

Research Paper

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Europe After Coronavirus: The EU and a New Political Economy



Summary

- The COVID-19 pandemic has created a health and economic crisis without modern parallel. The scale of its effects could prompt a far-reaching re-evaluation of the role of the state in relation to the market in Europe. This paper is a thought experiment examining the consequences of a change in Europe's political economy and the potential implications for the European project.
- The current form of the European Union, centred on the single market and the single currency, evolved during a period of economic liberalization. If the COVID-19 crisis leads to a larger role for the state and a move away from market-oriented policies, the EU will face a challenge in accommodating that change.
- In particular, attempts by member states to pursue more interventionist approaches could lead to clashes within the EU – especially around fiscal policy and taxation, labour markets and redistribution, and industrial policy.
- Given sufficient consensus between member states, the EU could conceivably be the driver of collective change in these areas. But because of existing political differences and the fact that the health and economic crisis has had asymmetric effects within Europe, it is more likely that the pandemic response will lead to an uneven shift in economic policy across the EU.
- The danger is that the EU may become trapped in a suboptimal status quo without a consensus on how to change it, and could therefore be unable to make the shift towards a more state-centric political economy that citizens may now demand.
- The EU could reform itself to accommodate a more interventionist economic model. But for this to happen, European leaders will have to avoid thinking of European integration as a linear, one-way process in which it is impossible to change course or reverse policies that have long been considered part of the EU's liberalizing vocation.

Introduction

The COVID-19 pandemic has created a health and economic crisis without modern parallel. In a matter of months, the virus has spread to almost every country and territory in the world, killing more than 400,000 people, profoundly disrupting the lives of millions, and leading to an almost complete shutdown of large sectors of the global economy. The world is now in an economic recession of unprecedented depth, unique character and uncertain duration. After locking down citizens and banning domestic and international travel, governments around the world have taken extraordinary steps to mitigate economic impacts, including providing enormous monetary and fiscal support to businesses and employees.¹

Europe has been hit both early and hard by the crisis. In a short space of time, the reach of the European state has grown enormously as governments have taken on new and remarkable roles both in providing economic relief and in regulating and restricting the private lives of citizens. In Germany, France and Italy alone, this has included more than €418 billion in direct fiscal measures (such as paying worker wages), €963 billion in deferrals (such as postponed tax payments), and €1.8 trillion in liquidity (such as credit lines and guarantees),² while the European Commission has proposed a recovery fund of €750 billion, composed of grants and loans.

We do not know yet the full effects of the pandemic, or how long these will last. But there has been much discussion about whether the scale of the crisis, and the response to it, could prompt a far-reaching re-evaluation of the role of the state in relation to the market. Could the crisis galvanize demands for different ways of organizing economic life from the ones that have predominated since the end of the Cold War – in short, could COVID-19 herald a substantially new model of political economy in Europe?

Beyond the extraordinary scale of national and EU-level economic recovery policies, there are signs of a broader shift in attitudes. President Emmanuel Macron of France has identified the need to remake capitalism and strengthen national and European ‘economic sovereignty’ by investing at home in the medical and high-tech sectors.³ The German chancellor, Angela Merkel, wants to address the overconcentration of the market for protective items in Asia by introducing a degree of sovereignty, both national and European, in this area.⁴ The Spanish government has passed a guaranteed minimum-income scheme to protect the most vulnerable households and foster social and labour inclusion,⁵ following other European states that have either introduced or piloted relevant measures at national or regional level. *The Economist* magazine expects a new economic settlement, while the *Financial Times* has called for one.⁶ These moves suggest that beyond the immediate crisis response, COVID-19 could lead to a wider rethink of Europe’s political economy.

¹ At the time of writing, European countries are starting to ease their lockdowns and reopen parts of their economies. However, activity in many sectors remains suspended or dramatically curtailed, and the prospects of anything like a return to pre-coronavirus levels of economic activity – without risking renewed spikes in infection – remain extremely low for the time being.

² Anderson, J., Bergamini, E., Brekelmans, S., Cameron, A., Darvas, Z., Jiménez, M. D. and Midões, C. (2020), ‘The fiscal response to the economic fallout from the coronavirus’, Bruegel Datasets blog, <https://www.bruegel.org/publications/datasets/covid-national-dataset/> (correct as of 27 May 2020).

³ Mallet, V. and Khalaf, R. (2020), ‘Transcript: ‘We are at a moment of truth’ (English)’, interview with Emmanuel Macron, *Financial Times*, 17 April 2020, <https://on.ft.com/3dfjPOn>.

⁴ Posaner, J. and Mischke, J. (2020), ‘Angela Merkel: Coronavirus ‘biggest test’ yet for EU’, *Politico*, 6 April 2020, <https://www.politico.eu/article/angela-merkel-coronavirus-biggest-test-yet-eu/>.

⁵ Gómez, M. V. (2020), ‘Spain to approve guaranteed minimum income scheme for vulnerable families’, *El País*, 29 May 2020, https://english.elpais.com/spanish_news/2020-05-29/spain-to-approve-guaranteed-minimum-income-scheme-for-vulnerable-families.html.

⁶ *The Economist* (2020), ‘Rich countries try radical economic policies to counter covid-19’, *The Economist*, 26 March 2020, <https://www.economist.com/briefing/2020/03/26/rich-countries-try-radical-economic-policies-to-counter-covid-19>; and *Financial Times* (2020), ‘Virus lays bare the frailty of the social contract’, Opinion: The FT View, 3 April 2020, <https://www.ft.com/content/7eff769a-74dd-11ea-95fe-fcd274e920ca>.

This research paper explores what such a model might look like, and what it would mean for the governance of the European Union. It is intended not as a forecast but as a thought experiment that examines the consequences of a change in Europe's political economy and the potential implications for the European project. It argues that, in the absence of consensus, current EU rules and structures could constrain the ability of member states to effect significant reform. This could lead to policy clashes between member states, as well as between member states and EU institutions, that go beyond much-discussed issues around risk-sharing in the eurozone. The danger is that the EU could now be trapped in a suboptimal status quo without a consensus about how to move forward – and could therefore be unable to make the shift towards a more state-centric political economy that citizens may now demand.

The evolution of the state–market balance in Europe

The history of the evolving relationship between the state and the market in post-war Europe can be divided into two phases. The first was the 30-year period after the end of the Second World War, which the French economist Jean Fourastié famously called 'Les Trente Glorieuses'. This Keynesian period was dominated by economic planning, which became, as Tony Judt put it, 'the political religion of post-war Europe'.⁷ As reconstruction drove growth in Europe, the post-war settlement between capital and labour produced the activist welfare state. But the settlement did not function in quite the same way everywhere. Different models of welfare capitalism evolved in Europe: a 'liberal' model (as in the UK), a 'conservative-corporatist' model (as in Germany and Italy), and a 'social democratic' model (as in Sweden).⁸

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A second period began after the oil shock of 1973, in which the balance shifted away from the state towards the market. In what is sometimes called the 'neoliberal turn', price stability replaced full employment as the primary goal of economic policy. Governments sought to reduce the power of organized labour, which was then seen as driving the rise in inflation. Keynesian thinking was replaced by monetarist economics, and by policies such as tax cuts and deregulation. As had been the case with welfare capitalism, this new settlement functioned in different ways from one European state to another. The UK went furthest in 'financialization' – that is, the growth in the size and importance of the financial sector. Germany, on the other hand, retained much of its social market economy, though it was always extremely hawkish on inflation – a key element of neoliberalism. Other European states followed their own paths, but the general direction of travel was towards a more limited state and an elevated role for market forces.

This evolution in the relationship between state and market overlapped to a large extent with the development of globalization. During the 30 years after the Second World War, barriers to the movement of manufactured goods were removed under the General Agreement on Tariffs and Trade (GATT), although agricultural goods were exempt and barriers to the movement of capital

⁷ See Judt, T. (2011), *Postwar: A History of Europe Since 1945*, New York: Penguin Press, p. 67.

⁸ Esping-Andersen, G. (1990), *The Three Worlds of Welfare Capitalism*, Princeton, New Jersey: Princeton University Press.

and people remained.⁹ After the end of the Cold War, this moderate form of globalization gave way to a more expansive model that significantly reduced the sovereignty of states – for example, through the rules of the World Trade Organization, which went further than GATT in liberalizing trade. In this period of what Dani Rodrik has called ‘hyper-globalization’, economic interdependence between states and regions increased as global trade surged and was restructured around international supply chains and ‘just in time’ manufacturing.

European integration developed against the background of this evolution of globalization. It, too, can be divided into two phases: a first that included the Schuman Plan in 1950 and the Treaty of Rome in 1957; and a second that began in the 1980s with the single-market project, and continued with the creation of the economic and monetary union in the 1990s. If we understand globalization as the removal of barriers to the movement of capital, goods and people, Europe clearly went even further in this second phase than the rest of world – at least by these measures. European integration can therefore be thought of as a particularly developed form of ‘hyper-globalization’, albeit limited to a regional context.

In the first wave of European integration beginning in the 1950s, continental European states formed a cartel to produce coal and steel, and then, in 1968, a customs union with a common external tariff. National governments retained extensive autonomy in many areas of policy. In fact, during this period integration seems to have strengthened the nation state rather than undermining it.¹⁰ As Alan Milward has argued, integration ‘rescued’ the European nation state after the Second World War.¹¹ After the 1957 Treaty of Rome, European integration stalled at the political level throughout the 1970s – though, importantly, ‘judicial integration’ continued through decisions by the European Court of Justice, with significant consequences for competition law.¹²

The relaunch of European integration that took place with the single-market project in the 1980s coincided with, and was closely connected to, the neoliberal turn. The British prime minister, Margaret Thatcher, was central to both developments. A further factor was that centre-left parties like the French Socialist Party had themselves embraced deep integration after the abandonment in 1983 of French President François Mitterrand’s experiment with ‘Keynesianism in one country’, amid growing hopes for a corresponding drive for a more ‘social Europe’ at the supranational level. The 1986 Single European Act, the first significant change to the Treaty of Rome, laid the groundwork for the single market, a project that drove deregulation, privatization, subsidy reduction and the removal of barriers to the flow of capital, goods and services. As Chris Bickerton remarked: ‘Closer European integration became a way of burying the post-war compromise.’¹³

What emerged during the 1980s was a European Community that was structurally skewed towards the removal of market barriers between European countries (a process known as ‘negative integration’) rather than the agreement of common policies to curb market excesses (or ‘positive integration’).¹⁴ The EU subsequently became a kind of machine for negative integration even in the absence of political agreement. Meanwhile, positive integration proved extremely

⁹ See Rodrik, D. (2010), *The Globalization Paradox: Democracy and the Future of the World Economy*, New York: Norton.

¹⁰ Bickerton, C. (2016), *The European Union. A Citizen’s Guide*, Harmondsworth: Penguin, p. 53.

¹¹ See Milward, A. (2000), *The European Rescue of the Nation State*, London: Routledge.

¹² See Scharpf, F. (1999), *Governing in Europe. Effective and Democratic?*, Oxford: Oxford University Press.

¹³ Bickerton (2016), *The European Union*, p. 68.

¹⁴ Scharpf, F. (1998), ‘Negative and Positive Integration in the Political Economy of European Welfare States’, in Rhodes, M. and Mény Y. (eds), *The Future of European Welfare: A New Social Contract?*, Houndmills: Macmillan, pp. 155–77, here p. 155.

difficult to undertake, particularly as the EU enlarged, because it required agreement (usually unanimous) between member states. The regulatory competition unleashed by negative integration put pressure on welfare models, while aspirations for a more ‘social’ Europe were largely frustrated.

What might be called the ‘neoliberalization’ of the EU continued and intensified in the 1990s after the end of the Cold War. With the creation of the European single currency, the EU went further in ‘constitutionalizing’ elements of neoliberal economic policy. The European Central Bank (ECB) was given a narrow mandate focusing almost exclusively on price stability. Meanwhile, the eurozone’s fiscal rules, which have been gradually expanded and tightened since their first iteration in the Maastricht Treaty that created the single currency, set limits on government debt and deficits, although an EU-wide framework of minimum rights for workers was also established. In parallel, freedom of movement increased as the EU enlarged, creating a more integrated European labour market and generating dynamism and efficiency, but also raising concerns about immigration – in particular, but not only, in the UK.

The 2008–09 global financial crash and subsequent eurozone crisis highlighted many of the challenges of market fundamentalism. The crisis was considered by many as an opportunity to recalibrate the state–market balance and address what they saw as market overreach. However, the political and policy dynamics of the time prevented a serious paradigm shift. Instead, after an initial fiscal stimulus, the collective EU and national responses to the crisis frequently entailed aggressive fiscal consolidation with massive social and political consequences. In particular, after the start of the euro crisis in 2010, the EU enforced austerity and structural reform on crisis-hit countries.

If a genuine shift away from market mechanisms and ‘sound money’ is to now take place in the context of the coronavirus pandemic, what will that mean for the relationship between the nation state and the EU? If priorities or preferences shift among governments and publics, as may now be occurring, the EU will both shape the degree to which it is possible to enact these preferences and itself be shaped by the outcome. The current form of the EU, centred on negative integration, the single market and the single currency, came into being during the neoliberal period. If the relationship between the state and the market now changes, what kind of supranational architecture and structures will Europe need? Can the EU as currently constructed adapt to a change in economic paradigm?

The EU’s future will also be conditioned by the existing and unresolved political tensions that predate the pandemic. Despite frequent predictions of its demise, the EU has proven politically resilient through more than a decade of crises, including the eurozone debt crisis, the migration crisis and Brexit. At the same time, it has not decisively resolved a number of fundamental internal challenges to its functioning. Many of these are rooted in the mixed or partial nature of European integration, the characteristics of which include: a monetary union (of 19 states) without a fiscal union; a borderless interior (linking 25 states) protected by largely nationally managed frontiers; central institutions (representing 27 states) of contested democratic legitimacy; and as yet unsettled relationships with key neighbours including Britain (a former member state of 66 million people), Turkey (a candidate country of 82 million), and a number of candidates and aspirant members from the Western Balkans to Ukraine. The capacity of the EU to shape itself and evolve in response to the pandemic will be influenced by this wider context.

A new political economy?

The exact shape of the post-coronavirus European political economy is impossible to predict. However, it is feasible to identify certain elements that could emerge at a national level, based on some of the clear shortcomings and vulnerabilities that the pandemic has revealed and exacerbated. First and foremost, it is assumed here that the crisis will lead to a larger role for the state in the economy. Following decades in which the governing consensus largely dismissed the effectiveness of state intervention in many areas of life (albeit with the balance struck differently in different parts of Europe), the pandemic and the response to it have highlighted the power of the state in no uncertain terms, notably its central role in providing universal healthcare and essential economic relief.

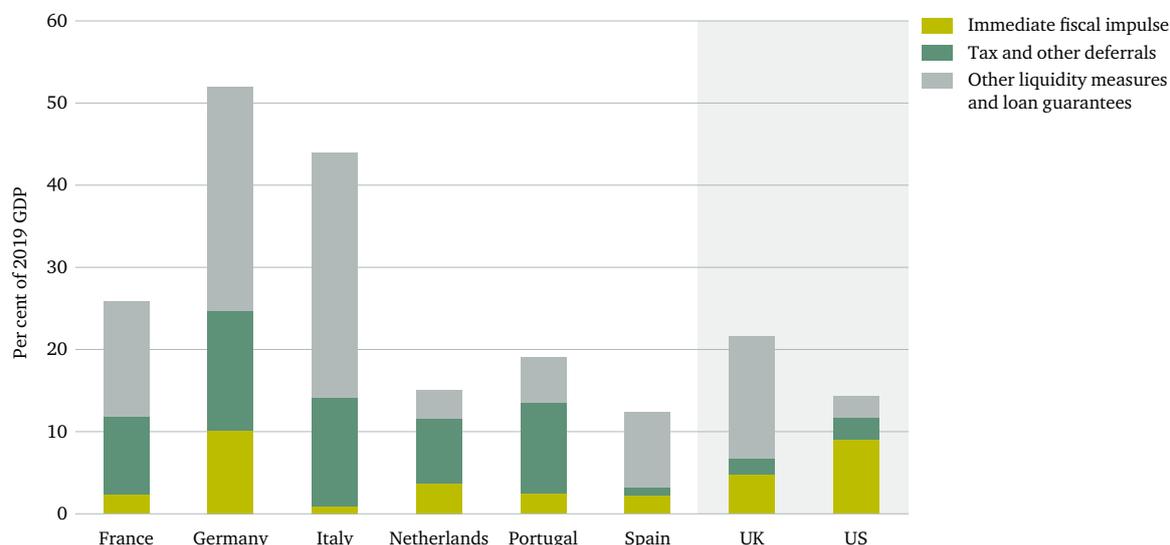
What was previously regarded by many as politically unnecessary, undesirable or just impossible has been shown to be both essential *and* deliverable.

The way in which many European governments have used unprecedented fiscal and monetary firepower to put economies into semi-hibernation is likely to change how people think about state capacity. The crisis has revealed the state as the fundamental guarantor of the economy, and has expanded public awareness of the policy options available. What was previously regarded by many as politically unnecessary, undesirable or just impossible has been shown to be both essential *and* deliverable. Governments have discarded long-standing policy restraints such as concerns for fiscal deficits and public debt sustainability (which, alongside the centrality of market mechanisms, were features of the dominant paradigm). In the future, governments may feel more compelled to solve challenges which they have previously considered beyond them, and to build on the experience of the current economic dislocation to push through significant changes to their political economies. One can envisage potential changes in three areas in particular: (1) fiscal policy and taxation, (2) labour markets and redistribution, and (3) industrial policy.

Fiscal policy

A larger role for the state would almost certainly entail increased government spending. During the coronavirus crisis, European governments have demonstrated an unprecedented willingness to increase spending by, for instance, paying the wages of millions of furloughed workers. In order to enable governments to put large parts of their economies into hibernation, the European Commission has suspended the EU's fiscal rules, and even the most fiscally conservative member states, such as Austria and the Netherlands, have announced large stimulus packages. Perhaps most strikingly, the German government has rapidly, albeit temporarily, let go of its so-called 'black zero' policy of balanced budgets, which in recent years has defined the country's approach to fiscal policy. The size and effectiveness of the stimulus measures, as well as the speed with which they were designed, approved and implemented, could create popular expectations of continued or more extensive state intervention in the future.

Figure 1: Different sizes of COVID-19 policy responses (% of 2019 GDP)



Source: Bruegel.

Comparison with the 2008–09 financial crisis is pertinent here. In its aftermath, many European countries primarily used cuts in public expenditure to tackle budget deficits and high public debt levels, which had been caused in part by the fiscal stimulus initially deployed in response to that crisis. But the painful experiences of austerity over the subsequent decade, combined with the political impact of the coronavirus crisis itself, suggest a similar approach is untenable this time. Instead, it seems likely that governments will both raise the overall tax burden and change how it is allocated. States may introduce wealth taxes in an effort to correct the balance between capital and labour and address broader issues of inequality.

Tensions over these issues were already present before the coronavirus crisis, but they are being exacerbated today, particularly as sectors such as tourism and hospitality (with the most precarious forms of employment) have been hit hardest. Meanwhile, more secure, high-wage sectors have had much more opportunity to continue operating in an environment of self-isolation, and have been able to access government support schemes. Correcting the distributive economic effects of the crisis could now become a policy priority, reflecting demands to reform the system that created such unequal vulnerability. Measures could include new or increased taxes on land, property, capital income or capital gains.

Higher corporate taxes would also be an obvious response in light of the massive support that governments have provided to the private sector. When the crisis struck, the lack of financial buffers in the corporate sector necessitated immediate government intervention. Policymakers may now try to regulate companies more robustly to make them more resilient to future shocks and downturns. European governments are likely not just to raise corporate tax rates but also to crack down more firmly and unilaterally on international tax optimization by multinationals – as Belgium, Denmark, France, Italy and Poland have already done in their responses to the coronavirus.¹⁵ The political

¹⁵ See van Dorpe, S., Braun, E. and Larger, T. (2020), 'If you want a bailout in Europe, don't use tax havens', *Politico*, 23 April 2020, <https://www.politico.eu/article/if-you-want-a-bailout-in-europe-dont-use-tax-havens/>.

imperative for such measures is clear: citizens are already complaining loudly about governments providing life support to businesses that had previously exploited favourable tax structures to lower their tax bills.

Labour markets, redistribution and the welfare state

European governments are also likely to move away from a focus on labour market flexibility towards a model that provides greater security for workers. This would be a natural response to the growth of precarious employment over the past decade, including of ‘critical workers’, whose vulnerability has been highlighted by the coronavirus crisis. The long-term social and political effects of a shift in welfare policy away from the limited and conditional model favoured under the neoliberal consensus to one with a broader reach are unclear, but could be substantial. Some governments have already discussed introducing temporary forms of basic income, which in time could be expanded (e.g. to offer more generous benefits) and/or made permanent. Once in place, universal benefits would likely create a change in the public mind-set and become entrenched and politically very difficult to remove.

Finally, European governments can be expected to spend more on healthcare and other selected policy areas. Even before the pandemic, healthcare expenditure was already rising in almost every EU country – a function of the easing of the euro crisis as well as long-term demographic trends and the increasing sophistication of modern medicine. As that process accelerates in the coming years, healthcare will consume an ever higher share of GDP. The same trend could be observed in a range of policy areas that have faced significant budget cuts in the past, including education and social welfare. There may also be a move to renationalize, or ‘remunicipalize’, previously privatized basic service providers in areas such as healthcare.

In contrast, certain other categories of spending may face greater scrutiny as changing political preferences lead to a reassessment of their value. In particular, governments may come under public pressure to reduce conventional defence capacity and reallocate resources towards spending that more visibly improves social and state resilience. Recession will add to the pressure on public finances. Defence budgets – frequently the target of government cost-cutting during economic downturns – will likely be reduced. For example, following the global financial crisis, European defence spending fell by about 11 per cent.¹⁶ Defence funding priorities also risk shifting in the post-COVID-19 world. With the UK defence secretary recently declaring ‘lack of resilience’ as the new number one threat,¹⁷ it may be harder for governments to justify expenditure dedicated to expensive procurement programmes for conventional capabilities against traditional threats.

Industrial policy

European governments may take a new and more activist approach to industrial policy, increasing state control and planning of the economy. The coronavirus crisis could undermine the previously prevailing orthodoxy which favoured smaller states, limited government and free markets. The EU has relaxed rules on state aid to allow governments to support businesses, including through large relief

¹⁶ Becker, S. and Mölling, C. (2020), *Deterrence and Defense in Times of COVID-19: Europe's Political Choices*, DGAP Policy Brief, No. 9, April 2020, German Council on Foreign Relations, https://dgap.org/sites/default/files/article_pdfs/dgap-policybrief-2020-09-en.pdf.

¹⁷ Chuter, A. (2020), ‘UK defense plans could take major hit from coronavirus fallout’, *DefenseNews.com*, 23 April 2020, <https://www.defensenews.com/global/europe/2020/04/23/uk-defense-plans-could-take-major-hit-from-coronavirus-fallout/#.XsfoB-Lf5s0.twitter>.

packages for hard-hit industries such as aviation. Member states might push to continue to bypass these rules after the crisis – initially to support the recovery but also for other reasons, such as in pursuit of climate goals. The risk is that this could undermine the single market by distorting the level playing field within the bloc. Some companies may be nationalized or continue to receive significant government support in order to sustain themselves.

Agriculture, for example, which already receives high levels of government support, could become further protected by the state. Governments could also take a more active role in energy provision by combining a new approach to state resilience with the ongoing need to address the climate crisis. Beyond these sectors, European governments or the EU may attempt to protect industries or favour national champions that produce critical supplies, such as in biomedical sciences – perhaps by applying something like the approach of the Common Agricultural Policy to other sectors of the economy.¹⁸ A potentially higher degree of caution towards China could lead to greater industrial support in new areas to avoid over-reliance on Chinese companies and technology, and to ward off perceived or real competition from Chinese firms.

Differential impacts

Changes in these policy areas will likely manifest themselves in different ways, and to varying degrees, across the EU, for two reasons. First, even within the framework of the EU and the single market, the extent of state activity and welfare provision varies considerably from one country to the next. Countries with more developed welfare states, well-funded healthcare systems and the resources to put their economies in hibernation – such as Germany and Austria – are likely to come out of the crisis with less damage, and may hesitate to make big societal changes. Despite the shared regulatory space of the single market, countries do not start from the same position when it comes to the relationship between state and market.

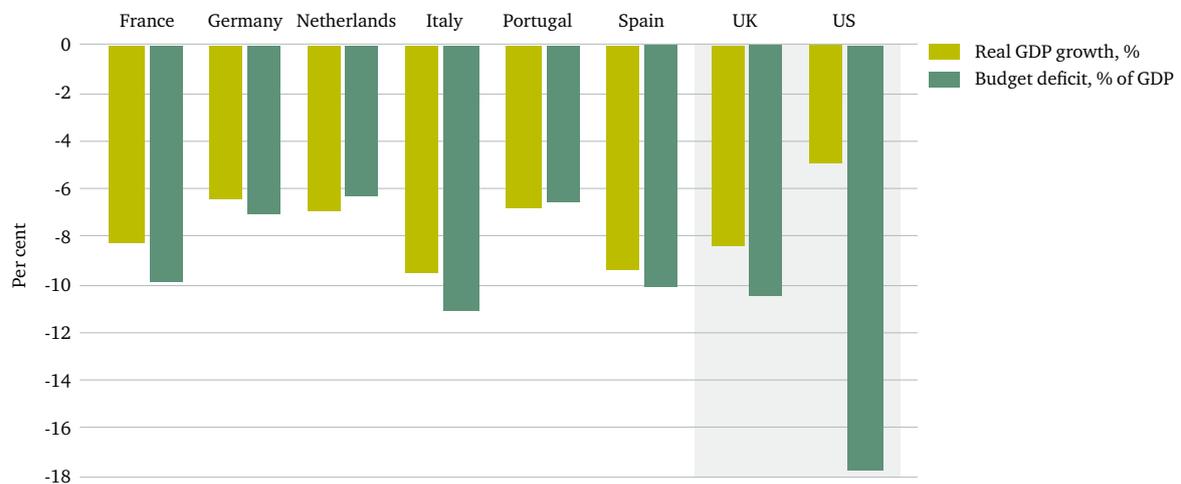
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Second, the pandemic has so far affected different European countries in different ways. At first glance, it seemed likely to be more of a *symmetric* shock than the eurozone debt crisis or 2015 refugee crisis – as COVID-19 has affected all countries in Europe. But whereas the crisis hit Italy particularly early and hard, other EU member states had extra time to develop their responses, which helped at least some of them (such as Greece) to minimize its impact. Other differences, such as in demographics and economic structure, have also contributed to variations in the spread of the virus and the effectiveness of state response. In other words, the shock also has elements of *asymmetry*. This means that one should not necessarily expect any shift in the relationship between state and market to occur in a uniform way. The danger is that the crisis may thus lead to further economic divergence within Europe.¹⁹

¹⁸ See, for example, Clark, S. and Dummett, B. (2020), 'Coronavirus Accelerates European Efforts to Block Foreign Takeovers', *Wall Street Journal*, 10 April 2020, <https://www.wsj.com/articles/coronavirus-accelerates-european-efforts-to-block-foreign-takeovers-11586516403>.

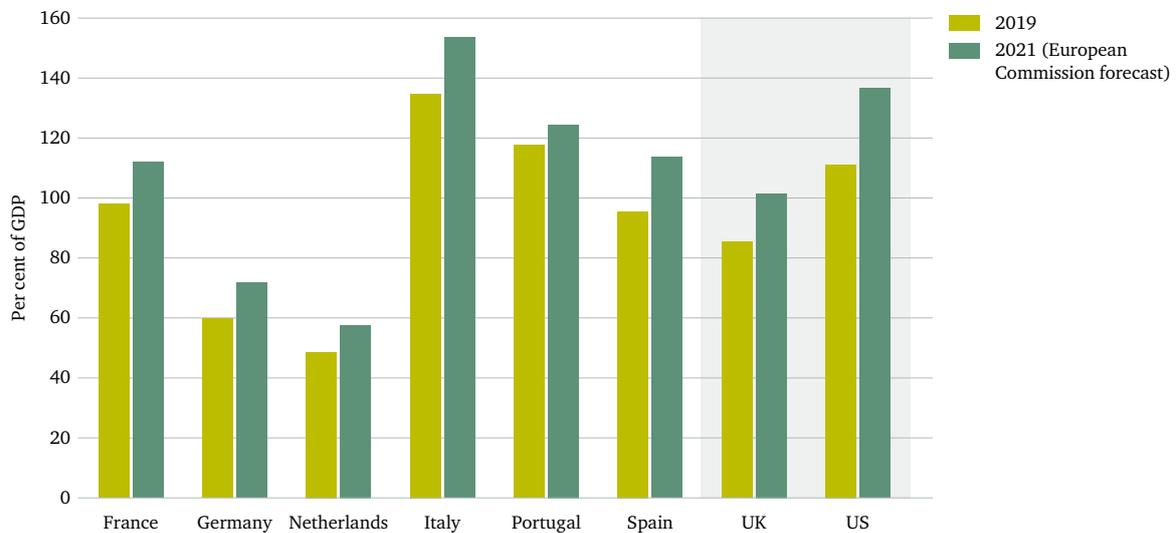
¹⁹ See Odendahl, C. and Springford, J. (2020), *Three ways COVID-19 will cause economic divergence in Europe*, Centre for European Reform, 21 May 2020, <https://www.cer.eu/publications/archive/policy-brief/2020/three-ways-covid-19-will-cause-economic-divergence-europe>.

Figure 2: Economic growth and government deficit forecasts for 2020



Source: European Commission (2020), AMECO database.

Figure 3: Government debt (% of GDP)



Source: European Commission (2020), AMECO database.

The EU and a new economic settlement

If a new political economy were to emerge at national level in some parts of Europe, what would this mean for supranational governance? Countries that are outside the EU will be comparatively freer to tailor the balance between state and market to their own needs – as the UK will be once it ends its transitional Brexit arrangements. EU member states, on the other hand, will need to reconcile any such shift with the requirements and obligations of their membership.

As discussed, the EU evolved in size and policy orientation against the background of the neoliberal turn and the emergence of ‘hyper-globalization’. Many of the structures of the EU as it is today were designed to limit the capacity of member state governments to intervene in the functioning of the market. In particular, the bias towards ‘negative’ integration had the effect of impeding state intervention at the national level. Yet in many areas it proved difficult to create the corresponding instruments at a European level to achieve social objectives or manage the consequences of interconnected markets. A shifting settlement between the state and the market would therefore raise questions over the sustainability of existing forms of integration and the institutional architecture created to govern them.

Potentially, the EU itself could become the driver of change in Europe’s political economy, championing a renewed focus on solidarity, welfare and the reduction of inequality between and within states. In some areas, such as tax policy, working at the EU level would be more effective, potentially reducing capital flight and regulatory and tax arbitrage. In a Europe in which a broad consensus emerged on changing the balance between state and market, EU institutions might take the lead on reform. This could involve a number of ambitious measures:

- A **new set of fiscal rules** to replace the Stability and Growth Pact. This would give governments greater space to run expansionary fiscal policies.
- A **massive infrastructure stimulus programme** to address regional inequalities through productivity-increasing and carbon-reducing investments at a scale above and beyond that currently envisaged under the European Commission’s ‘Green Deal’.
- A significant **expansion and reform of the European Multiannual Financial Framework (MFF)**. This would allow the EU to play a more significant redistributive role across states and regions than is feasible under the current budget, which accounts for only about 1 per cent of the EU’s aggregate GDP.
- The **creation of a system of risk sharing within the eurozone** to better cope with economic shocks to one or more members of the single currency. This could include the issuance of common debt instruments.
- **Reform of the ECB’s mandate** to explicitly target full employment as well as price stability.
- **Corporate tax harmonization** to prevent distortive practices and tax avoidance.
- The **establishment of a common European unemployment insurance scheme**, both to provide additional income security for those out of work and to facilitate macroeconomic stabilization.
- **Increased employee protections**, in particular targeting those in precarious employment, through a new common approach to workers’ rights.
- A **change to EU state aid rules**, with states given more leeway to support and champion European industries.
- A **new approach to trade** that would take full account of environmental objectives and labour rights.

Delivering such an ambitious agenda, aspects of which have been extensively debated or considered at EU level in the past, would require wide consensus among member states on implementing substantive economic and legal reform of the EU. It would almost certainly require negotiating changes to the EU treaties, as well as wider reform of the EU's institutions in order to provide legitimacy and accountability for such a large-scale expansion of the role of the EU – or what is sometimes termed ‘political union’.

However, while some modest measures appear both possible and likely, it seems doubtful that the coronavirus crisis will lead to a decisive political breakthrough, given the uneven impacts of the pandemic and the different starting points of member states, both economically and politically. The recent political quarrels over ‘coronabonds’ exposed the gaps between member states rather than helping bridge them. At the outset of the crisis, the only EU institution to move in a more radical direction from past policies was the ECB, which does not require agreement from member states – though the recent ruling by the German constitutional court on the ECB's bond-buying programme has now limited its room for manoeuvre.²⁰

It seems doubtful that the coronavirus crisis will lead to a decisive political breakthrough, given the uneven impacts of the pandemic and the different starting points of member states, both economically and politically.

In mid-May, France and Germany proposed an EU recovery fund, which was subsequently turned into a more detailed proposal by the European Commission. Such a fund – totalling €750 billion in grants and loans – would be financed by collective borrowing through the European Commission. This has been interpreted by some analysts as a response to the German constitutional court ruling and even as a kind of ‘Hamiltonian moment’ that may lead to a real fiscal or even political union analogous to the United States.²¹ But while the recovery fund would undoubtedly be a step forward, it would be a one-off EU instrument, as opposed to a permanent mechanism to address structural imbalances in the EU. It therefore would not constitute a significant step towards ‘completing’ economic and monetary union, nor would it represent a significant change in the EU's economic governance structure.²²

These difficulties may reflect a more fundamental challenge: whether the EU as currently constituted (and encompassing such a diversity of states) is capable of major structural changes. The long-standing practice of treaty-driven integration, in which regular and periodic evolutions in constitutional aspects of the EU have been agreed through new treaties, has effectively come to a halt. As discussed above, it was through treaty change that the EU was able to evolve and reflect wider shifts in the political economy in the 1980s and 1990s. For long periods during the euro crisis, it was widely expected that another treaty change would occur at some stage. However, although minor amendments were made to the treaties, European leaders avoided a major overhaul because this would almost certainly have required multiple referendums across the EU and would therefore

²⁰ See Wolf, M. (2020), ‘German court decides to take back control with ECB ruling’, *Financial Times*, 12 May 2020, <https://www.ft.com/content/37825304-9428-11ea-af4b-499244625ac4>.

²¹ See, for example, Hackenbroich, J. (2020), ‘How Germany's Constitutional Court jump-started the Franco-German Engine’, European Council on Foreign Relations, 22 May 2020, https://www.ecfr.eu/article/commentary_how_germanys_constitutional_court_jump_started_the_franco_german; and Hall, B., Fleming, S and Chazan, G. (2020), ‘Is the Franco-German plan Europe's ‘Hamiltonian’ moment?’, *Financial Times*, 21 May 2020, <https://www.ft.com/content/2735a3f1-bc58-477c-9315-c98129d12852>.

²² See Bergsen, P. (2020), ‘Franco-German Recovery Fund will not Fix Eurozone’, Chatham House Expert Comment, 20 May 2020, <https://www.chathamhouse.org/expert/comment/franco-german-recovery-fund-will-not-fix-eurozone>.

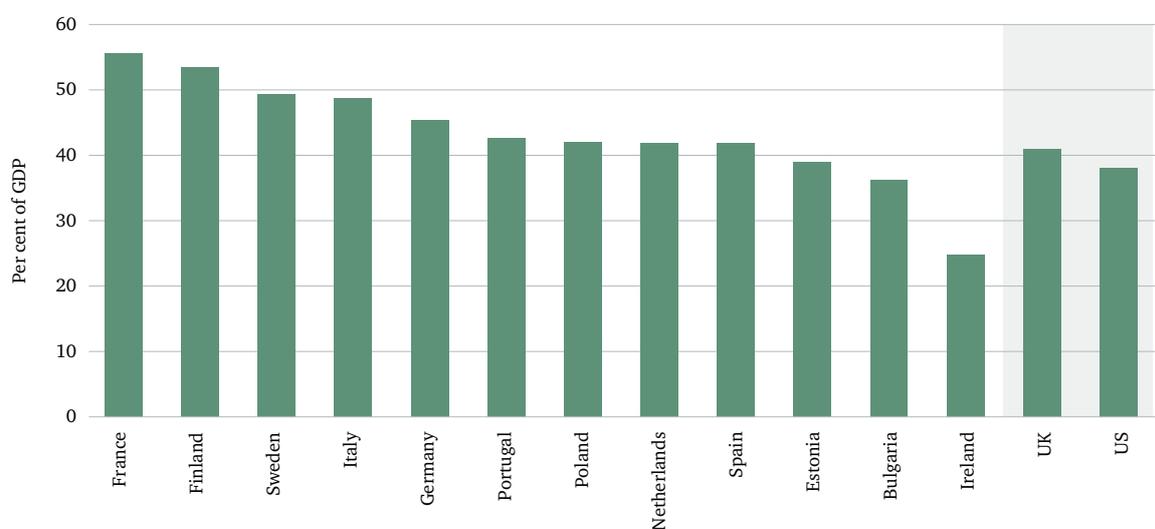
have been fraught with political risk (as the experiences of France and the Netherlands over the constitutional treaty in 2005, and of the UK in its 2016 referendum on EU membership, illustrate). As mentioned, the risk is that the EU may now be stuck in a politically unstable status quo without a shared view among member states on how to change it, and therefore be unable to accommodate national shifts in the state–market paradigm. Working *around* the treaties – the strategy employed during the euro crisis – is a lot harder when the problem lies with what the treaties say instead of what they lack.

Rather than catalysing a transformation of the EU in support of a different economic model, it seems more likely that COVID-19 will lead to an uneven shift in economic policy across different countries. This would bring the political trajectories of some member states into conflict with the existing regulatory framework, and generate greater economic and political divergence within the union. One way to start considering the implications for European integration is to examine how shifts in the three policy areas discussed above might specifically intersect with this EU framework.

Fiscal policy

The most obvious clash between the EU system and a shift towards a more interventionist state could be over the fiscal rules, which are particularly relevant for the member states that use the euro. There is no EU rule prohibiting a high level of state spending *per se* – several European governments, such as France and Finland, were already spending more than 50 per cent of GDP before the current crisis. But for some states, expenditure increases will almost certainly mean continuing to break the fiscal rules, which prohibit eurozone countries from running a budget deficit equivalent to over 3 per cent of GDP or accumulating public debt equivalent to over 60 per cent of GDP. The question is whether the EU will reform these rules or try to enforce them again, the latter of which would require drastic austerity.

Figure 4: General government spending, 2019 (% of GDP)



Sources: Eurostat, OECD Data.

Shifting the burden of taxation will also be difficult without EU-wide, or preferably global, cooperation. Attempts to tax wealth or capital gains are famously vulnerable to capital flight. The success of national efforts in this direction will be seriously constrained if they are not followed through uniformly. A similar issue arises around attempts to end tax competition and tax optimization by multinational firms. This topic has created tensions within the EU in the past, as southern members were irked by the practice of some northern members (such as Ireland and the Netherlands) using favourable tax regimes to persuade companies to locate headquarters in their jurisdictions. Meanwhile, despite being able to choose where they pay tax, companies can still sell throughout the single market from their chosen base. In time, there is a risk that these single-market rules will come under pressure as governments attempt to tax multinationals, for instance large technology companies, more aggressively.

Labour markets, redistribution and the welfare state

Attempts by national governments to build more protective and less precarious labour markets would not immediately conflict with EU rules. Except for rules related to the free movement of workers, labour market policy remains largely a member state competency. This is visible in the wide divergence in labour market institutions and protections between member states. The European Commission has been moving to expand the EU's role in this area through the Work Programme 2020, intended to create more commonality at a European level on issues such as minimum wages and unemployment insurance. However, significant shifts in how labour markets are governed within member states could conflict with the imperative of keeping markets open to workers from across the EU.

For instance, despite the European Commission's published guidelines to ensure the movement of critical workers during the pandemic, there have been reports of seasonal workers being sent back to their countries when attempting to cross borders. If restrictions of this kind persist beyond the end of the COVID-19 state of emergency in place in several EU countries, it could heighten tensions among member states and jeopardize the integrity of the principle of free movement. Previous disagreements between western and eastern member states over the 'posted workers' directive highlight the political salience of these issues and the difficulty of resolving them.

Some tensions in these policy areas have always been visible in the EU. Many social security and labour market protections require strong social contracts, as they are a form of obligatory collective insurance. This has often led to politicized demands to exclude some groups – usually foreign workers – who have not paid into the relevant scheme for a sustained period or who are seen as somehow less legitimate users of public services. There are also potential questions over unfair competition when some workers are covered by and paying into the insurance system and others are not.

Industrial policy

Increasing the hand of the state in the economy potentially clashes with a number of fundamental tenets of the EU, particularly where any measures involve state support for specific companies. EU state aid rules prevent governments from granting national monopolies, and EU competition policy can throw up barriers to attempts to create, or maintain, national 'champions' – as the current

case of Lufthansa illustrates.²³ It can even be a barrier to the creation of European champions, as was demonstrated by the failed merger of the German engineering conglomerate, Siemens, and France's Alstom in 2019. Even before the COVID-19 crisis, France, Germany, Italy and Poland were demanding that the European Commission show 'more justified and reasonable flexibility' in allowing mergers that could forge European champions. Such demands will likely become stronger in the future.

The imperative to increase economic resilience is also likely to be reflected in stronger state controls over ownership of critical industry, and wider definitions of what constitute 'critical' sectors. For now, restrictive measures tend to apply to investments originating outside the EU – see, for instance, the German government's new plans to include healthcare in its more stringent investment screening mechanism. However, further moves to 're-shore' critical production could lead to a decreased openness to *intra-EU* capital flows. If states started exploring ways to ensure critical national industries were domestically owned or located, rather than owned or based in other EU states, this would likely bring them into conflict with EU competition law. National-interest dynamics similar to those that have played out in the defence-industrial sector could thus apply in new areas. For example, in 2017, France nationalized the STX shipyard to prevent it falling into Italian ownership.²⁴

Attempts to support national industry could also have consequences for the EU's external trade policy. Some member states might want to use trade policy to protect national champions, for instance by stronger insistence on maintaining tariffs or non-tariff barriers on specific sectors in trade agreements. This would lead not so much to a clash with the EU as to tensions between member states about the future direction of EU trade policy. It would also complicate an area of European cooperation – over trade policy – that has been among the most successful in recent years.

Implications for the EU

Where will these potential clashes leave the EU? The section below focuses on the implications for the two fundamental projects at the heart of the EU: the single currency and the single market.

The eurozone

Perhaps the most vulnerable element of the EU, and the most discussed since the coronavirus pandemic hit, is the eurozone. While Germany has shifted position to support one-off transfers from north to south through the mechanism of the recovery fund, the fault line on policy – also roughly between north and south – that characterized the euro crisis from 2010 onwards has broadly re-emerged.²⁵ Indeed, the recent argument about 'coronabonds' is to a large extent a continuation of the argument about solidarity and debt mutualization that has been taking place over the past decade. However, because of the human cost of the health emergency and the scale of the expected economic recession, the 2020 crisis has a much greater urgency and moral potency. It represents

²³ Lufthansa is seeking a €9 billion bailout from the German government, which will take a 20 per cent stake in the company. See White, A. (2020), 'Germany, Lufthansa Prove Tougher Foes for Vestager Than Google', Bloomberg, 31 May 2020, <https://www.bloomberg.com/news/articles/2020-05-31/germany-lufthansa-prove-tougher-foes-for-vestager-than-google>.

²⁴ Topham, G. (2017), 'France nationalises strategic shipyard to thwart Italian ownership', *Guardian*, 27 July 2017, <https://www.theguardian.com/business/2017/jul/27/france-nationalises-strategic-shipyard-emmanuel-macron>.

²⁵ See Tooze, A. (2020), 'Coronabonds' and Europe's north-south divide', *International Politics and Society*, 13 April 2020, <https://www.ips-journal.eu/regions/europe/article/show/coronabonds-and-europes-north-south-divide-4256/>.

a fundamental challenge to European solidarity. As political scientist Jonathan Hopkin has put it, ‘You can’t just talk about mass death the same way you talk about unemployment.’²⁶ In Italy, one of the member states hit hardest by the pandemic, many already feel betrayed by the EU.²⁷

At first the anger in countries such as Italy focused on the lack of immediate support from the EU in dealing with the public health crisis, despite the EU’s very limited competence in health policy. But the real political dispute in the eurozone erupted when questions were raised around how to finance the policy response. Following several weeks of tense negotiations, a compromise package was reached, which includes cheap loans for any member state asking for them and an unspecified expansion of the EU budget to fund investment during the recovery. These measures are being facilitated by the ECB expanding its balance sheet, but they continue to fall short of outright debt mutualization – which remains a highly controversial subject.

This lack of deep fiscal integration, and the resulting lack of manoeuvring space for fiscally weaker member states, has several potential consequences for the post-coronavirus eurozone. Firstly, it means that countries such as Italy and Greece will grow and recover from the crisis much more slowly than those, such as Germany, that can afford to provide more of the temporarily allowed state aid. Secondly, it means that fiscally weaker economies will be much less able to support investment in the way that, after the experience of this crisis, citizens may demand. A prolonged recession in such countries, combined with the sight of other European economies performing relatively better and a sense of the EU response being deficient, could reinforce popular demands to leave the single currency – particularly in Italy – and create wider political dangers for the union.

The four freedoms and the single market

A shift to a more interventionist policy paradigm by a number of European governments could clash in several ways with the requirements of membership of the single market. There is the potential for all four freedoms that underpin the single market – that is, free movement of goods, capital, services and people – to be affected.

The movement of goods could be impaired by attempts to increase national resilience, as was demonstrated early in the coronavirus crisis when several member states applied export controls to medical equipment. Although the EU subsequently worked to keep its internal borders open, it temporarily put in place export controls on vital equipment destined for markets outside the bloc. The European Commission has warned of political frictions if the exit from the lockdown is uncoordinated; the risks associated with this will only increase if emergency measures become permanent or if companies move supply chains closer to their consumers. The EU could also become more selective or demanding in its role as a champion of trade liberalization, which could in turn have knock-on effects on global trade.

The free movement of capital could be hindered by national-level attempts to curb tax optimization, build national champions, or keep out certain types of foreign investment deemed undesirable. The free movement of services could be affected by efforts to preserve domestic social contracts as governments provide more income protection. More ‘protective’ states might also seek to ignore EU procurement rules and favour domestic suppliers over those from other member states.

²⁶ Hopkin, J. (2020), Tweet, 1 April 2020, <https://twitter.com/jrhopkin/status/1245267821099171840>.

²⁷ See, for example, Johnson, M., Fleming, S. and Chazan, G. (2020), ‘Coronavirus: Is Europe losing Italy?’, *Financial Times*, 6 April 2020, <https://www.ft.com/content/f21cf708-759e-11ea-ad98-044200cb277f>.

Free movement of people and the open borders of the Schengen Area could be affected in several ways. Labour mobility could be reduced by shifting national social contracts, as discussed above. Meanwhile, the swiftness with which borders – some of which were still being controlled in the wake of the European refugee crisis – were closed in the initial phase of the COVID-19 response could set a precedent. Particularly in the case of potentially repeated outbreaks of COVID-19, and thus repeated border closures, disruptions to the movement of people could start mounting. This could lead to a ‘new normal’ of systemic opt-outs from Schengen provisions, disrupting the proper function of the borderless zone and potentially emboldening unilateral action on issues unrelated to disease control.

Consequences for the EU

Overall, the consequences for European integration of a shift from market to state within EU member countries are likely to depend on the depth and extent of demands for a new economic settlement. If most states push for a modest adjustment, for example some flexibility in the fiscal rules and an increase in investment, this might be incorporated within the EU’s existing framework relatively straightforwardly. In other words, the COVID-19 response would be seen in retrospect as a minor course correction rather than as an inflection point.

Similarly, if there is a new and broad consensus on the need for a radical approach, this would create the conditions for a genuine paradigm shift in the EU’s political economy, a recalibration of the state–market balance that could be led and achieved with significant reform at the European level. This could herald a third phase in the post-war evolution of the relationship between state and market in Europe – and a new phase in European integration.

However, if the shift in approach is uneven across the EU, as seems likely, it will make consensus on major reforms difficult to achieve. While it would clearly not be impossible under current EU rules to implement many of the policies associated with a more statist model – as demonstrated by variations in the size of the state across the EU pre-coronavirus – the room for policy manoeuvre would be more limited. This would open the door to increased friction between, on the one hand, the framework of the single currency and single market and, on the other, the preferences of individual member states. This could create serious political stand-offs if the political programmes of particular governments clashed substantially with what was achievable within the EU system (which itself would be difficult to amend), or if there were a widespread perception that EU institutions or unsympathetic member states were an impediment to the realization of a new economic settlement. It could also heighten the vulnerability of the EU to external shocks, such as a renewed migration crisis, further exacerbating political divides.

Conclusion

The coronavirus crisis has exposed large vulnerabilities in Europe’s economies and raised fundamental questions about the legitimacy and sustainability of the current economic settlement. This paper has posited that the post-coronavirus European political landscape could be marked by demands for a new social and economic contract. It assumes that citizens will expect and demand more of the state, and that states will seek to make themselves and their economies more resilient to global forces and future external shocks. As a consequence, the crisis has the potential to fundamentally shift Europe’s

political economy towards a new balance between the state and the market. This new balance would likely emphasize a stronger and more interventionist role for the state, and a reduced openness to market forces.

Such a paradigm shift would have long-term implications for the governance of the EU. For member states, and especially eurozone countries, big changes in policy on taxation, trade, labour markets and industry would necessarily require consultation and adjustment at the EU level. This paper has argued that increasing the role of the state in several key policy areas could clash with fundamental tenets of the EU as it is today. However, the current political economy model is not set in stone – and neither is the type of European integration it has produced since the 1980s. The EU could be adapted and reformed to accommodate a more interventionist model. For this to happen, European integration should not be approached as a linear, one-way process in which it is impossible to change course or reverse steps that have been taken.

The coronavirus crisis provides Europe with a unique opportunity to evaluate the efficiency, sustainability and legitimacy of its economic settlement. As EU leaders assess the past and start planning for the future, they should think not simply of seeking to return to the pre-COVID-19 ‘normal’, but of how a more sustainable, balanced and fairer political economy can emerge from the crisis, and from there decide how the EU might need to be reformed to accommodate that. The real debate is therefore not whether the answer lies in ‘more Europe’ or ‘less Europe’ – to the extent that this implies a judgment on the value of integration *per se* – but about what *kind* of European ‘union’ is needed. A post-coronavirus Europe with a changed political economy will need reformed economic structures, a different political architecture, and thus a different EU.

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Cover image: A Deliveroo rider wearing a protective mask rides his bike in the Jardin des Tuileries, Paris, 15 April 2020.

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