4. Markets, Policies, and Structural Change during and after the Covid Crisis

After the emergency responses and as the health shock appears to be under reasonable control, policy makers should turn to an evaluation of the measures that have been put in place. Some of the crisis responses, although crucial in the emergency, hamper the reallocation of economic activity across sectors and countries. Such reallocation is now even more important because the shock is structural and likely to persist. The emergency measures have been characterized by their national(istic) character. The subsidies put in place can address distortions, such as those due to imperfect capital markets that result in liquidity constraints, but they can also distort for distributional reasons or because uncoordinated reactions are inefficient. The response to a sudden dramatic crisis left little time to consider how they may hinder dynamic adjustment when some permanent reallocation is needed. It is now time to do so.

During the lockdown, consumption concentrated on food, electronically delivered services, and home-produced leisure. Part of this reallocation will be reversed as economies recover, but some of it may well continue in the medium term. These changes will stem from households shunning certain types of expenditures because of health concerns, production costs increasing due to the need for employee and customer protection, and new business practices. The tourism sector, for example, will be seriously affected and airline companies and much of the service sector will be subject to a particularly sharp decline in medium-term demand from households and also from businesses that have established new work practices. Various forces are hence at play that make it hard to predict the direction of change.

Moreover, although policies to maintain household incomes imply that aggregate consumption is recovering fast, business investment remains weak. This weakness is a combination of liquidity constraints and uncertainty about the future, and while the former may be solved relatively quickly given that investor confidence has fared relatively well, the latter is likely to remain for a considerable time since firms face increased uncertainty about both consumer demand and access to suppliers.

An efficient response to the pandemic hence requires massive intertemporal and sectoral reallocation. Reallocations occur all the time; they are necessary for economic efficiency and operate through the signals sent by relative prices. The pandemic triggered immediate price changes: the dramatic decline of oil and fuel prices account for most of the drastic decline of aggregate inflation, but relative price changes are unusually sharp across all sectors. In the United States, for example, travel has become much cheaper, as both demand and supply declined with the former falling more, whereas food has become much more expensive as supply fell (especially meat products, since the virus breeds well in humid and cool slaughterhouses) but demand remained constant, or even increased as a result of hoarding.[1]

In Europe, price responses are similar if somewhat weaker.[2] This may be due to less flexible and competitive markets: European grocery shops announced a commitment not to raise prices to avoid damaging their reputation with customers and governments, and perhaps also to implement a degree of tacit collusion. Instead of higher prices that allow the rich to buy, queuing rationed supply across all society. Massive restrictions on travel similarly implied much smaller changes in airfares,[3] whereas other policy interventions, meant to support wages and rescue troubled firms, also stifled price reactions.

The short-term benefits of these emergency measures now have to be assessed relative to the distortions that they create. Emergency packages supporting particular firms and jobs risk impairing the dynamic adjustment processes essential to the market mechanism and prolong the downturn to the medium run. To prevent this, policy should orient itself toward a speedy exit from the less market-conforming elements of the emergency packages. The political economy of achieving this is complicated, as usual, because while the benefits of competitive markets are diffused in society, backtracking the newly

[1] The detailed CPI items at https://www.ustravel.org/research/travel-price-index report an 11 percent decline of travel prices in the 12 months to May 2020, with hotel rooms contributing almost – 18 percent and airfares – 28.8 percent along with motor fuel's – 33.5 percent contribution. The same data in the more aggregate form at https://www.bls.gov/charts/consumer-price-index/consumer-price-index-by-category-line-chart.htm indicate that "Food at home" contributed 4.8 percentage point increase to CPI inflation for the 12 months to May 2020, offset not only by travel prices but also a by a – 7.9 percent contribution from "Apparel" prices in a negligible 0.1 percent "All items" CPI change.

[2] Eurozone HICP growth in the 12 months to May 2020 was exactly the same as the US CPI at 0.1 percent, with contributions of 3.5 percent each by "Food and non-alcoholic beverages" and "Alcoholic beverages, tobacco" and – 4.5 percent by "Transport". See European Central Bank (2020).

[3] "Passenger transport by air" contributed a positive 3.8 percent to the HICP in the Eurozone (Domestic flights – 0.2, International flights 4.7). These and all other contributions to inflation are likely to be based on historical expenditure shares, which are particularly incorrect for air travel at a time when flights were very few.

introduced interventionist policies is likely to encounter strong support from special-interest groups.

4.1. THE DRAWBACKS OF EMERGENCY POLICY REACTIONS

An aggregate shock's welfare effects should be distributed evenly, but this is not what happened during the emergency, when the disappearance of most services markets hurt the poor the most.[4] Government policies have tried to even out the asymmetric consequences of the shock within each country where the prospect of future reciprocity can make redistribution politically acceptable, with additional public expenditure today being repaid by national taxpayers in the future. Moreover, governments that interact in markets also have legitimate distributional concerns: they favor their own citizens over other countries'. This tendency, which exists regardless of the health shock, has been exacerbated by exceptional circumstances. The result has been that in response to the lockdowns imposed across the Union, national emergency legislations have been put in place in an uncoordinated manner across the European Union.

In the emergency, national governments supported workers locked out of production facilities with a large variety of schemes that paid them a percentage of their pre-crisis wage. The European Union quickly introduced a Temporary Framework suspending most state aid rules, allowing member countries to also support businesses with a variety of subsidized financing, grants, fixed-cost rebates, and tax deferral or tax holiday measures. Providing much needed income and financial support, these policy actions did prevent an even larger collapse of expenditure and increase in unemployment. But they reduced incentives for labor market reallocation across sectors and locations and allowing firms to continue unprofitable operations (as in the case of fixed-cost rebates to businesses experiencing large declines in sales) hampered adjustment also in the goods market.

4.1.1. Fettered Reallocation

The virus shock has had vastly different implications across sectors and individuals, as noted above. These structural changes have had and will likely have long-lived labor demand implications.[5] While costless mobility would let an aggregate shock affect all factor owners equally, mobility is in practice costly, and financial markets do not readily fund individual mobility costs in a way that would share them across society. As factors are specific to sectors, if not firms, their owners suffer income losses when the shock has different implications for different specializations. This is particularly relevant for human capital, and all countries have put in place policies to at least partly restore workers' income losses.[6]

Countries have boosted the types of policies that they traditionally deploy. In most of Europe, subsidies aimed at preserving not only the income but also the jobs of workers, as is the case with *Chômage Partiel* in France, *Cassa Integrazione* (and prohibition of all dismissals until September) in Italy, *Kurzarbeit* in Germany, and job furloughs in the United Kingdom. In the United States, a very generous Federal UI supplement does not preserve jobs, but PPP forgivable paycheck protection loans to small businesses do, and employment preservation is also a feature of US airline rescues in the United States and other countries.

These policies (and similar subsidies to self-employed individuals) were useful for maintaining welfare and, potentially, expenditure during the lockdown, but clearly hamper the labor reallocation that was already useful during the crisis, whereby airline personnel might have been tasked to contact tracing and hotel staff to grocery shop disinfection, and will be needed during the recovery phase. Subsidized temporarily layoffs can usefully patch a temporary demand shortfalls and preserve the preexisting production structure (*Kurzarbeit* was good for Germany in the Great Recession because machinery export restarted quickly to countries outside of the European Union, also thanks to a weak euro), but are inefficient when reallocation is needed across industries and across countries as the preexisting production structure will be obsolete (construction work in Spain was not furloughed, and should not have been). Similarly, overly generous unemployment compensation can prevent re-employment.

Reallocating capital is a second concern. Investment takes time and is strongly affected by uncertainty. The resulting weak expenditure on capital goods stifles hiring of complementary workers by sectors and firms facing rising demand, while support schemes focused on the preservation of existing employment lock both labor and capital in the sectors and firms most negatively affected by the crisis. Business subsidies should remedy the consequences of a temporary shock, such as the lockdown due to the pandemic, but not those of either long-standing difficulties in a sector, to which there should be no extraordinary response, or of the medium-term reallocation needs in the aftermath of the pandemic, to which economies should adjust.

[4] The detailed US evidence at https://www.tracktherecovery.org/ indicates that much of the aggregate consumption decline was accounted for by high-income households, who could cut discretionary spending without suffering a large welfare loss, and removed earning opportunities for low-wage service workers, who would have had to cut essential consumption in the absence of generous supplementary unemployment insurance. A similar pattern is observed for France (Conseil d'Analyse Economique – Chaire Finance Digitale).

[5] See Barrero, Bloom and Davis (2020) for sketchy survey evidence indicating that up to 40 percent of firm-level net job destruction is likely to be permanent in the relatively flexible US labor market.

[6] See OECD (2020).

4.1.2. Fettered Competition

Undistorted market competition has traditionally been the key European instrument for achieving growth, a crucial if conspicuously elusive goal of the European Union. The benefits of efficient market interactions should be even more apparent after the lockdown experience, when lack of opportunities to buy and sell considerably reduced economic welfare. Among EU policies that remove barriers and ensure a well-regulated even playing field, banning industrial policy and state aid prevents inefficient producers backed by their governments from displacing lower-cost producers, which would increase production costs in an integrated goods market. Like doping in sports, such aid is better forbidden because if every country tries to give a competitive advantage to its producers, none will succeed, and much revenue will be wasted.

The Temporary Framework suspension of EU state aid rules since the start of the pandemic has both eased the requirements to accord the possibility to give aid and dramatically shortened response time for approval of such requests by member countries.[7] This contradicts the long-standing pillar of European integration, aimed at increasing welfare by enhancing competition through a level playing field, and has triggered a scramble for expenditure.[8] The unprecedented volume of subsidies has often been biased toward domestic production. For example, aid to the French automobile industry is tied to a commitment to repatriate car plants, and Italy is introducing a voucher for its taxpayers to be spent on holidays in Italy. In many countries, less formal programs encourage stores and households to prefer domestically produced food. These are more extreme instances of preexisting anti-single-market biases, exemplified by tariff-equivalent constraints on service provision and resistance to the Bolkestein directive, and the European Commission finds itself limited in its power to keep them under control.

These policies have several drawbacks. The first is economic inefficiency.[9] Supporting domestic producers, like export subsidies, is an inefficient if myopically attractive beggar-thy-neighbor policy option. A clear example is found in the experience of the 1930s, when such policies were implemented, among others, by the United Kingdom and the United States and contributed to the collapse in trade.[10] Second, this form of intervention can be ineffective as well as inefficient. In a globalized world, identifying a "national firm" is not easy. Subsidies to firms that have delocalized part of their production may lead to foreign rather than domestic jobs being saved, and corporate subsidies are controversial when the name and history of a firm is national but its multinational corporate tax base is offshore.[11] To avoid such drawbacks, most schemes impose conditions on receiving firms, notably no dividends, no stock repurchases, and no worker dismissals over a certain period of time.[12] But introducing distortions in order to redistribute is inefficient in itself, since the restrictions are yet another source of rigidities hindering reallocation.

Lastly, there are distributional concerns across countries. State aid can simply grope for market share in "strategic" industries that may or may not remain strategic after the crisis (such as airlines and automobiles) and tilt the playing field in favor of firms located in countries that can better afford the subsidies. The sectors in which countries specialize is also a major source of distributional conflict when policy apportions the consequences of the pandemic shock. For example, when vacations have to be canceled, Northern European tourists can be sheltered from losing all or part of their advance payments, but requiring refunds can bankrupt Mediterranean tourist service producers, unless their governments rescue them (and their customers).[13] This situation has similarities with what happened during the 2011 sovereign debt crisis, when policy options created a conflict between taxpayers in indebted southern countries and creditor banks in northern ones.

4.2. THE NEED TO REALLOCATE OUT OF THE EMERGENCY

As economies start easing out of the emergency, two major challenges appear: reallocating labor to the "new normal" and dealing with the political economy consequences of government aid.

4.2.1. Moving Toward a New Normal

Reallocation requires investment and, like consumption, is hampered by binding liquidity constraints. Fiscal instruments can usefully smooth consumption and finance reallocation when markets do not, allowing demand and supply to meet at a higher level. The

[7] See European Commission (2020) for recent and previous developments.

[8] Commissioner Vestager reported that by May 4 measures amounting to EUR 1.9 trillion had been approved, roughly half submitted by Germany, see Euraktiv (2020). The figure reported by The Economist on May 30 was just a little higher.

[9] Of course, state aid is not always inefficient: subsidies can remedy well identified market failures. However they are inefficient if they protect or build market shares and prevent competition, and are always fiscally expensive and prone to lobbying.

[10] See Irwin (2011).

[11] Poland actually tried to restrict subsidies to corporations owned by Polish stockholders, which proved to be unfeasible.

[12] The suspension of EU state aid rules has created a grey zone that is also resulting in conflicts. For example, Ryanair is suing the Commission because national carriers are getting support that is being denied to low-cost airlines (Politico 2020) while the Commission is pointing out that the EUR 3 billion Italy is budgeting to nationalize of Alitalia violates State Aid limits, because the temporary framework forbids recapitalization of firms that already needed it at end of 2019.

[13] During the lockdown 12 EU countries allowed vouchers in lieu of refunds for cancelled travel. The European Commission objected, and in July 2020 is opening infringement proceedings against the two (Greece and Italy) that did not repeal that legislation.

implications of fiscal policy for the sectoral allocation and distribution of consumption and income, however, depend on which consumers and producers receive fiscal subsidies matters for microeconomic allocation and income distribution.

Fiscal policy can give purchasing power to individuals and let them spend it freely across sectors and countries: this eases reallocation, yet expenditure on imports of foreign goods or services may be seen as implying a leakage from domestic taxpayers to foreign producers. Alternatively, policy can try to preserve specific individuals' production and income: product-specific subsidies increase producer surplus and, when subsidies are funded by broad tax bases or debt, shift welfare from consumers to producers. Similarly, wage support and consumption subsidies are alternative ways to try to boost demand. Yet, ensuring household income does not drop (too much) does not imply that that income will be spent. The European lockdowns have resulted in a much larger drop in consumption than in incomes, and although part of it was due to the impossibility of consuming, it is unclear to what extent consumption will return. This type of mechanism works at the micro-level as well as at the macro-economic one. In a demand-side recession, what should be boosted is expenditure, rather than income per se. Recent examples of countries running large trade and government surpluses show how expenditure may not become someone else's income. To ease out of the emergency measures, it is thus necessary to find the right balance of income support, producer subsidies, and consumer subsidies.

A second challenge is to ease economies out of the support to wage-earners and companies that tend to freeze the existing supply structure and prevent reallocation across sectors or countries. To do so, it is essential to understand which reallocation is needed and over which horizon, something we cannot yet answer. While it is not known how long the health-shock aftermath will last, it is clearly going to last much longer than wage-for-no-work subsidies can reasonably last.

4.2.2. Getting the Politics Right

A further concern relates to the willingness of politicians to implement the necessary policy changes, since their actions are likely to be influenced by short-term electoral aspirations and the ease with which nationalistic instincts have risen during the crisis. For example, anti-competitive subsidies and regulations are politically more appealing when the resulting market distortions appear to damage foreign corporations (such as Amazon) and help small national producers. Politicians may try to ride on the wave of popularity that such intervention awakes, making them unwilling to remove popular but inefficient handouts.

An additional initiative that was put in place in April is the creation of a temporary Support to mitigate Unemployment Risks in an Emergency (SURE). This new scheme, to be implemented in September, provides financial assistance of up to EUR 100 billion in the form of low-interest loans to member countries experiencing a sudden increase in public expenditure due to schemes aimed at preserving employment. This is a useful signal of the Commission's willingness to help, rather than constrain, the member countries' labor policies. The short-time wage subsidies envisioned by the scheme, however, need not fit all sectors in the face of permanent structural change. Like many of those enacted at the national level and those envisioned in the European Recovery Fund framework, they may hamper reallocation and adjustment in the medium term. Protecting existing jobs and dirigisme (even if it is oriented toward worthy Green Economy objectives) run the risk of stifling market-driven structural adjustment within and across country borders.

4.3. EUROPEAN EXIT POLICIES AFTER THE EMERGENCY

Emergency legislation at the country level and relaxation of public debt and state rules in the European Union has made national governments more powerful. The crisis did require powerful governments, but in the recovery phase excessively intrusive and poorly coordinated policies are in danger of hampering the market's role in reallocating resources in the face of structural developments. The longer it takes to realize that such policies need to be reversed, the harder it will be to do so from the political-economy point of view. An exit strategy should be designed quickly and implemented clearly, focusing on the following aspects.

4.3.1. Restoring Incentives for Labor Reallocation

In countries where UI has played a primary role in preserving worker incomes and consumption, the aim should be to replace expiring entitlements with in-work benefits, such as those envisioned for re-employed UI recipients in the United States. In countries where job protection has been the focus of labor market policy, it would be advisable not to rely too much on in-firm retraining and reallocation of labor when structural shifts are needed. To this end, governments could introduce tax credits for workers moving out of declining sectors and firms, with a top-up for those who pay too little tax to benefit from tax credits. To encourage reallocation towards jobs that might yet disappear, it would also be useful to envision extended unemployment benefit entitlements for workers who switch sectors.

4.3.2. Supporting Aggregate Expenditure with Market-Friendly Policies

Since monetary policy is exhausted, small appetite for consumption and investment in the private sector may call for fiscal policy. As the stagflation experience of the 1970s shows, there are potential issues in continuing to do so when the crisis moves from the emergency phase to the need to address longer-lasting structural issues. In that situation, country-specific and EU instruments deployed to stimulate consumption and investment should not suppress the market-based reallocation that is necessary on the recovery path.

Country-level policies may boost consumption without constraining the sectoral pattern of consumer expenditure by alleviating liquidity constraints or by inducing the unconstrained wealthy households that accounted for most of the consumption decline during the acute phase of the crisis to anticipate consumption, but these measures may not be effective. Income subsidies or temporary mortgage and rent suspension only stimulate consumption if they are targeted at liquidity-constrained households. VAT reductions do not stimulate consumption if they fail to result in lower purchase prices, because sellers face weak competition and need to pay for additional administrative costs, or if they are not expected to be repealed as promised at a future time when economic activity will still be weak.[14] While across-the-board temporary VAT reductions are less distortive and more market-friendly than other stimulus policies (such as a VAT reduction on restaurant meals only, as implemented in the United Kingdom along with subsidies on certain weekdays), their appeal depends on country-specific features, notably on the extent to which it is advisable for a country to reduce consumption rather than labor income taxation.[15]

Given accumulated savings and pent-up demand, consumption may in fact pick up quickly even without any VAT holiday. However, it can then wane, or encounter bottlenecks and increase prices, and the effects may depend on how firms' investments recover. On the way to exit, it would be advisable to finance investment, rather than working capital, as was the case during the crisis, when it would have been pointless to try and stimulate investments that require careful planning and cannot be performed effectively under extreme uncertainty. Promoting investment should focus on dealing with uncertainty about future demand, not with preserving the current productive structure. State guarantees of loans across all investments can prevent a collapse in investment driven by firms' and banks' pessimistic expectations.[16] These guarantees should be partial, to provide banks with incentives for risk assessment and monitoring, and should be offered across the board, so as to let the market allocate capacity to firms and sectors in a way that prevents supply bottlenecks.

4.3.3. Releasing the Benefits of the Single Market

The European Commission should monitor country-specific policies to avoid national biases and come up with reallocation-friendly policies that should not distort the relative appeal of employment profitability of investment across sectors and countries. The latter aspect is problematic in the EU's situation of integrated markets and subsidiary fiscal policies.

To ensure a level playing field and foster efficiency, for example, the investment loan guarantees discussed above might in theory be offered to firms operating in a country regardless of their "nationality," or perhaps to firms with a legal or fiscal seat in the country irrespective of where they invest. This is not generally done. For instance, the Italian government's guarantee of a EUR 6.5 billion euro loan by an Italian bank to FCA (a Dutch corporation that pays taxes in the United Kingdom) entails a commitment to invest in Italy, rather than wherever it is most efficient to invest. Many of the above policies raise similar questions about how precisely to apply them.

While speedy approvals of state aid were welcome during the early stages of the crisis, a rapid review of the Commission's rules on state aid and greater concertation are now needed. Approval of state aid measures should be based on sector- rather than country-specific considerations, aiming to ease reallocation while preserving a level playing field and keeping beggar-thy-neighbor national policies in check. Coordinated responses at the EU level would both put pressure on (and make it less costly for) national politicians to reverse the emergency measures. Sector-level special interests remain important, however, and centralization of policy decisions (such as the Commission's proposed EUR 750 billion aid package) need not make them immune to lobbying pressure, which may in fact be more effective in Brussels, where a greater distance from the electorate makes policy makers less accountable.

Because national borders do not coincide with markets, all members of the single market partake of the benefits of each country's policy. This makes it important to consider the possible advantages of supranational fiscal instruments that feature transfers across countries. If efficiently bargained in the

[14] Indeed, the VAT holiday would not have a strong effect on current consumption should it be perceived to be permanent, and the possibility that the VAT rate might or might not increase destabilizes expectations.

[15] Germany implemented a 3 percentage point reduction of the standard VAT rate (and 2 percentage points of the reduced rate) for the last 6 months of 2020; however its labor tax wedge is the second-highest in the European Union (after Belgium) and it would benefit from being reduced according to the European Commission, see https://ec.europa.eu/info/sites/info/files/economy-finance/ip130_en_chapter_i.pdf .

[16] See ETH Zürich (2020) for further discussion. Note that any temporary VAT declines create expectations of future consumption declines, thus they may depress rather than stimulate investment.

EU institutional framework, they can help preserve the common market, a European public good, and are vastly preferable to uncoordinated country-level policies that inefficiently distort production and expenditure toward their own industries, and in doing so reduce the overall size of Europe's economic welfare.

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