaking growth, cohesion, and stability.

It will not be easy – for two related reasons. One is that the crisis brought new common policies to Europe, but also shifted policymakers' focus away from the well-regulated market interactions that can deliver those objectives. The EU no longer lacks policy instruments, but still needs to use them in pursuit of the common good, helping markets deliver the growth needed to satisfy citizens and service the debt accumulated in the crisis. The other is that pursuing long-term objectives with coherent policies is very difficult when policymakers face unprecedented challenges and electorates feature unusually deep divisions.

This is of course a global problem. The US is at least as deeply divided as most European countries between the educated and uneducated, the residents of globalized cities and of rural provinces, and more or less recent immigrants. Culture and economic circumstances vary at least as much within as across the sharp policy borders of countries, and within as well as across countries, debtors and creditors have different opinions about inflation and interest rates. The problem is particularly important and difficult in a European Union that has grown large, heterogeneous, and disunited in many respects. Russian aggression could bring Europeans together and make them realize that they should share markets and policies for the common good, as the Swiss did when the 20th century's World Wars prompted the introduction of federal income taxes to fund military expenditures (Bertola et al. 2014). Unfortunately, however, there is much to disagree about when the market and its flanking policies are viewed not as a common good, but as a weapon. Disagreements about economic policy abound along political lines that are to some extent reflected in European Parliament coalitions of national parties with relatively homogeneous green policy preferences and market friendliness and are difficult to reconcile in the Council, where governments represent unstable majorities and adopt shortsighted perspectives on single issues that typically require unanimous decisions.

Across and within countries, policy choices are not supposed to be easy, but must be clear and farsighted. Populist politicians like to put their nations first, to take without giving, and blame the market and European policies for all country-specific misfortunes. Of course, the integration of markets and policies cannot always benefit all countries and individuals at all times. However, it should be viewed as a feature of the European politico-economic landscape that is permanent, and as the only possible way to sustain growth in a long run where ups and down balance each other out over time. In recent decades, countries in the EU took turns to be sick, as did the states within the US. For example, Italy is commonly pitied for its dismal growth since 1993, which can be explained by the failure to adjust its specialization when the Single Market and globalization deprived portions of its manufacturing sector of their Northern European customers who, could procure textiles and shoes from the Far East more cheaply (Andersen et al. 2019), by accumulation of public debt that had bad implications during and after the Great Recession, and marginally by an early and devastating Covid-19 epidemic followed by a robust recovery spurred by tourism and NGEU investments. And Germany in 2003 was still struggling with its unification and beginning to reform labor and welfare policies, a natural politico-economic reaction to capital outflows toward the EU periphery triggered by the Single Market (Bertola 2016). At the time, German policy problems seemed dire indeed (Sinn 2007), but somewhat ironically, Germany was saved by the Great Recession, when production declined sharply but only briefly as temporary layoffs limited employment losses, then recovered quickly as growth resumed in emerging countries and the euro was weak against the US dollar and the Japanese yen. Loss of trade with Russia and China now deprives Germany of what boosted its economy after the Great Recession.

The Single Market is still incomplete, especially in the service sector. Some of the NGEU national investment and reform programs aim to improve the physical and legal infrastructure that benefits all market participants. But much current policy deploys dirigiste and protectionist subsidies, which are prone to lobbying efforts and can hamper growth by obstructing market-driven adjustment within and across national borders. Unfortunately, they are an equilibrium choice for all countries in the absence of such supranational coordination as the prohibition of state aid in the Single Market. Europe as a whole feels a need to respond to US and Chinese moves, and EU member countries are more or less inclined to do so at the national level: history makes Germany less comfortable with the current dirigiste and protectionist policy climate than France, which lets its government spend over 60 percent of GDP and justifiably views itself as an international nuclear power.

Agreement and compromises are elusive but needed. To try and achieve them it is essential to remember that the market brought us cell phones from Finland, and smartphones designed in the US and produced in Asia. If the West denies Dutch advanced chipmaking machinery to China, which swiftly embargoes exports of chipmaking materials, those chips cannot be produced anywhere. If voters and policymakers realize that it is impossible to produce everything in a small country or region, with suitable focus and some luck it may be possible to restore the fragile trust that keeps international markets open, and perhaps even treat migration as an opportunity rather than a threat. Otherwise, nothing will prevent the return of earlier eras of isolation, cold or overt war, inflation, and slow growth.

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