MARKETS, GOVERNMENTS, AND CRISES IN THE PAST AND FUTURE OF THE EU

The common-market project, that after World War II aimed to prevent future wars among European Nations, evolved through crises into a complicated and unstable set of European Union policies and institutions. The COVID-19 pandemic and the war in Ukraine reinforced coordination and added common debt issuance to the supranational policy toolkit. But the NextGenEU program relies heavily on government subsidies rather than on market incentives, and Russia's invasion of Ukraine shows that economic integration can at most move the boundaries of war to those of the integrated economic area, rather than of Nations. These developments weaken the crucial role of integrated markets as the principal instrument for growth, cohesion, stability, and peace in Europe.

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Pandemics, Wars, and Nations in European History

Like viruses and bacteria in biological organisms, pandemics and wars trigger reactions in socio-economic structures. Decades of economic growth and political reorganization followed the 14th century Black Death epidemic in Europe and World War II, which also triggered the integration process that developed into the European Union (EU).

Market integration aimed to remedy the shortcomings of the Nation-State model which was introduced a few centuries ago to complement the industrial revolution's internal markets, urbanization, and factory work with large governments engaged in social protection, cultural assimilation, and military administration. Each Nation-State naturally tended to be autarchic, draw a sharp distinction between citizens and potential enemies, and wage war on other Nation-States. French and German attempts to extend the Nation-State model to the Continental scale, which was achieved in the United States and Russia, were unsuccessful in the 20th century Europe.

Believing that economic interdependence would make wars more damaging and more difficult to wage, hence less likely to occur, the designers of the post-war European economic integration progressively removed barriers to trade and factor mobility. What is now the EU has expanded across Europe much like Empires did, but adopted market integration rather than war as the way to reach its continental size. Economies of scale and specialization made it possible to achieve economic growth objectives, but economic integration was also a key to political objectives.[1] In the aftermath of World War II, the original six members chiefly wished to prevent future wars. Accession had important implications for Spain, Portugal, and Greece's commitment to democracy after dictatorships; and EU membership had similarly obvious political implications for the formerly communist countries of Central and Eastern Europe.

When the markets integrate before governments, it is necessary to prevent governments from distorting markets in pursuit of National objectives. Economic integration was mostly "negative" in the eyes of national interests and it deprived governments of some traditional prerogatives in order to provide their markets with a well-regulated and even playing field.[2] Centrally mandated and homogeneous product standards were as crucial as the prohibition of industrial policy and state aid; which might let inefficient producers backed by their governments, displace

[1] André Sapir, Philippe Aghion, Giuseppe Bertola, Martin Hellwig, Jean Pisani-Ferry, DariuszRosati, José Viñals, Helen Wallace, Marco Buti, Mario Nava and Peter M. Smith, *An Agenda for a Growing Europe - The Sapir Report* (Oxford: Oxford University Press, 2004).

[2] Fritz Scharpf, "Negative and Positive Integration in the Political Economy of European Welfare States," in Martin Rhodes and Yves Mény (eds) *The Future of European Welfare* (London: Palgrave Macmilla, 1998): p.157-177.

lower-cost producers and increase production costs in an integrated goods market.

Aspects of "positive" integration, whereby traditional Nation-State competencies are reassigned to the supranational policy level, lagged behind and evolved mostly through crises. Policies were reassigned from member countries to the European level only when the shortcomings of Europe's supranational politico-economic framework became apparent and threatened its very existence. Enforcement of competition policies by the Court of Justice was introduced after the 1975 "wine war" between France and Italy. The Single Market Program and free capital mobility brought about exchange rate crises, and triggered adoption of a single currency. The European Stability Mechanism financial facility was introduced as a response to the financial and sovereign debt crises of the 2000s.

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Policy Consequences of COVID

Like reactions to infection in human bodies, reactions to pandemics in societies can be dangerous: immune system reactions can kill an infected body, desperation and riots can destroy a society. And, just like how a long stay in an intensive care unit can permanently weaken a human body; the emergency policies that avoid desperation and riots can inflict long-lasting damage.

Governments had an essential role to play when the pandemic made it impossible for many workers to perform in-person services. They needed support from the savings of those who continued to work and did not have opportunities to spend, but interpersonal credit contracts are obviously difficult to stipulate and enforce. Fiscal and monetary government policies can usefully mediate the appropriate interpersonal and intertemporal transfers of resources. Through public debt directly, or via banks' balance sheets, government deficits and the very low interest rates implied by expansionary monetary policy allowed the savings of those who could not consume their unchanged income to support the consumption of individuals out of work.

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impact of epidemics is asymmetric. For the same reasons that make private lending and borrowing difficult within an economy; across countries that participate in tightly integrated markets, fiscal and monetary policy can more effectively smooth out the uneven economic consequences of the crisis when deployed jointly. In an integrated market, capital can fly to less risky assets, and self-fulfilling expectations of default can make it difficult to issue National public debt. This is especially for countries that export tourist services who suffered greater income losses and also happened to be already more heavily indebted than Northern consumers of tourism. Issuing common debt has the same coordination advantages as joint vaccination procurement, which prevents individual countries' competing bids from raising vaccine prices for all. Both encounter resistance from countries that feel frugal or fear opportunistic behavior, and both were possible in the pandemic.

The COVID-19 experience has not improved the EU in other respects. The virus weakened the European organism's economic integration not only by triggering occasional trade barriers for personal protective equipment and eliminating international tourism and labor mobility, but also by relaxing supranational State Aid coordination and public deficits constraints. The Temporary Framework For Aid Measures To Support The Economy adopted in March 2020 suspended EU state aid and competition regulation, allowing an unprecedented volume of country-specific subsidies, and does not appear particularly temporary: as in October 2020 it was extended to June 2021, in January 2021 to 31 December 2021, and in November 2021 to 30 June 2022.

The resulting tilt of the playing field may not have materially affected markets when they were essentially shut down by lockdowns. But the pandemic's structural implications require a medium-term reallocation of resources that should be guided by economic incentives.[3] Government policies may easily become excessively intrusive and poorly coordinated, and hamper the market's role in reallocating resources in response to an economic shock of unprecedented magnitude.

Joint EU debt funds international redistribution as well as the recovery, resilience, and climate and digital transition expenditures in the NextGenEU framework. The market and competition ingredients of the European integration recipe are also largely missing from that plan. The Just Transition Fund and Digital Europe Programme target their objectives by vast subsidy programs that need not ensure appropriate reallocation of investment and labor towards growing sectors. Markets may indeed fail to invest appropriately when there are important network and environmental externalities, as there are in digital infrastructures and carbon emissions. Nevertheless,

[3] Torben Andersen, M., Giuseppe Bertola, Clemens Fuest, Cecilia García-Peñalosa, Harold James, Jan-Egbert Sturm, and Branko Uroševic, "Beyond the Corona Crisis: Investing for a Viable Future," *EEAG Report on the European Economy* (Munich: CESifo, 2021).

when investments are decided by bureaucrats and politicians rather than by markets, and when policies are shaped by myopic electoral goals, they may boost current incomes instead of future output. Carbon taxes can certainly steer market incentives towards environmental objectives. Electric-car subsidies may also do that, and target objectives in the distant future, but certainly steer income towards designers and producers of electric cars.

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Like any medicine with dangerous side effects, economic policies should be administered with caution, and those that were appropriate in the crisis can be damaging in its aftermath. Monetary and fiscal macroeconomic policies prevented dangerous downward spirals during lockdowns, but they were not correcting a temporary demand-driven recession. Productivity is lower when markets cannot be efficient, and pressure on central banks to keep interest rates low on large public debts may easily result in high inflation, as it did in in the 1970s when macroeconomic policies and regulation failed to address structural problems.

Subsidies paid to firms and workers that produce goods and services not in demand do not increase the future income and tax revenues needed to service public debt. Financing investment subsidies with public debt is appropriate if that investment generates future income and tax revenues, but growth depends not only on the quantity, but also on the quality of investment. It is politically attractive to pursue climate and digital objectives with subsidies financed with public debt and subject to lobbying pressure but setting appropriate carbon taxes and allowing markets to choose the investments that minimize tax burdens would be preferable from the economic point of view.

New Policies, New Politics, New Wars

Not only government policies, but also political and labor market conditions are

influenced by the pandemic experience. Free and effective vaccines and vast subsidy programs foster an impression that government can be powerful and useful. Workers, especially "essential" ones, have similarly established relevance and legitimacy in the public's and their own eyes. Their withdrawal from the labor force and demands for higher wages and better working conditions contribute to supply-side shortages and inflation after the pandemic and may persistently change the socio-economic structure of European and other advanced societies.

There are traces of the shock induced by local variation of the 14th century Black Death labor shortage in contemporary German election results.[4] In the aftermath of the COVID-19 pandemic, labor shortages are caused not by death, but by subsidies that made it apparent that work need not always be a prerequisite of spending and consumption. Such political factors underlie plans for minimum wage regulations at the EU level that, like interventionist industrial policy instruments, counter the traditional market orientation of European integration patterns.

Empowering governments and workers, the COVID-19 pandemic triggered policy changes that persist in its aftermath. In 2022, unexpected inflation not only redistributes resources away from those who during the pandemic saved and purchase public bonds, but also prevents the workers subsidized by those bonds during the pandemic from earning higher real wages during the recovery. It results from supply constraints, but also from continuation of the fiscal and monetary policies that during the pandemic provided useful redistribution and relief.

Those policies resembled those advocated by modern monetary theory and universal basic incomes.[5] Proponents of modern monetary theory argue that any unemployment can and should be eliminated by monetary expansion, but tend to forget that unemployment and underutilized resources occur naturally in conditions of imperfect competition and limited information. Proponents of a minimum income guarantee emphasize its favorable distributive implications, but tend to disregard its disincentive effect on labor supply through income effects. Those concerns were not relevant in exceptional pandemic conditions, but the efficacy of non-standard policies in extraordinary times can make them persist when low employment and productivity, and pressure on central banks to keep interest rates low on large public debts, result in high and persistent inflation.

[4] Daniel Gingerich and Jan P. Vogler, "Pandemics and Political Development: The Electoral Legacy of the Black Death in Germany," *World Politics*, Vol. 73, No. 3 (2021): p. 394-440.

[5] Philippe Van Parijs, "Basic Income: A Simple and Powerful Idea for the Twenty-First Century," *Politics & Society*, Vol. 32, No. 1 (2004): p. 7-39; N. Gregory Mankiw, "A Skeptic's Guide to Modern Monetary Theory," *AEA Papers and Proceedings*, Vol. 110 (2020): p.141-44.

Well-organized markets are crucial to economic progress, as should be apparent after experiencing lockdowns when lack of opportunities to buy and sell considerably reduced economic welfare. The pandemic gave more power to governments, deemphasizing markets. Democratic politics and fair market competition may or may not continue to keep at bay totalitarianism and war, which in the many decades since World War II have not come to Western Europe's increasingly integrated economic area. Ukraine's invasion by Russia reinforces that tendency, adding more debt-financed government spending, further State Aid as the Temporary Framework is extended to allow compensating firms for the cost of high energy prices, and more inflation to that caused by relief policies and supply constraints during and after the COVID pandemic.

A possible consequence of Russian aggressiveness is more cohesion in the EU. The 20th century's World Wars prompted Switzerland to introduce federal income taxes to fund military expenditure, long before establishing an internal single market and welfare state at the beginning of the 21st century.[6] Outside threats may similarly let Europeans overcome their cultural differences and share not only markets, but also military expenditures, and economic policies. Like joint vaccine procurement, a common approach to energy imports can keep its price lower than it is when Europeans compete for its monopolized supply.

However, economic integration can at most move the boundaries of war to those of the integrated economic area rather than of Nations. Russia was well integrated in world markets but was not deterred by the threat of sanctions, also because Ukraine-Russia trade opportunities would be reduced by the EU's enlargement to that border. While trust in markets is supposed to prevent war, loss of faith in markets makes war an almost logical tool for conflict resolution: equilibria featuring war and autarky remain possible alongside better equilibria with integrated markets and no war. Just like an equilibrium where fears of default trigger default becomes possible when the ratio of government debt to income is high,[7] so a wider range of problems admits an equilibrium where war is their solution when National protectionism reduces the extent to which war disrupts trade and reduces welfare.

As security concerns let self-sufficiency trump efficiency objectives, integrated markets are no longer the focus of EU policies they have been in past experience. If the EU's Single Market is a victim of the recent pandemic and war, the future configuration of the EU might yet differ substantially from that which has ensured some stability, cohesion, growth, and peace in Europe since World War II.

[6] Giuseppe Bertola, John Driffill, Harold James, Hans-Werner Sinn, Jan-Egbert Sturm and Ákos Valentinyi, "Switzerland: Relic of the Past, Model for the Future?" *EEAG Report on the European Economy* (Munich: CESifo, 2014): p. 55-73.

[7] Harold L. Cole and Timothy J. Kehoe, "Self-Fulfilling Debt Crises," *Review of Economic Studies*, Vol. 67, No. 1 (2000): p. 91-116.