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EUROPEAN UNION, PANDEMICS, AND WARS

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ABSTRACT

Economic and social crises like those experienced in 2020-2022 are familiar from earlier European experiences. What is now the European Union originated in a common-market toolbox in the aftermath of World War II. It evolved through crises into a complicated and unstable set of policies and institutions. The COVID-19 and war in Ukraine reinforced policy coordination and added a novel common fiscal facility to that supranational policy framework, but renewed emphasis on governments and subsidies threatens the crucial role of integrated markets as the principal instrument for growth, cohesion, stability, and peace in Europe.

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1. Pandemics and wars

The pandemics that long before 2020 struck Europe had economic as well as physical causes. The 6th century plague that struck the Eastern Roman Empire just when Justinian had managed to restore order and prosperity to the Mediterranean (Rosen 2007) was facilitated by the Late Antiquity Little Ice Age climate change episode and by large-scale migration from inner Eurasia towards Europe and China. Trade moves diseases as well as goods, and the 14th century Black Death similarly struck Western Europe when the Pax Mongolica had boosted its commercial economy.

The consequences of pandemics are also economic as well as biological, and different in different societies. Contagious diseases make individuals ill and sometimes kill them. Epidemics weaken societies that produce

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less when lockdowns and social distancing hamper market interactions, and may break down in riots and wars. Just like some individuals and some of their organs are more seriously harmed by viruses, so pandemics damage more severely some societies and some of their segments. Justinian's Plague caused some 25 million deaths in Europe, but did not affect the isolated Arab nomads who in the following decades conquered large swathes of the Roman, Persian, and Indian territories where germs more easily infiltrated more complex and productive webs of urban interactions.

Like viruses and bacteria in biological organisms, pandemics trigger reactions in socio-economic structures. Decades of economic growth and political reorganization followed the Black Death, and World War II also triggered the integration process that developed into the European Union (EU), and aimed to remedy the shortcomings of the Nation-State model 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.

Like epidemics, wars are more or less likely to break out in human societies with different politico-economic structures. Each Nation-State naturally tended to be autarchic, to draw a sharp distinction between citizens and potential enemies, and to wage war on other Nation-States. French and German attempts to extend the Nation-State model to the Continental scale it was achieving in the United States and Russia were unsuccessful in Europe. What is now the EU expanded across Europe much like Empires did, but adopted market integration rather than war as the way to reach a size and scope adequate to increasingly important economies of scale in production, and to achieve growth, stability, and cohesion objectives (Sapir *et al.* 2004).

2. Union in markets

Believing that economic interdependence would make war 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. Markets were integrated before governments, so it was necessary to prevent governments from distorting markets in pursuit of National objectives. Economic integration was mostly "negative": it deprived governments of some traditional prerogatives in order to provide markets with a well-regulated and even playing field (Scharpf 1998). 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 lower-cost producers and increase production costs in an integrated goods market. Like doping in sports, such behaviour is best forbidden because if every country tries to give a competitive advantage to its producers none will succeed, and much tax revenue will be wasted.

Aspects of "positive" integration, whereby traditional Nation-State competencies are reassigned to the supranational policy level, lagged behind and evolved mostly through crises. When the shortcomings of Europe's supranational politico-economic framework became apparent and threatened its very existence, policies and politics were reassigned from the member country to the European level. 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.

In many European countries, if not in Germany and Russia, the yearly average deaths caused by COVID are comparable to those caused by World War II. In 2020-2022, COVID-19 killed about 150,000 Italians; in 1940-1945, the war killed 457,000. The death of a few tens of thousands of individuals does not destroy an advanced economy and democratic society. But like reactions to infection in human bodies, also in societies reactions to pandemics need not effectively fight the epidemic, and may have long-term negative consequences: immune system reactions can kill an infected body, desperation and riots can severely damage or destroy a society; and just like a long stay in an intensive care unit can permanently weaken a human body, the emergency policies that avoid desperation and riots can permanently weaken a society.

3. The economic consequences of COVID

To share appropriately the negative economic impact of the 2020 pandemic, individuals who during lockdowns could not perform in-person services needed to be supported by the savings of those who continued to work but did not have opportunities to spend. Working individuals might have financed idle individuals directly, or through banks, but interpersonal credit contracts are obviously difficult to stipulate and enforce, and personal credit is technically difficult to manage even for banks.

Fiscal and monetary government policies can 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 cannot easily consume their unchanged income to support the consumption of individuals out of work.

Consumption needed to be lower on average, but powerful governments could and did even out consumption across individuals affected asymmetrically by the aggregate shock. Subsidies or tax forgiveness, are appropriate for producers of nondurable goods and services: barbers and restaurants will not supply in the future the haircuts and meals foregone during lockdowns. Publicly guaranteed loans are appropriate for producers of durable goods, such as cars that will be purchased after a lockdown, or of services that, such as legal or dental work, are delayed but not permanently suppressed.

4. What does not kill you…

During the pandemic, monetary and fiscal policies were not meant to increase aggregate demand, but to relieve and redistribute the economic consequences of the pandemic shock. The COVID-19 crisis has not broken the EU, and like previous crises has added useful elements to its awkward mix of integrated markets and national policies.

As in wars that some lose and some win, so in epidemics the economic impact 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 for countries that, like those that export tourist services, suffered greater income losses, and also happened to be already more heavily indebted than Northern consumers of tourism.

Unless one views governments as Leviathans and all their policies as wasteful, common policy frameworks are preferable to uncoordinated country-level policies that inefficiently distort market interactions. 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 too frugal or are too opportunistic to accept them, but the pandemic made it possible to issue joint EU debt to fund subsidies as well as the recovery, resilience, and climate and digital transition expenditures in the NextGenerationEU framework.

Transfers can help preserve the common market, a European public good (Andersen *et al.* 2020: 26). Joint debt repayment can also address issues arising from the EU's freedoms of movement, which allow not only investors but also workers to move out of highly indebted countries, escaping burdensome labour taxes and pension contributions. This can trigger damaging race-to-the-bottom policy tensions. For example, countries that generously finance the education of medical doctors also pay them lower salaries, but cannot continue to do so if their graduates have the option to move to countries where salaries are higher. To the extent that the common debt issued in the NextGenerationEU funds education or welfare and is repaid in proportion to future income, it automatically transfers future resources from countries that offer high incomes and attract migrants to countries where low incomes induces outmigration. This gives stronger incentives for each country to fund policies that are assigned to them but, because national borders do not restrain market interactions, benefit all single market participants (Andersen *et al.* 2021: 49).

5. A stronger EU?

The COVID-19 did not improve 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 labour 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. (Andersen *et al.* 2020: 23), and does not appear particularly temporary, as in October 2020 it was extended to June 2021, in January 2021 to December 31, 2021, and in November 2021 to June 30, 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 (Andersen *et al.* 2021: 55). 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.

The market and competition ingredients of the European integration recipe are also largely missing from recovery plans. The Just Transition Fund and the Digital Europe Programme target their objectives by vast subsidy programs that need not ensure appropriate reallocation of invest-

ment and labour towards growing sectors. More investment is needed, but if its allocation is decided by bureaucrats and politicians rather than by markets it easily tends to preserve existing jobs rather than to boost future income and welfare. Increasing expenditure on education and subsidizing development of electric airplanes may improve human capital and the climate in the more or less distant future, but need not do so because money, while necessary, is not sufficient to solve reallocation problems (Andersen *et al.* 2021: 47). Public spending certainly helps teachers and aeronautical engineers now, however, and need not improve future prospects if policies are politically supported by myopic objectives.

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. Past decades offer many other cautionary examples of the dangers of not accepting market discipline, such as those of countries that in the 1980s did not restructure their economies to exploit opportunities offered by international economic integration (Andersen *et al.* 2019), and of short-sighted populist backlashes in the aftermath of the Great Recession (Andersen *et al.* 2022).

Common issuance of public debt does improve the EU's policy framework, but public debt may appear to be a costless solution even when it really is expensive, and not a solution. Funding is necessary, not sufficient to solve 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.

6. New policies, new politics

Not only government policies, but also political and labour 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 labour 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 labour shortage in contemporary German election results (Gingerich and Vogler 2021). In the aftermath of the COVID-19 pandemic, labour 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 may partly explain electoral shifts towards leftist parties in Germany and Italy, as well as in Chile and other Latin American countries, and marginally in the United States. They also 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.

Giving more power to 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 expansionary fiscal and monetary policies. During the pandemic that policy stance provided useful redistribution and relief, rather than a Keynesian aggregate demand boost. Their resemblance to universal basic incomes and modern monetary theory, and their efficacy in extraordinary times, can make them persist when more normal circumstances would call for more orthodox policies. Low employment and productivity, and pressure on central banks to keep interest rates low on large public debts, can only result in high and persistent inflation.

7. War and Nations, again

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. 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. The pandemic gave more power to governments, deemphasizing markets. 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 desirable 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 (Bertola *et al.* 2014). 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 (Cole and Kehoe 2000), so a wider range of problems admits an equilibrium where war is their solution when protectionism gains political favour in Nationalistic electorates and 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 be very different from the one that since World War II ensured peace and some stability, cohesion, and growth.

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