Will the Role of Governments in the Economy Change after the Crisis?

Will the role of governments in the economy change after the Covid-19 crisis, and if so how? During the crisis, governments did much to protect the economy, supporting households, job matches, and firms. This was accompanied by soaring budget deficits and extremely expansionary monetary policy. Governments also restricted individual freedoms in an unprecedented way. Overall, government intervention increased massively during the pandemic. Some people argue that governments should also take a more active role after the pandemic, at least for a longer phase during the economic recovery.[1]

For instance, in his book on politics after the pandemic, Gerbaudo (2021, p. 250) claims that "the public has increased its acceptance of the need for greater government interventionism beyond what was already considered necessary in light of the upcoming climate emergency." Others object that weaknesses and deficiencies of government responses to the pandemic reflect limited effectiveness of the public sector in general, suggesting that devoting more resources to it may be counterproductive. At least, governments would need to change before they can be trusted to play a more important role in the economy. Of course, one could also argue that the situation is so special and different that it does not have any implications for the future of government.

How did governments perform during the crisis? This question is not easy to answer because there is no obvious benchmark. Still, performance can be compared across countries, and outcomes can be compared to what citizens expected. From a political economy perspective, the perception of citizens of whether governments performed well is likely to be an important factor affecting the role of government after the crisis.

Next to the performance of governments during the pandemic, the future role of governments will also depend on other consequences of and lessons drawn from the crisis. First, public debt has increased considerably, limiting the financial resources available to governments in the future. Second, the disruption of international trade and supply chains and the lack of critical medical supplies like masks and ventilators in certain countries in the early phase of the pandemic is sometimes presented as a reason to foster autarky and roll back globalization and international trade. From this perspective, governments are expected to take measures to secure the availability of critical medical supplies in future health crises. Given that we do not know the type of crisis we will face in the future, achieving this is not easy. In addition, the view is widespread that governments should take action to foster the resilience of supply chains more generally. Of course, this raises the question of why companies should not be trusted to do what is necessary in this field.

Third, the idea that many companies and even entire sectors need support to restart their activity has given rise to the idea of "building back better," suggesting public support for the recovery should steer the economy towards more sustainability, in particular decarbonization. The European Green Deal reflects this view. But it is also a concern that exaggerated views on what governments can accomplish can lead to inefficient policies and stifle adjustment and growth.

At the same time, economic challenges which existed before the crisis have not gone away. Demographic change and the aging of the population reduce the potential for future economic growth and put severe pressure in particular on the European welfare states. The digital transformation of the economy implies deep structural change. The Covid-19 crisis has underscored the importance of digitization as a factor not just for productivity but also resilience. In key areas of the digital economy, especially in consumer platforms, but also in areas like public sector digitization and data sharing, Europe is lagging behind. Improving in this key area will be a high priority on the post-crisis policy agenda.

In the global economy, the rise of China and other emerging economies implies that the relative weight of the EU will decline. Increasing geopolitical conflicts between the USA and China raise the question of how Europe can protect its interests and whether it will have to choose one of the two sides, implying a collapse of cooperation with the other.

What does this imply for the future course of economic policy and the economic role of governments in Europe? These are very broad questions, and providing a comprehensive answer would be beyond the scope of this report. Instead, the contribution of this chapter is to analyze a number of issues which are important for this debate. In the next section we briefly discuss how previous crises affected the political landscape and the role of government. We also compare the Covid-19 crisis to the financial crisis and the Eurozone debt crisis. In Section 3 we take a closer look at the performance of

[1] Stiglitz (2021) puts this as follows, mostly with a view to the role of government in the US: "Beyond the public health aspects of recovery, there are multiple roles the government can fill, especially when it comes to fixing problems that the market cannot resolve on its own." , ibid, p.5.

governments during the Covid-19 crisis in different policy areas and the implications for their future role. In the subsequent sections we turn to two key economic policy areas and how the crisis may affect the way in which they will be addressed: public finances and labor market policy.

4.1 HOW DID PREVIOUS CRISES AFFECT POLICY-MAKING AND THE ROLE OF GOVERNMENTS?

In a discussion about how the Covid-19 crisis will affect the role of governments in the economy, it is natural to consider the experience with previous crises. In the past, deep economic crises have often had a profound impact on the economy as well as on the political climate. Fortunately, pandemics are relatively rare events. Jorda et al. (2020) have analyzed the economic consequences of pandemics. Most of the pandemics they considered happened centuries ago. Pandemics caused by the black death, the plague, or the cholera usually have had a very high death toll, leading to a scarcity of labor after the pandemic. As a result, rates of return to capital and land rents declined while wages increased. Politically, pandemics often led peasants or workers to ask for an extension of their rights.

In more recent decades, economic crises often took the form of financial crises. There is a growing literature on the political consequences of financial crises.[2] The years after financial crises are often characterized by high policy uncertainty, political fractionalization, and polarization. In many cases this goes along with growing political support for right-wing populist parties. A possible explanation is related to the slow pace of the economic recovery. It is plausible that policy uncertainty delays the economic recovery. At the same time, the causality may run both ways – if economic hardship persists, it is likely that trust in the ability of governments to overcome the crisis erodes and political polarization and support for populists intensifies. This is related to the more general issue of government performance. If citizens have the impression that the established political actors manage the crisis badly, they may turn to parties who challenge the political mainstream.

The global financial crisis of 2008, which was followed by the Eurozone debt crisis, confirms this pattern. As mentioned in Chapter 3 of this report, there was a strong increase in support for populist political parties after the financial crisis. Although the Covid-19 crisis differs from the financial crisis and the Eurozone crisis in many respects, it is interesting to compare the two with respect to their likely political consequences in Europe.

In the financial crisis, the prevailing perception was that greed, fraudulent behavior of financial elites, and a lack of appropriate regulation of banks and financial markets triggered the crisis. A large part of the financial help provided by governments went to banks, who had caused the crisis in the first place. This was seen as unjust. Unsurprisingly, this led to a backlash against a type of capitalism where banks and financial products seem more important than the rest of the economy.

The Covid-19 crisis is a natural disaster. It is not perceived as the result of flawed institutions or greed. The debate about the causes of the pandemic does include theories about the possibility that the virus was released by accident or on purpose from a laboratory, but the credibility of these theories is limited. There is also a debate about overpopulation and the destruction of wildlife habitat as potentially causing growing risks of pandemics. But overall, the Covid-19 crisis is primarily perceived as a natural disaster which happened without anyone being directly "responsible" for it.

Another difference is that, in the Covid-19 crisis, government support went primarily to small businesses, freelancers, and employees, not to banks. In Europe, many employees benefited from furlough schemes, rather than losing their jobs. Government support therefore enjoys broad political support. Maintaining it while the crisis lasts is hardly called into question. There are demands that the financial burden of this support should be borne by well-off taxpayers or by those who benefited from the crisis.[3] There is also critique that some of the support goes to companies or individuals who are wealthy enough to survive without support. But this debate is not nearly as critical as the debate in the financial crisis about billions of taxpayer money going to those who were perceived as being responsible for the crisis – the banks and their creditors and owners.

Moreover, the Covid-19 crisis affected the daily lives of virtually the entire population. Everybody had to reduce social contacts and travel, wear masks, and follow stay-at-home orders. The public health crisis underlines the importance of the common good for the wellbeing of each individual citizen. At the same time, it shows that all citizens bear responsibility for the common good.

The financial crisis, in contrast, left the impression that the economic problems can be solved with money, and the debate is primarily about who pays the bill – inevitably a zero-sum game. Since collapsing banks and their managers could not be forced to foot the bill, the crisis left behind a general feeling of injustice and fraudulent behavior by the financial elites.

These differences suggest that resentment against elites and anti-capitalist backlash, which played an important role after the financial crisis, are less likely after the Covid-19 crisis. This is despite the fact that, economically, the Covid-19 crisis also affects people very differently.

[2] See Funke et al. (2021) and the literature cited there.

[3] See the discussion in Ayaz et al. (2021).

As far as Europe is concerned, it is interesting to compare the Covid-19 crisis to the Eurozone debt crisis. The Covid-19 crisis was seen as a shock coming entirely from the outside. It was not perceived as a crisis caused by policy errors or "bad behavior" of individual countries or governments. This was an important factor explaining that the European countries showed some solidarity in financial terms and agreed to create the recovery fund Next Generation EU, which provides financial support to the economically weaker EU member states. This was based on a narrative about solidarity in times of need and a common interest in avoiding a deeper economic crisis in the poorer or more highly indebted countries.

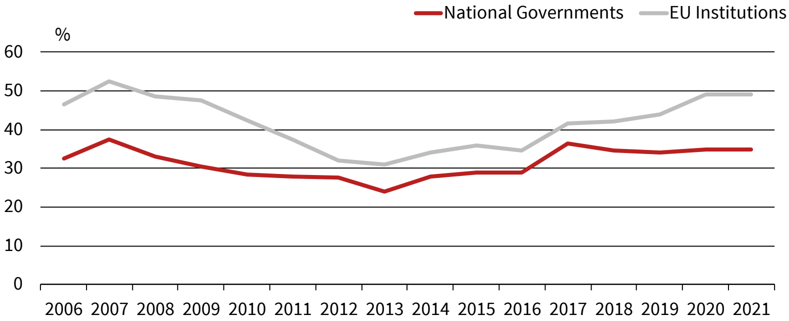
The Eurozone debt crisis, in contrast, was deeply divisive. It pitched the highly indebted "periphery" countries against the less indebted "Northern" countries, in particular Germany. What made things worse in terms of generating a divisive narrative was the fact that the crisis started with the revelation that Greek public debt statistics were incorrect. From the beginning, the perception prevailing in the Northern countries was that the mostly Southern European periphery countries had caused the crisis by violating fiscal rules by overborrowing in the private as well as the public sector and by neglecting structural reforms to boost productivity. The periphery countries, in turn, saw themselves confronted with a crisis of confidence, much of which was triggered by the financial crisis that had its origins in the US. They suddenly saw themselves confronted with a situation where they risked losing their political independence to the Troika, just because they needed liquidity support or, such as in the case of Greece, at least some debt relief.

Trust reflects institutional performance, but it is also important for effective governance. Evidence on the financial crisis shows that the decline in trust in general was temporary (Eurofond 2018). Figure 4.1 illustrates that the financial crisis and the Eurozone debt crisis affected trust of EU citizens in national governments as well as EU institutions. The data shows that it took a long time before trust recovered. This is no surprise, given the divisive nature of the crisis and the widespread perception that those who caused the crisis received more help than ordinary citizens affected by the fallout. There is a strong social gradient in the development of trust, and people in low-status positions experience large declines in trust in national institutions, which can cause polarization (Eurofond 2018). The dynamics of trust may thus contain both a virtuous and vicious cycle, where strong (weak) trust is supportive (impairing) of reforms and changes which in turn improves (deteriorates) performance and thus strengthens (weakens) trust.

As in the financial crisis, but now with governments rather than banks in the focus, dealing with the situation was again seen mostly as a zero-sum game. The recovery took a long time. Lack of mutual trust between countries and their governments and diverging views about how the crisis can be overcome, combined with populist approaches to economic policy, almost led to Greece being excluded from the Eurozone in 2015. Currently, assessments of the reasons for the debt crisis and the appropriate remedies still differ across countries. But in the Covid-19 crisis, the EU member states did agree to put aside their differences about economic and fiscal policy, a common fund was created to respond to the crisis, and the net contributors were not happy but agreed. The view prevailed that there was a common interest in preventing a return of the Eurozone debt crisis or worse.

Figure 4.1

Trust in National and EU Institutions



Note: The table shows the average of the trust values for each year. Survey question: For each of the following institutions: Do you tend to trust it or tend not to trust it?
Source: European Commission (2021), Standard Eurobarometer 95-Spring 2021, Public Opinion in the European Union, First Results Report; author's calculations.

Although the Covid-19 crisis is far from over, it is remarkable that the economic recovery so far has been much quicker than the recovery after the Eurozone debt crisis (see Chapter 1 of this report). There is currently no sign that the Covid-19 crisis will boost populist political forces in the same way as the financial crisis. But before drawing conclusions, it is necessary to take a closer look at the performance of governments and the perception of this performance in the last two years.

4.2 A DIFFERENT ROLE FOR GOVERNMENTS IN THE ECONOMY AFTER THE COVID-19 CRISIS?

In a public health crisis like the Covid-19 pandemic, governments play an even more important role than in other types of crises. The health system becomes the center of attention. Most health systems are heavily regulated or run by the government, and they often depend on funding which comes from the public social security system or simply tax money. At the same time, the government is expected to provide help for closed businesses and employees whose jobs are temporarily suspended or even lost. In addition, governments need to act to stop the spread of the disease. Some of the measures taken to reign in infections, like closures of shops, restaurants, and schools, have drastic implications for the economy but also for well-being and basic individual freedoms. Individual citizens feel the impact of government action or the consequences of its absence much more than in normal times. Of course, without these policy interventions, well-being and individual freedoms would also be affected.

However, the extended role of governments *during* the Covid-19 pandemic does not directly imply that more government activity is also needed *after* the crisis. It is plausible that exceptional circumstances like those of a pandemic require exceptional policies, but once the crisis is over these exceptional policies are no longer needed. One might even argue that there should be less government simply because debt accumulated during the crisis needs to be serviced so that less tax money is available for other public sector activities. Another argument for smaller government could also be that citizens are fed up with restrictions of their freedoms and want less regulation and less government intervention.

In fact, the implications of the Covid-19 crisis for the future role of governments are more complex than this. One important factor is how the crisis affects trust in the ability of governments to operate effectively. Here, the performance of the public sector during the crisis plays an important role. Moreover, the policy agenda after the crisis may not be the same as before, and that may also have implications for the role of governments. We discuss both issues in the next sections.

4.2.1 The Performance of the Public Sector During the Crisis

How did governments perform during the Covid-19 crisis? The answer clearly differs across policy areas, countries, and time. Since the Covid-19 crisis is not over yet, it may also be too early for conclusions. Nevertheless, some patterns can be identified, and some data is available about outcomes as well as perceptions of government performance in the crisis.

4.2.1.1 Management of the Health Crisis

The public health crisis caused by the Coronavirus was a stress test for the ability of governments to react fast and appropriately. In the early phase of the pandemic, some countries reacted quickly while others reacted too slowly, so that measures to limit the spread of the disease came late. Some countries failed more than others. In the United Kingdom, the government first played down the dangers and rejected lockdown measures until infections and, a little later, hospitalizations surged. It then made a U-turn, but it was already too late: the death toll as well as the economic downturn in the United Kingdom in 2020 were much worse than in most other European countries.

To what extent late reactions to the initial outbreaks reflect a lack of effectiveness of government action is debatable because decision-makers faced a high degree of uncertainty regarding many aspects of the pandemic. In addition, countries were affected very differently. For instance, in Italy and Spain the virus had already spread before Europe became fully aware of the danger it represented.

At the same time, it should be noted that the risk of a global pandemic was not unknown to governments. Many experts had repeatedly argued that countries should do more to prepare for this type of crisis. In Germany, for instance, a detailed scenario for a pandemic was produced in 2012 and presented to the Federal Parliament.[4] It had no significant impact. The fact that past pandemic warnings like the SARS turned out not to affect OECD countries also contributed to the downplay of such risks.

During the Covid-19 pandemic, a key challenge for governments was to strike an appropriate balance between measures to reign in infections on the one hand and, on the other, avoiding excessive or ineffective limitations of economic activity and individual freedoms through lockdowns and other measures to fight the pandemic. An intensively debated issue was whether damage to the economy could be reduced by avoiding lockdown measures. Some countries, in particular the United Kingdom, Switzerland, and Sweden as well as a number of US states initially followed a strategy of avoiding lockdowns. Experience also showed that voluntary precautionary behavioral responses played an important role. However, this came at the cost of higher infection rates and a growing number of deaths related to Covid-19.

Figure 4.2 relates the Covid-19 death toll to the loss of GDP in a number of countries. There is a positive correlation between the size of the GDP loss and the death toll. Moreover, there are three clusters of countries. The first includes Germany, the Scandinavian countries, with the exception of Sweden, and Australia as well as New Zealand. These countries took relatively early measures including rather harsh lockdowns. The number of Covid-19 deaths was relatively small. The second cluster includes Sweden, the United States, and Switzerland. These countries first avoided lockdown measures, hoping, among other things, that this would limit the economic damage caused by the pandemic. Figure 4.2 suggests that this did not work. The economic downturn was comparable to that which occurred in the first group of countries, but the number of Covid-19 deaths was much higher. Then there is a third group of countries, which includes France, Spain, Italy, and the United Kingdom. In these countries both the loss in GDP and the death toll were very high.

[4] Bundesregierung (2013), Bericht zur Risikoanalyse im Bevölkerungsschutz 2012, Deutscher Bundestag, Drucksache 17/12051, 3.1.2013.

It is tempting to conclude that the governments of the first group of countries managed the crisis better than those of the second group and much better than those of the third group. But things may not be so simple. First, the pandemic affected countries very differently depending on health strategy, economic structures, and economic policies. In Europe, the virus first arrived in Italy and Spain–these countries had no time to prepare. When it became clear that the virus had reached Europe, it had already spread widely in Italy and Spain. At the same time, the health systems of these countries had limited capacities and were affected by shortages of ventilators and other types of medical equipment. As a result, massive lockdown measures had to be taken, and economic activity declined, not just because of the lockdowns but as a result of the pandemic itself.

The other European countries were warned and had the opportunity to take measures before the virus could spread. Some of these countries nevertheless decided to avoid lockdown measures, at least until they saw that this strategy could not be sustained.

Second, economic and health data for 2020 are incomplete as indicators of how countries are affected by the pandemic. For instance, some countries limited the spread of the virus by closing schools early while other countries avoided school closures as long as they could, as documented further below. The latter has certainly increased the spread of the virus and the death toll while doing little to prevent a decline in GDP. However, the smaller educational loss may have a positive impact on human capital, which will only be felt in the medium and long term.

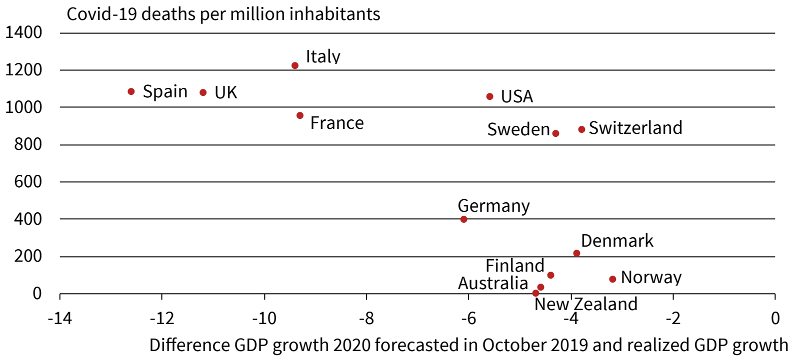
Third, the impact of the pandemic in 2020 across countries may be very different from the impact in 2021. In 2021, the situation changed because vaccines became available; also learning and adaptability implied that economic activity was affected less despite the same containment measures being deployed. One key indicator of government effectiveness is the distribution of the vaccines. Here, the United Kingdom and the United States were more successful than the EU countries.

Moreover, already in the autumn of 2020, when the second wave of the pandemic came, some governments which had reacted swiftly to the first wave were too passive, despite stark warnings coming from experts. Measures to stop the spread of the disease were delayed, probably because many politicians were more afraid of being blamed for overreacting than for reacting too late. This was also when it became clear that too little had been done to improve the infrastructure for testing, tracking, and isolating infections.

French President Emmanuel Macron compared the fight against the pandemic to a warlike situation, and many other politicians agreed. However, the effort did not always match the rhetoric. In Germany,

Figure 4.2

GDP Loss and Covid-19 Death Toll



Source: IMF World Economic Forum; Our World in Data. ©CESifo

for instance, testing and tracking was strongly restricted over the weekends because the public health authorities were partly closed. The German economist Moritz Schularick commented as follows: Imagine in 1940, facing the threat of a German invasion, Winston Churchill had said: "… we will continue to fight, except on the weekends!"[5] However, other countries did expand the capacity of the health system, including testing and tracking abilities, and fared better in the second wave. Differences in the degree of digitalization play a large role for the economic effects of the pandemic across countries.

In the autumn of 2021, another wave of infections hit in particular Austria, Germany, and the Netherlands, where vaccination rates are lower than in other parts of Europe. Again, measures to reign in the infections were taken late, and neither schools nor public health services seemed much better prepared than a year ago. Therefore, some governments which seemed to perform better in the early phase of the pandemic were much less effective in later phases, and vice versa.

Trust in institutions has played a large role during the Covid-19 crisis for compliance with recommendations and willingness to vaccinate against Covid-19. Trust is also important for the ability to undertake and implement structural reforms. Both health and economic development influence the trust in government, and declining trust in government tends to be associated with declining trust in democracy, see Becher et al. (2021). Importantly, declining trust in democracy is not synonymous with support for non-democratic regimes but can also fuel political engagement.

4.2.1.2 Border Closures and Trade Disruptions

When governments reacted to the crisis after the initial outbreak, the reactions were not always appropriate, and they were not coordinated. Many countries reacted by closing their national borders, as was also

[5] Schularick (2021), p. 28.

done within the EU. Borders were closed not only for people but also for the transport of goods. The latter contributed little to stop the spread of the virus, but the economic impact was significant. The disruption of border-crossing supply chains led to a collapse of industrial production and intensified the economic downturn. This is an area where policymakers did learn from the early phase of the crisis. During the second wave of infections in the autumn of 2020, travel restrictions returned but they were more differentiated, and the transport of goods was mostly exempted. As a result, industrial production in Europe and worldwide recovered.

4.2.1.3 School Closures

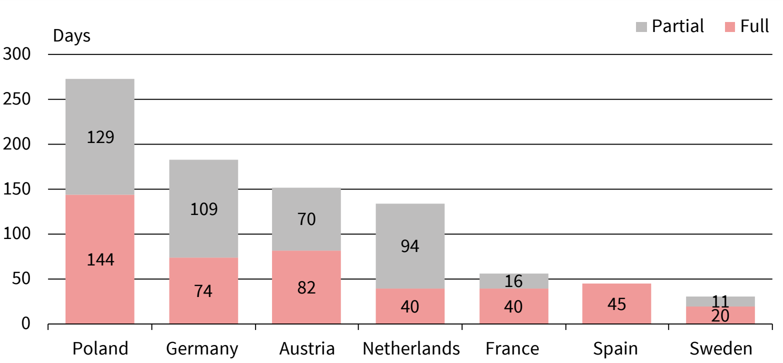
From an economic perspective, the impact of the pandemic on schools is particularly severe. School closures have a significant long-term impact on human capital and later lifetime earnings of the affected children. The school closures affect children asymmetrically, with larger losses of education for children of parents with lower education and incomes, so that future inequality is exacerbated.

It is striking that the European countries pursued very different strategies regarding school closures. Figure 4.3 shows that the duration of school closures differed greatly. In Poland, Germany, Austria, and the Netherlands, schools were fully or partially closed for more than 100 days, in some case much more. In Sweden, schools were closed just for 31 days, in Spain and France school closures lasted for less than 60 days. In some countries, in particular in Sweden, keeping the schools open was part of a general policy which tried to avoid lockdowns but ultimately came at the price of a very high number of infections and Covid deaths. In other countries like France and Spain, schools were given priority over other areas of public life.

4.2.1.4 The Vaccines

One of the positive surprises in the pandemic is that it was possible to produce a vaccine relatively quickly.

Figure 4.3
School Closures
January 2020–May 2021



Source: Freundl et al. (2021).
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This was also a European success. The first highly effective mRNA-based vaccine was developed by the German biotech company BioNTech. The work of BioNTech was partly supported by public subsidies for research and development, but the key factor in this success was the entrepreneurial decision by BioNTech to give up its main activity, which was to produce a cancer treatment, and shift its resources fully to the development of a vaccine based on the innovative mRNA technology. Shortly afterwards more vaccines produced by companies in the UK and the US became available. This is clearly a success of both science and research and private entrepreneurship combined with the resources of large pharmaceutical companies like Pfizer, which cooperated with BioNTech in making the vaccine available and getting it through the regulatory processes.

Unfortunately, Europe was less successful in organizing the mass production and delivery of the new vaccines. Originally, the EU member states had decided to organize the purchases and the distribution of the vaccines individually or in spontaneously formed groups. But then the decision was made to involve the EU, although health policy is a responsibility of the member states. There are good reasons for EU-wide coordination in this area, but finally the process was slowed down. Despite the urgency, the European Union was significantly slower than the United States and the United Kingdom in making the vaccines available to the population. This had a high cost in terms of lives lost and economic damage, which could have been avoided. While the reason for the delays has never been fully revealed, the impression remains that the decision-making process, which required coordination between national governments and EU-level institutions, was too slow and inefficient.

4.2.1.5 Macroeconomic Crisis Management

As far as the economy is concerned, the key role of governments in crises is to stabilize the macroeconomic situation and provide assistance to firms or private households strongly affected by the crisis. In most European countries, support to individuals is supplied through "automatic stabilizers" in the form of social safety nets, in particular unemployment insurance systems and short-time work schemes. In financial markets, large economic shocks like the Covid-19 crisis can easily give rise to a collapse of confidence, which leads to a liquidity crisis and a self-enforcing downward spiral of insolvencies and fire sales. Governments and central banks can prevent this by providing liquidity to banks and companies and by acting as a lender of last resort.

In the Covid-19 crisis, macroeconomic stabilization required measures which differ from those necessary in other crises in so far as stabilizing aggregate demand was not the main concern. The main concern was that parts of the economy, mostly activities where people come together, could not operate. As a result, demand was redirected towards other sectors. Demand for durable consumption goods, for instance, increased during the pandemic, as did online purchases and food sales of supermarkets since restaurants were closed except for take-out.

In this asymmetric situation, rather than stabilizing aggregate demand, more targeted measures were needed, which helped employees and firms in the strongly affected sectors and preserved job-matches and production capacity, making a swifter recovery of economic activity possible alongside reopenings. At the same time, a concern was and continues to be that the measures used to support job-matches and firms have a status quo bias and risk interfering with the reallocation of human and real capital which accompanies "normal" structural change.

Overall, in the area of macroeconomic policy, most governments reacted appropriately to the crisis. This is also true for the European Union. In Europe, the economically weaker member states of the Eurozone are particularly vulnerable to economic shocks. Since Eurozone countries do not have national central banks with full control over a national currency, they lack a traditional lender of last resort. To some extent the ECB has taken over this role through the (controversial but effective) OMT program and by extending government bond purchases.

But in this crisis the EU member states did not just wait for the ECB to act, they decided to support the poorer and more highly indebted member countries by introducing a recovery fund financed through common debt. This took pressure off the ECB and changed expectations of investors in financial markets as well as those of consumers and companies and helped to maintain confidence in the ability of the Eurozone member states to service their debt and stabilize their economies after the crisis. Of course, the fundamental problem of very high levels of public debt in some member countries has not been solved through these measures. Addressing these issues has only been postponed.

The macroeconomic policy response is certainly a rather successful part of government reactions to the Covid-19 crisis. Nevertheless, the crisis leaves governments in a situation with high levels of debt and deficits as well as highly expansionary monetary policy. At some point this fiscal and monetary support for the economy will need to be scaled back. In particular, fiscal policy will need to stabilize and eventually reduce debt ratios because the next crisis will come, and when it comes fiscal space will be needed again to respond.

Scaling back crisis support is also important because there needs to be a balance between helping companies and their employees in unusual crisis situations and letting structural change take place, even though structural change implies that some jobs get lost or some firms shrink or may even go bankrupt. However, new companies and jobs will emerge and this is essential for productivity growth. In many countries there is now a tendency to call for government support whenever there are signs of declining activity, even if there is no direct link to the special situation of the pandemic. There is a risk that, as a result of the crisis, the political economy will shift in such a way that governments are expected to protect established economic activity against all pressures for change. It is paramount that the special, crisis-related support measures are phased out after the crisis since they will otherwise constrain adjustments and reallocations of resources in the form of both human and physical capital which are necessary for structural change and economic progress.

4.2.2. Implications for the Future Role of Governments in the Economy

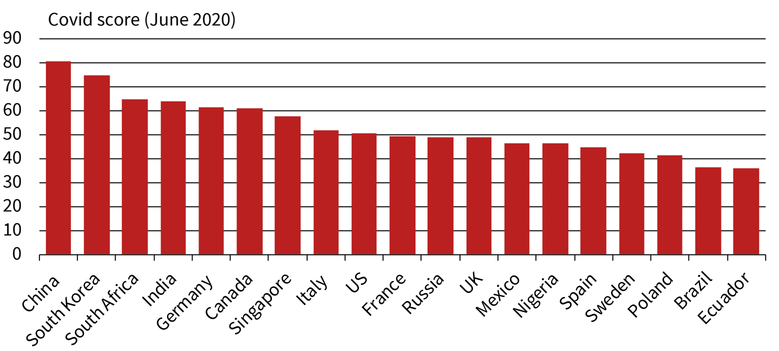
4.2.2.1 What does Performance During the Crisis Imply for the Future Role of Governments?

Which conclusions can be drawn from the performance of governments during the crisis? The answer to this question is far from easy. One reason is that there may be disagreement about how governments performed during the crisis and about what can reasonably be expected from them. Some decisions taken during the pandemic were misguided or came too late, but what is the benchmark?

While measuring the effectiveness of government crisis management is certainly difficult, it is possible to measure the perception of citizens about the effectiveness of their governments. Figure 4.4 summarizes the results of a survey study conducted by Lazarus et al. (2020), which covers various dimensions of government crisis management. For instance, respondents were asked whether they think their government made sure accurate information about the pandemic was provided, whether they received medical, financial and other help when they needed it, whether

Figure 4.4

Satisfaction of Citizens with Covid-19 Crisis Management of Their National Governments



Source: Lazarus et al. (2020).

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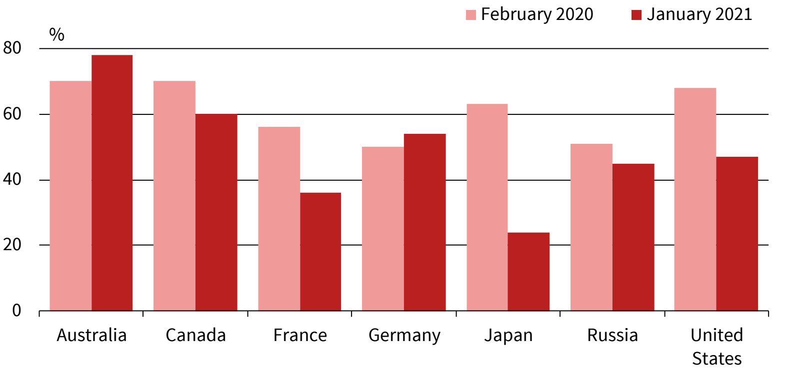
they think the government took the right measures and protected vulnerable households and so on. The answers to these questions were aggregated into an overall “Covid-19 score,” which could take values between 0 and 100, where 100 was the highest possible satisfaction.

It is important to note that the survey was conducted in June 2020, after the first infection wave and before further waves as well as the vaccination campaigns followed. As Lazarus et al. (2020) show, the results are closely correlated with the number of Covid-19 deaths as well as with the general level of trust in government.

The scores reported in Figure 4.4 do not reveal much about whether citizens got from their government what they expected, or whether they are disappointed and how this affects their views about the government. However, there are survey studies which try to identify the particular impact of the Covid-19 crisis on political views by tracking government approval over time and through survey experiments.

Figure 4.5

Changing Confidence in Government Crisis Management



Source: Ipsos (2021).

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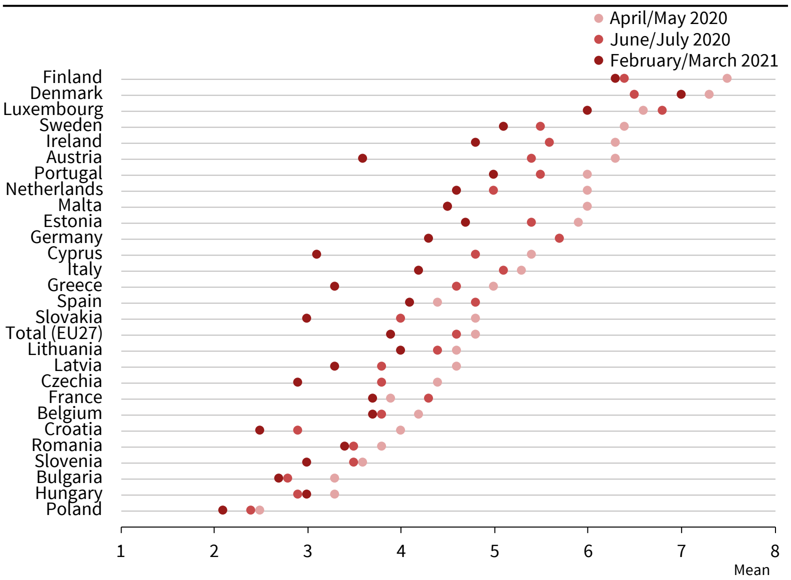
Figure 4.6

Trust in National Governments



Source: Eurofound.

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Herrera et al. (2020) used high frequency polling data about government approval. The dataset covers the time span between January and July 2020. The data confirms that there was a “rally-around-the-flag” effect in the early phase of the pandemic which boosted support for incumbent government, but that support disappeared quickly in countries where governments failed to reign in the pandemic and infection numbers were high.

Gianmarco et al. (2020a) report results from a survey carried out in June 2020 to measure the impact of the crisis on socio-political attitudes in Italy, Spain, Germany, and the Netherlands. The results show that both interpersonal trust as well as trust in institutions, support for the European Union, and for a tax-financed welfare state all declined as a result of the crisis. But the authors also identify a “rally-around-the flag” effect around incumbent governments and growing trust in scientific expertise. At the same time, populist positions are losing ground. This might hint at a growing demand for competence in political leadership. In Gianmarco et al. (2020b) the authors conclude:

“In this sense, a new fault line in the political arena may be opening up, confronting the increased demand for simple policy solutions of the past two decades with the complex, nuanced, and competent approaches demanded by the future.”[6]

It should be taken into account, however, that this survey is from June 2020, a rather early phase of the pandemic. The authors also acknowledge that whether the demand for competence effect they detect persists will depend very much on how governments and other actors including scientists are perceived to perform in the course of the entire crisis.

In the meantime, more evidence exists, including surveys, which track trust in government over longer time spans. Figure 4.5 shows results from Ipsos (2021). These results are from two surveys. The first was conducted in February 2020, when the pandemic was only beginning to be felt in Europe. The second is from January 2021, a time when the respondents had already experienced how their governments managed the first and much of the second wave of the pandemic. The results are quite striking. Australia is the only country where the share of respondents who are confident that their government manages the crisis effectively increased significantly. In Germany the increase is small, implying at least that confidence has not declined, but in all other countries confidence did decline, in some cases dramatically.

Another survey which allows tracking the development of trust in national governments as well as EU institutions over time is offered by Eurofund (Figure 4.6–4.9). The results are similar. Since April 2020,

[6] Gianmarco et al. (2020b).

trust in national governments has declined in almost all countries under consideration.

An interesting question is whether the decline in trust differs across age groups. The older population was most exposed to the health risks caused by the pandemic, and this group arguably benefited most from measures to stop the spread of the virus. The younger population in turn was more affected by the economic fallout as well as closures of schools and universities, and parents with schoolchildren also had to bear a heavy burden, including working from home and looking after the children and their schooling. Figure 4.7 shows that the decline in trust was similar across age groups.

The picture is different when it comes to trust in the European Union, as Figure 4.8 shows. Here differences across countries are striking. While trust in the European Union declined sharply in Germany, Austria, Finland, and France, it increased significantly in Portugal, Italy, and Spain.

One possible explanation for declining trust is the delayed supply of vaccines, where the EU played an important role. However, this does not explain the increase in trust in some countries. Here the transfers provided by the fund Next Generation EU may play a role. Italy, Spain, and Portugal are all net beneficiaries in this program. Again, the change in trust across age groups is similar (Figure 4.9).

What is the link between trust in government and the role of government in the economy? Empirically, there is a positive but small correlation between indicators of trust and the size of government, as Figure 4.10 shows.

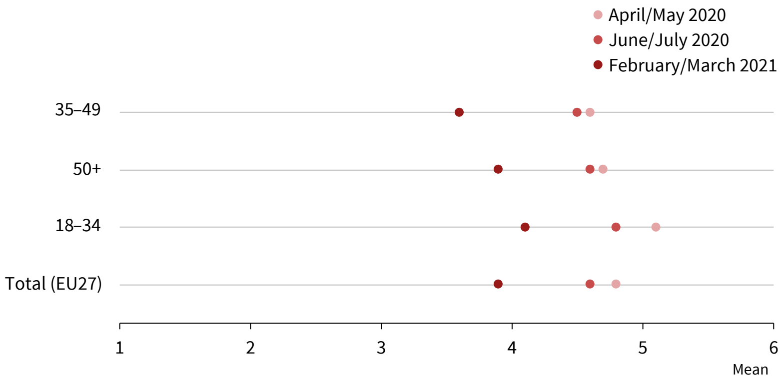
It is, of course, far from clear whether there is a causal link running from trust to the size of government. There may be no causal relationship between these two variables at all. For instance, it may be that countries with stronger democratic institutions and rule of law are countries where both trust and public sector size are larger. However, it is certainly even less likely that causality runs from public sector size to trust than vice versa.

One should also bear in mind that a decline in trust as documented in the surveys cited above does not necessarily reflect a decline trust in the public sector as such. It may also reflect that citizens no longer trust the incumbent government and want a change.

If it is true that on average governments are not perceived to have performed very well during the crisis, what does this imply for their future role? One possible conclusion is that governments should get fewer resources because they cannot be trusted to use them wisely. Another possible conclusion would be the exact opposite. Maybe governments failed because they did not have the necessary resources?[7] In this case, the answer would be to give them more resources to increase government spending on hospitals, public health authorities, or schools. Of course, government failures may also be a consequence of lacking institutional capacity to act appropriately.

[7] One example for this view is Stiglitz (2021), who argues that "Decades of weak government intervention have left the health and economic systems of the United States fragile in the face of a prolonged pandemic.", ibid, p. 4.

Figure 4.7
Trust in National Government Across Time and Age Groups



Source: Eurofound.
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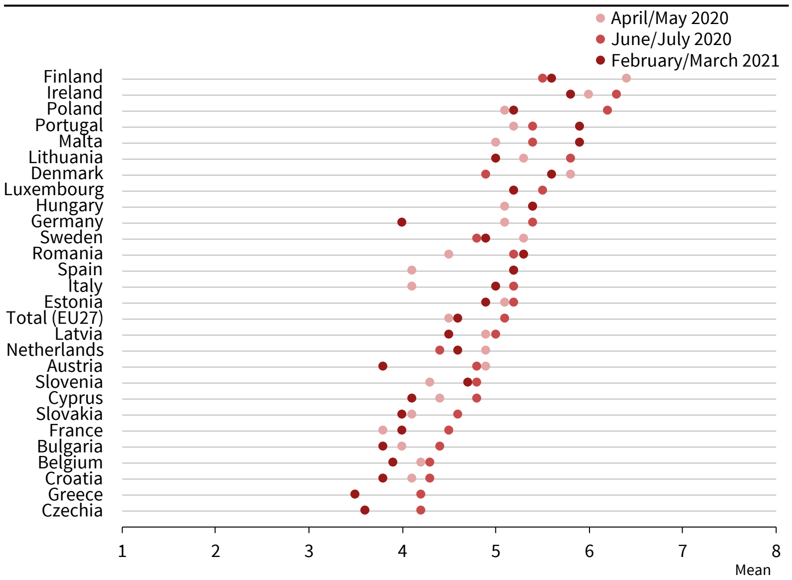
Figure 4.8
Trust in EU Institutions



Source: Eurofound.
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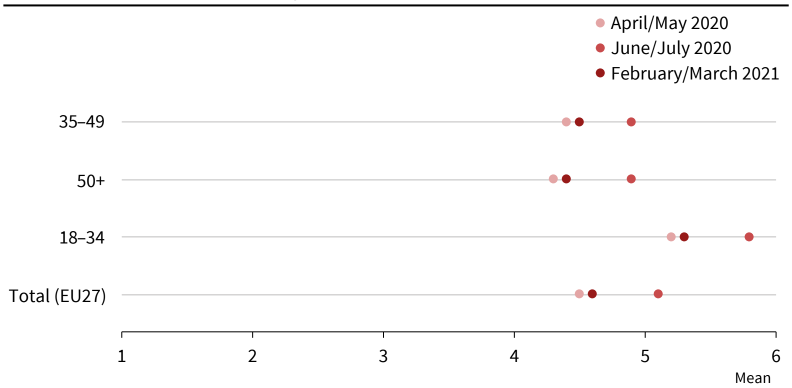
Figure 4.9
Trust in EU Institutions Across Age Groups and Time



Source: Eurofound.
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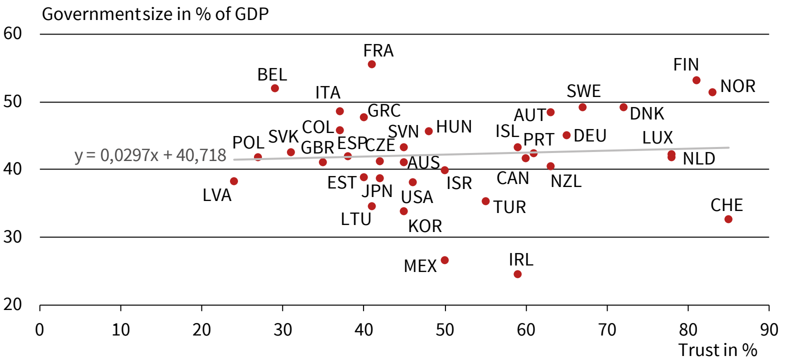
Figure 4.10
Trust in Governments and Public Sector Size



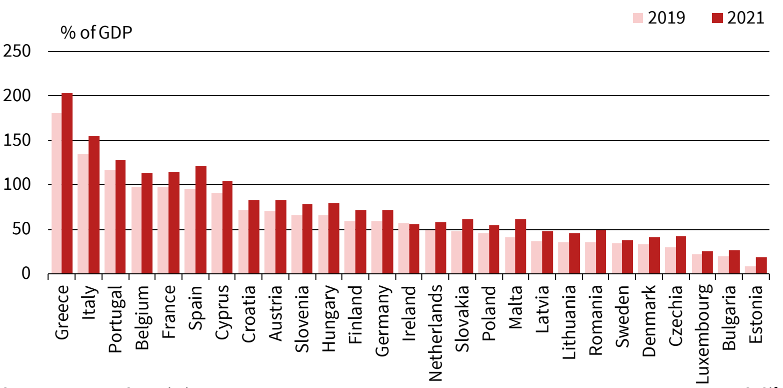
Source: OECD. © CESifo

In this case institutional reform would be required. Clearly, the differences in satisfaction with government performance across countries suggest that lessons to be drawn for the future role of governments and for necessary reforms are very country-specific.

Nevertheless, a number of tentative conclusions can be drawn from the insights presented in this section. First, compared to the financial crisis, a similar backlash against capitalism and financial globalization is unlikely. Second, the importance of science, expertise, and competent leadership which is able to address complex challenges like those posed by the pandemic suggests that demand for competent governments which draw on expertise and scientific advice may increase. The fact that at least some leaders with populist leanings like Donald Trump did not appear to act very competently in the Covid-19 crisis suggests that political support for populists will not be boosted by this crisis. If the economic recovery continues and turns out to be faster than the recovery after the financial crisis and the Covid-19 crisis, this will further reduce the likelihood of growing political support for populism.

At the European level, the fact that the economically more vulnerable countries received support and were able to stabilize their economies in this crisis better than in the Eurozone debt crisis implies that resentment against European institutions and among member states is much less likely, even taking into account the fact that the EU countries member states were rather slow in providing medical help to the countries strongly affected in the early phase of the pandemic. The experience of a certain amount of solidarity among the EU member states may boost trust in EU institutions and open opportunities for more cooperation at the European level. However, the asymmetric development of trust in the EU in different countries suggests that universal support for more EU policies, let alone redistribution, should not be taken for granted.

Figure 4.11
Public Debt



Source: European Commission. © CESifo

4.2.2.2 A Shift in What People Expect from Governments? "Getting Back to Normal" versus "Building Back Better"

Decisions about the future role of governments will not only depend on perceived performance during the Covid-19 crisis. Another relevant factor for the future role of governments is that the crisis may change what people expect from the government and its policies after the crisis. As mentioned above, it will also depend on what governments can do, given that their finances have deteriorated.

Governments support the economic recovery with a lot of money. It has been argued that, given the huge efforts required to mobilize these resources, it would not be enough to use them just to get back to normal, that is restore the economy as it was before the crisis. We should rebuild back better. The view is widespread that more emphasis should be placed on sustainability, inclusion, and resilience. This is why the European Union has geared its 750 billion recovery fund NGEU towards spending on decarbonization and the digitization of the economy. If the policy agenda changes after the crisis, this is likely to have consequences for the role of the public sector in the economy.

In the following, we discuss the perspectives for the role of governments against the backdrop of the Covid-19 crisis in two key policy areas: public finances and labor market policies.

4.3 FISCAL POLICY: DOES THE PUBLIC DEBT LEGACY OF THE CRISIS DIMINISH THE ACTIVE ECONOMIC ROLE GOVERNMENTS CAN PLAY?

The increased level of debt has direct implications for the future role of the public sector. On average, across EU countries public debt increased by roughly 15 percentage points of GDP between 2019 and 2021 due to public sector deficits and declining GDP (Figure 4.11). If more resources are needed to service the debt, fewer resources are available to provide public goods and services. In this area the public sector will either need to shrink, taxes will need to rise, or reforms will be needed which increase economic growth and tax revenues so that the additional debt can be serviced without reducing spending on public services or raising taxes. If more revenue needs to be collected, this may come at the price of a less redistributive tax system, because raising revenue and redistribution are competing objectives (Ayaz et al. 2021). Most likely, the burden of public debt incurred as a result of the crisis will increase the overall tax burden, but it will also tend to reduce the active economic role of the public sector, that is its role in public goods provision and income redistribution.

It has been argued that public debt is less of a problem today compared to previous decades since the growth corrected rates of returns for governments (the r-g debate) are low or even in some cases negative (Blanchard 2019). It is true that there has been a long-term trend towards lower interest rates in particular on relatively secure assets as government bonds. However, the Eurozone debt crisis demonstrated that doubts about access to liquidity and debt sustainability may trigger spikes in risk premia, even in an environment with generally low and declining interest rates. Currently, interest rates on government debt are particularly low because of the asset purchase programs of central banks. But these programs will have to be phased out at some point. Moreover, high debt levels place countries in a very vulnerable position if and when returns normalize. In addition, interest rates on government bonds tend to rise if debt levels rise. This implies that a rising debt level may increasingly undermine the ability of governments to successfully achieve fiscal consolidation. Importantly, the debate often overlooks that a low growth corrected rate of returns does not preclude an increasing debt level if the primary balance is in systematic deficits.[8] In the absence of reforms this is the situation for most European countries.

The challenges arising from aging have been known and discussed for some time, also the consequences for fiscal sustainability. With unchanged policies, systematic budget deficits arise and debt ratios increase further due to a shrinking work force and increasing expenditures on pensions and health, see OECD (2021) and European Commission (2021). Figure 4.12 reports a recent assessment of fiscal sustainability for EU countries. The specific assumptions underlying the analysis can obviously be discussed, and these projections may also differ from country-specific projections, but the message is quite clear; a number of countries face substantial challenges to ensure fiscal sustainability.[9] About 2/3 of all EU countries have a sustainability problem requiring a permanent improvement of the primary budget balance exceeding 1 percent of GDP, and in about 1/3 of the countries the needed improvement exceeds 3 percent of GDP. These numbers do not include any fiscal implications from the Covid-19 crisis. Note that these requirements are only to make existing policies sustainable.

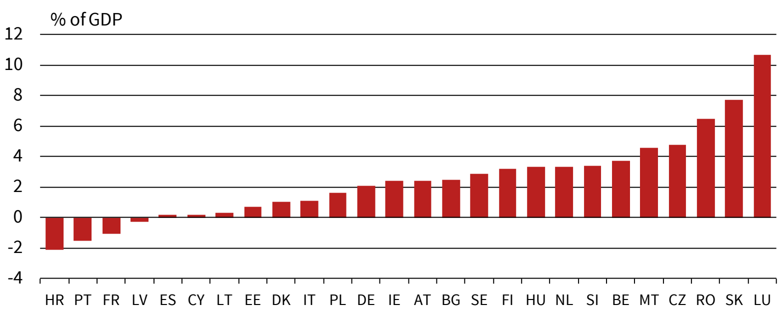
In this situation it is striking that many policymakers, rather than calling for more fiscal prudence, denounce what they call fiscal austerity and ask for more room for deficit financing of public spending. One example is the debate about the reform of fiscal rules in Europe. The European Stability and Growth Pact requires countries, among other things, to keep their debt-to-GDP levels below 60 percent. In most EU countries, debt levels are much higher than that. Many policymakers as well as advisers and technocrats are now calling for an increase in the debt limit. For instance, the European Fiscal Board has proposed to replace the general debt rule by a more realistic approach, which would set country specific targets for fiscal consolidation.[10]

It is true that the fiscal rules enshrined in the Stability and Growth Pact were made at a time when interest rates were much higher and lower public debt limits were needed to limit the cost of servicing the debt. But it should not be forgotten that economic growth rates were also higher, and stability risks are not only related to interest costs but also to the fragility of investor confidence in economic crises, especially when it comes to highly indebted countries which are members of currency unions or whose monetary policy is restricted by fixed exchange rates.

A reform of fiscal rules in the EU should take into account that the 60 percent limit for the public debt-to-GDP ratio is so far below the existing debt levels for many countries that its relevance is called into question. But reforms should not just increase room for debt: reforms should also create better incentives to improve the solidity of public finances, in particular in the medium term. This requires a balance between,

[10] https://www.euractiv.com/section/economy-jobs/news/eu-fiscal-watchdog-wants-to-scrap-60-debt-limit/.

Figure 4.12
Fiscal Sustainability Indicator



Note: The fiscal sustainability indicator is the permanent change in the primary budget balance in % of GDP needed to ensure that the present value of revenue equals the present value of expenditures plus initial net debt. The computation is based on population forecasts and maintaining unchanged policies.
Source: European Commission (2021).

[8] See Fuest and Gros (2019).
[9] In a bit less than half of the Member States the sustainability gap is due to both an unfavorable initial fiscal position and the cost of aging.

on the one hand, changes for more flexibility and solidarity, and on the other hand, reforms which prevent soft budget constraints and imprudent fiscal policies. For instance, a reform of fiscal governance should include a more realistic approach to debt levels, but it should also introduce new capital requirements which require banks to underpin highly concentrated portfolios of national public debt with equity.

The debate about the reform of fiscal rules reminds us that they were introduced in the first place primarily to prevent a fiscal dominance of monetary policy. In the current economic and political environment, this issue is particularly important because, after a long period of very low inflation rates, monetary policy now faces a scenario of rising inflation. The pandemic has led central banks to engage in unprecedented monetary expansion. At the same time, supply constraints due to trade disruptions and worker shortages as well as rising energy prices give rise to stagflation fears. This raises the possibility that we may face a scenario similar to the 1970s and early 1980s, when the world was hit by the stagflationary oil shock, and policymakers were surprised that expansionary fiscal and monetary policy only made things worse (see Chapter 2). This time, conflicts may arise between the need to reign in inflation and the fear that contractionary monetary policy measures may raise interest costs of highly indebted governments. In the Eurozone, there is the additional risk that, as a response to tighter monetary policy, risk premia on government bonds of highly indebted Eurozone member states may rise drastically, leading to a scenario similar to the Eurozone debt crisis.

Anticipating such a scenario, the ECB announced on December 16, 2021 that it may deviate from the capital key when rolling over its government bond portfolios and buy a large share of Greek government bonds.[11] This points to the fact that the ECB may face a conflict between limiting inflation and limiting interest rate spreads in the Eurozone. Its mandate clearly requires it to prioritize fighting inflation, but whether that will be politically feasible is an open question. To avoid such a scenario, it is important that the Eurozone develops its institutions and policies so that i) the sustainability of public debt is protected and ii) cases where public debt is excessive can be resolved without relying on the central bank monetizing the debt. The introduction of the NGEU fund was an important step in this direction as it redistributes the burden of newly incurred debt from highly indebted and less prosperous member states to the others. But the magnitude of NGEU is not large enough to solve the sustainability issues of the most highly indebted member states, and mutualizing the debt has its limits, not least because it creates adverse incentives for future fiscal policy.

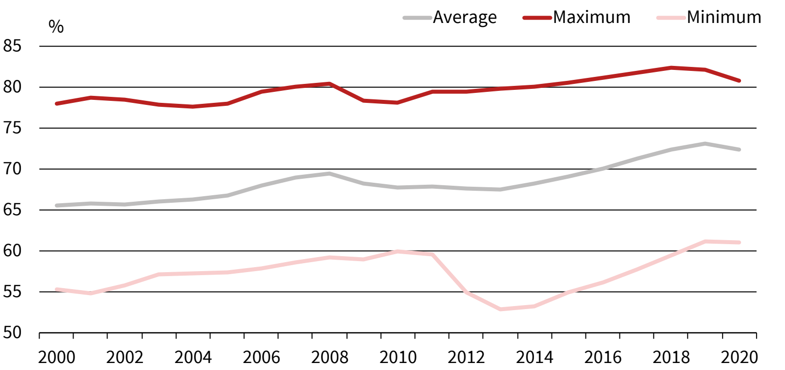
4.4 THE LABOR MARKET – THE FUTURE OF WORK

Future economic developments crucially depend on the labor market. Employment (job-type, work conditions, wages, etc.) is crucial for the individual but also for society, affecting both the level and distribution of incomes and public finances/social cohesion. The key to solving many economic problems is labor market reforms.

The debate on labor market developments since the Industrial Revolution has been dominated by job pessimism and a concern whether there would be enough jobs. This job pessimism also enters contemporary discussions, although historical developments have consistently refuted this concern and there is no indication that it is going to be a problem within any reasonable forecast horizon. The development in the employment rate in the European Union is shown in Figure 4.13 for a period which includes several crises, intensive globalization, and new technologies, and if anything, there is a slight upward trend in employment rates. In a number of countries – e.g., The Netherlands, Sweden, and Demark – labor market reforms have played a crucial role in supporting employment growth.

The debate on the future development spans from dystopian views to very optimistic views on the future development of society. The dismal views at the outset take in the fact that productivity growth in recent years has been low in historical comparison,[12] and the risk of secular stagnation due to a shrinking population and workforce due to aging (Summers,2015; Gordon,2014). These developments imply that growth rates and rates of return will be "low for long." The term "shrinkonomics" coined by

Figure 4.13
Employment Rate



Source: Eurostat. © CESifo

[11] "PEPP reinvestments can be adjusted flexibly across time, asset classes and jurisdictions at any time. This could include purchasing bonds issued by the Hellenic Republic over and above rollovers of redemptions in order to avoid an interruption of purchases in that jurisdiction …", ECB statement on monetary policy decisions, December 16, 2021, https://www.ecb.europa.eu/press/pr/date/2021/html/ecb.mp211216~1b6d3a1fd8.en.html

[12] There is an issue whether measurement of productivity growth is downward biased, not properly capturing quality and welfare improvements following from ICT, see e.g., Feldsteain (2017).

Hong and Schneider (2020) refers to the troublesome economic development in Japan over the last couple of decades. The Japanese experience may be seen as an early indication to other countries of the consequences of an aging society since the change in the age composition of the population in Japan is a few decades ahead of most other countries. A more optimistic view is associated with the so-called Fourth Industrial Revolution in terms of automation and robots, see e.g., Brynjolfsson and McAfee (2014). But even this is seen as a threat to jobs by many, and how many jobs are at risk due to automation has been the subject of debate, see e.g., Nedelkoska and Quintini (2018) and OECD (2021). While productivity growth is indisputably important for material living conditions, the implications for overall employment are less clear, and it is reminiscent of the job pessimism already associated with the first industrial revolution. Notions like "shortage of jobs" do not make much economic sense in a medium- to long-run perspective. Developments in labor demand and supply ultimately determine wages and employment and eliminate any shortages.

Aggregate numbers like those reported above conceal large structural shifts across sectors and job types. Labor markets are characterized by ongoing in- and outflows from neither across business cycles nor jobs. Labor market developments are not smooth, either across business cycles or structural changes. Along economic development there have been employment crises and persistent unemployment, and particular groups have been affected. This is a result of differences in policies and institutions, etc., but also reflects that structural changes have different effects across groups and countries. Structural changes affect underlying demand and supply conditions, tending to produce winners and losers. In the process some job prospects deteriorate, and others worsens, causing changes both within and between countries.

The Covid-19 pandemic underscores this point in a clear way. To control the pandemic most countries have resorted to lockdowns, travel restrictions, and work-from-home policies. In particular, service, trade, and tourism has been affected (see Chapter 1), and this is different to the Financial Crisis, which affected construction, industry, and manufacturing. Clearly, the scope of work-from-home differs across sectors and job types, but also the level of digitalization is important. Hence, sectors/countries depending on physical contacts or being less digitalized are more adversely affected than other sectors/countries. Hence, while shock and policies are largely the same, the effects are very different across sectors and countries. The experience during the pandemic has so far been that economic activity in many countries has recovered rather swiftly alongside reopenings (see Chapter 1) which suggests a less persistent downturn than during the Financial Crisis. From a labor market perspective, this reduces the risk of a persistent increase in unemployment.

It is a fact that the nature of jobs has changed significantly and will likely continue to do so. This is reflected in both the sectoral distribution of jobs and the educational level of the work force. The broad trend has been first a decline in employment in primary sectors and an increase in manufacturing sector. Recently, the latter has declined and employment in services (private and public) has increased. The educational level has changed dramatically, and the work force is much more educated than in the past. The Covid-19 crisis is also speeding up and creating new source of structural changes including possible changes in, e.g., retail business, travel, and tourism.

Structural changes produce both winners and losers, within and between countries. A key example is so-called skilled bias technological changes producing what Tinbergen (1972) dubbed a "race between education and technology." Skill-bias technological change increases the demand for skilled and reduces the demand for unskilled labor. If the skill-distribution is unchanged, the outcome is an increasing wage gap between skilled and unskilled labor. However, if the skill-distribution can be changed such that it matches the changes in the composition of demand, an increase in wage differences can be avoided. Globalization has increased trade-flows between high- and low-income releasing effects similar to skill-biased technological changes. While there has been a heated controversy on the role of technology and globalization in empirical work[13] it is difficult to separate the two – also because the two are mutually dependent – but this is less important for the overall trend. Empirical analyses show that the educational expansion during the 1960s and 1970s implied that education was ahead of or on par with changes on the demand side. More recently wage inequality has been increasing, and this has been interpreted as technology and globalization winning over education. Goldin and Katz (2009, s. 291) conclude that a "lion's share of rising wage inequality can be traced to an increasing educational wage differential."

An extra dimension has been added to this development, namely, so-called task bias, see, e.g., Acemoglu and Restrepo (2020). Technological developments imply that job-functions which involve routine work can be overtaken by ICT, etc. This effect is not affine to the skill content of the job: some jobs which in the past required skills can now be overtaken by computers. The latest development is automation

[13] Some empirical work OECD (2011, 2017) suggest that technology is less important than globalization, but that policy changes also play a role: deregulation of product market, lower unemployment insurance benefit, and tax reforms have also contributed to widen the wage distribution; see also Jaumotte, Lall og Papagerogiou (2013). For more of a review on how globalization affects labor markets see, e.g., Helpman (2016).

and robots (cobots). What is important here is that relative demand and supply changes. If some skills can be automated, they are less in demand, but then social skills which are less easily automated become scarcer, see, e.g., Deming (2017). The Covid-19 crisis has shown the importance of digitalization and the ability to substitute from physical to virtual activities and contacts, and this will accelerate this development.

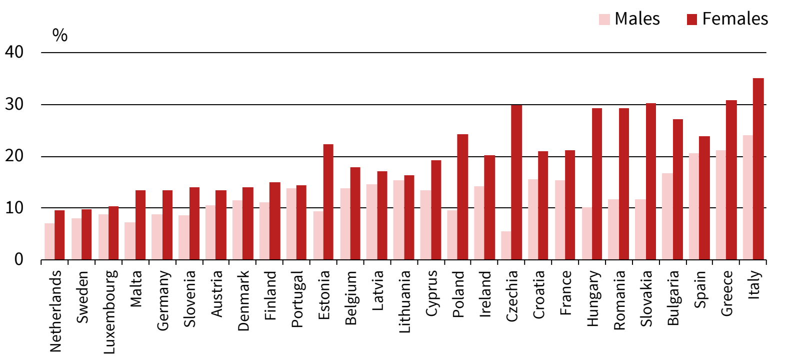
The bottom line is that there are ongoing structural changes in the labor market. This has always been the case, and it will continue to be so. Whether structural changes are happening faster than in the past is not clear, but they are moving fast. Structural changes happen for many reasons, and at present the Covid-19 crisis may accelerate some ongoing processes like digitalization. Simple views of the labor market projecting the current situation into the future or detailed attempts to project future labor demand do not have a good track record. Few anticipated in the 1980s the role ICT would have for almost all jobs today. Some broad trends can be predicted, but not the finer allocation across job types. Rather than focusing on predicting the exact structure of demand for labor in the future, it is more important to ensure that there is a qualified labor force capable of adjusting to future demand.

That structural changes create winners and losers and raise the issue on how best to help the losers. In the first place the social safety net provides support to those losing their jobs, but this is only a temporary solution. The social safety net is meant to provide insurance, not permanent support to those affected more long-term by structural changes. Support via the social safety net may also be termed passive in the sense that it aims at repairing on some of the consequences of loss of job, while a more active approach aims at improving the possibilities of finding a new job.

Active labor market policies play an important role here, but it has its limitations. Particular problems arise for those who in a mature age find that their education, qualification, and experience has become obsolete due to structural changes. A risk which may increase when retirement ages are increased to cope with the aging problem, see below. A longer working career has several preconditions. An obvious one is adequacy of qualifications, which in turn has two key elements. Longer working careers increase the return to education, and this gives an argument for more investment in education. But the form of education should also be considered. Evidence on professional training shows that broad-based education rather than more specialized catering to immediate needs in the labor market is associated with later retirement; see Hanushek et al. (2017). This is suggestive that individuals with a broad knowledge base have better scope to adjust to new needs and requirements in the labor market and to update their knowledge, see, e.g., EEAG (2021). Another element is the possibilities for maintaining and developing human capital; life-long learning. The work environment is also important; including multiple job careers to prevent too long tenures in, e.g., physically very demanding jobs.

Equally important is the inflow of new generations. This raises questions on the educational system, in particular that a significant share of each cohort does not obtain a labor market-relevant education. One measure is the share of youth neither in employment nor education or training (NEETS) (Figure 4.14). In EU countries this group constitutes between 10 percent and 30 percent of a cohort and is generally higher for females than males. This is evidence of the absence of equal opportunities, which have implications for inequality and social cohesion. Addressing this problem is one of the most fundamental for policy decision-making today to ensure high employment and low inequality.

Figure 4.14
NEETS – Youth Neither in Employment nor Education, 2020
20–34 year-olds



Source: Eurostat. © CESifo

4.5 CONCLUSIONS AND OUTLOOK

The Covid-19 crisis has prompted a debate not only on how to restart economies after the pandemic but also on the need to rethink economic policies to address policy challenges including the climate, aging, technological developments, inequality, etc. Much of the debate centers on whether more or less government intervention in the economy is needed. Many observers see the Covid-19 crisis as an example of the importance of government intervention, and it is sometimes claimed that governments should also play a larger role after the pandemic. However, since the crisis situation is exceptional, that conclusion may be premature. During the crisis trust in governments has declined, potentially suggesting that demand for larger government is limited. But trust in governments usually declines in times and crisis and recovers later.

For this discussion it is important to note that the Covid-19 crisis is different from any other crisis encountered for about a century. The situation is different and unusual and the needed policy intervention therefore also unusual. It is not clear why this experience is of much guidance in addressing future policy challenges. It is also worth being reminded of the optimism surrounding the power of fiscal policy (demand management policies) in the 1970s and the rather dismal track record despite substantial policy activism. The brief but important answer is that the policy interventions were not well designed to the problems arising from supply side changes (oil price hikes) and structural problems in the 1980s, see Chapter 2 and 3. This is not saying that fiscal policy is unimportant or not useful, but a reminder that no policy is omnipotent for all kinds of problems. Later developments, and in particular the growth of populism, are also a reminder that it is important to take a broad-based perspective on policymaking, focusing not only on the winners but also how to cope with the losers. A serious policy discussion starts by understanding the problem and why and how policy intervention is needed, and not by defining the solution.

Intergenerational distribution is a common denominator in many contemporary policy themes. The climate and environmental issues have important intergenerational implications. But so has aging and public debt. The agenda of structural reforms to strengthen employment and growth to reduce inequality and improve public budgets and to make pension systems more resilient has not become obsolete as a consequence of the Covid-19 crisis – if anything it has become more urgent. Projection shows that aging is driving up public expenditures, causing financial problems, and it is not obvious that such increases should be passively accepted leading to large government. Increases in retirement ages – motivated by increasing longevity – and strengthening of private savings are part of the solution.

The degrees of freedom in fiscal policy depend critically on debt. The pandemic has taken public debt to record levels. At present, interest rates are low but so are growth rates, and interest rates may change quickly. It is therefore very risky to base policy making on an expectation that the current low costs of servicing public debt are permanent. The present situation strongly depends on central bank intervention, and a normalization of monetary and fiscal policy will change the situation. The current increase in inflation underlines the fact that central bank support for highly indebted governments may end rather sooner than later. Neglecting the debt issue may thus imply some short-term degrees of freedom at the risk of policies being severely constrained by debt problems in the future. Looking back, there are many examples of countries having lost room for maneuver due to high debt levels.

Prudence in fiscal policy and fiscal rules have not become irrelevant as a result of recent developments. Such rules play an important role as guidepost for ensuring fiscal sustainability and thus addressing the problems arising from aging. However, the current debate about fiscal rules is justified in particular because debt ratios have reached levels far beyond the 60 percent limit foreseen by the treaty of Maastricht. While fiscal rules have their limits and enforcement is difficult, they remain important benchmarks in conversations and negotiations about economic policy at the European level. Just making these rules laxer by increasing, e.g., the maximum debt ratio to 90 or 100 percent of GDP, is not solving the problem. There is a need for a better balance between flexibility, incentives, and discipline. One way forward would be to combine higher debt limits with reform requirements like the introduction of equity requirements for banks holding domestic debt portfolios.

Regarding the future role of governments, the consequences of the pandemic are in fact limited. Most importantly, the pandemic is a highly unusual situation, which required unusual policies. The role of government in this crisis offers little guidance regarding its role when the situation is back to normal, as much as a surgeon may play a key role after an accident, but this does not mean the patient needs him permanently. There is rather a significant risk that the exit from the crisis mode, with government support for many individuals and companies, back to a situation where market forces are in play, may come too late. It would be highly problematic if the perceived role of government in the economy changed towards the expectation that government support shields companies and employees from any kind of pressure. The reallocation of human and physical capital which is needed to allow for structural change would be inhibited. This is why it is important that crisis-related support measures are eventually phased out.

A rather straightforward consequence of the pandemic is that it has led to an increase in government debt, which will constrain government action in the future. The higher debt levels also underline the importance of structural and growth enhancing reforms, so that bearing the higher debt burden is easier. If there is a change in what is expected from governments, there may be a shift towards demand for competence. At the same time, populist politicians have not been very successful in this crisis: Whether this will reduce support for populism in the coming years remains to be seen.

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