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## Preparing for the next crisis: How to secure the supply of essential goods and services

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### 1 What went wrong?

The COVID-19 crisis caught our economies largely unprepared. Across Europe, we have seen a shortage of products and services essential for dealing with the pandemic.<sup>2</sup> For all our sophisticated and technologically advanced firms, we could not obtain enough facemasks (whether surgical or more protective), hand sanitisers, tests to detect the virus or the reagents needed to process those tests, protective garments for health care workers, ventilators, and so on.<sup>3</sup>

Stockpiling of such products was mostly inexistent,<sup>4</sup> partly because some governments had been heavily criticised for ‘wasting’ funds when they had accumulated stock of vaccines and protective equipment in response to the SARS pandemic and in preparation for a flu pandemic which never materialised (e.g., Jenny, 2020). In some cases, EU manufacturers exported all of their production just before the crisis hit. As the crisis took hold of Europe, some EU member states prohibited exports of some goods as a precautionary measure, thereby creating shortages in others where they were badly needed.

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2 This Policy Insight is motivated by the European experience. Similar problems occurred in other parts of the world.

3 As the World Health Organization writes, “The COVID-19 pandemic has highlighted preparedness gaps across levels around data and information sharing, communication and messaging, medical equipment (e.g. personal protective equipment) distribution, skilled personnel, managing travel restrictions, and testing and tracking cases.” (WHO, 2020, p. 33). While it is too early for further assessment, as of now, some parts of the economy have been resilient. Despite an increase in usage of certain digital services (e.g. online streaming of videos) the internet infrastructure has proven to be resilient; the provision of utilities (electricity, water, garbage collection) has not been at risk; the food supply chain was fully operational and transport across borders did not suffer major interruptions for longer periods. Thus, within Europe there have not been major food shortages or disruption of basic services.

4 An exception was Finland, where a stockpiling programme has been in place since the Cold War, apparently in case of an invasion. In the rest of the EU, some private firms also held stocks (e.g., some factories store facemasks to protect workers in production and/or against accidental release of toxic fumes). However, such local storage is inadequate to deal with non-local shocks.

Presumably, the strategy (if any) or hope was that – should the need arise – a surge in demand would be met with imports and/or a timely supply response. But neither worked. The combination of reduced production (due to its own confinement measures, which had slowed down production) and an increase in demand (China started to import from everywhere) made it impossible to rely on imports from China, at least during the initial stages of the crisis.

European production, to the extent that it existed, suffered from the disruption of supply chains. In several cases, certain goods could not be produced because an essential input was no longer available due to other countries' export restrictions or because of disruptions in its production. Facemasks provide a case in point: their production requires a type of non-woven polypropylene that acts as a filter, which is referred to as 'meltblown'. In February, China, which is the producer of half the world's production of meltblown, prohibited its exports, thereby halting or slowing down the production of masks elsewhere.<sup>5</sup>

Even where procuring the inputs might not have been a problem, uncoordinated and short-sighted state intervention did the rest. For instance, in Italy the government first appealed to national firms to increase production of facemasks, but then introduced a 50 cent cap on sales price per mask, which reportedly eliminated the incentives to reconvert plants or increase production. As a result, the shortage of facemasks continued and became even more severe. (It was not only production but also import volumes that were affected, among other things because other countries either did not regulate prices or, as in the case of Spain, established a higher price cap.)

While shortages due to an epidemic are now at the front of our minds, there are other types of shocks that can lead to major disruptions of the economy and society. A non-exhaustive list of 'unforeseen' circumstances that may create shortage of essential goods in the future includes<sup>6</sup> other pandemics;<sup>7</sup> disasters triggered by natural hazards and severe weather conditions such as earthquakes, tsunamis, or super-volcano eruptions; heat waves with widespread impact and associated food shortages; food and water poisoning; nuclear accidents; disruption of internet and communication networks (including due to cyber-attacks by state and non-state actors); biological terrorism; and wars (unfortunately, not impossible...).

Depending on the type of shock, several goods and services may turn out to be essential. These include medical equipment, pharmaceuticals, intensive care units, makeshift hospitals, strategic oil and natural gas reserves (and in the future, hydrogen), emergency power supply, internet and mobile telephony infrastructure, food (in particular, staples), emergency drinking water provision, human capital (doctors and nurses, rescue and civil protection teams, fire fighters) and equipment (e.g., air transport capacities), among many others.

<sup>5</sup> "Masks are in short supply not because they're difficult to produce, but because the meltblown industry is used to stable, long-term demand. It churns out just enough for its customers and no more. To install an assembly line of meltblown takes many months, even at the calmest of times; with demand now soaring, some companies supplying meltblown equipment are quoting timelines of up to two years to even deliver a new machine" (*The Guardian*, 28 April 2020).

<sup>6</sup> See also "The next catastrophe", *The Economist*, 27 June 2020.

<sup>7</sup> Tirole (2020) writes: "We are trembling with fear at the melting of permafrost which, in addition to emitting large volumes of greenhouse gases, will also release old viruses and bacteria, with unpredictable consequences." See also "There are diseases hidden in ice, and they are waking up", BBC Earth, 4 May 2017.

Of course, many countries have been investing in resources for disaster relief (for floods, fires, earthquakes, etc.). Disasters triggered by natural hazards are often concentrated in a specific region and thus can be dealt with using equipment that is stored locally (possibly with additional resources being made available from other regions or countries). However, the recent pandemic shows that we also need to be prepared for (natural or man-made) events that simultaneously hit entire continents or even the whole world.

In this Policy Insight, we take an economist's perspective regarding these issues; that is, we consider the private and state incentives to take adequate measures before and during a crisis triggered by an adverse shock. Our starting point is the observation that there are severe market failures in the provision of essential goods and services during pandemics and other negative shocks with major impact. In Section 2, we point to important infrastructure requirements as a prerequisite for being prepared for a crisis. We address prevention measures, measures that help early detection and mitigation, as well as measures for effective and efficient reaction. In Section 3, we draw lessons from electricity markets for how to ensure that security of supply of essential goods and services will be achieved.<sup>8</sup> These lessons are relevant to coping with the ongoing COVID-19 threat as well as with any future crisis of as yet unknown nature. While some of our proposals are specific to the European Union, most insights are broadly applicable. Section 4 concludes.

## 2 Prevention, early detection and mitigation

Preparation for catastrophic events should consist of an articulated strategy, which goes from having an adequate research infrastructure and human capital to investing in prevention, and from early detection (in order to mitigate their impact) to building the ability to react should such events materialise. Mitigation and adaptation strategies for climate change provide a related example. Whereas mitigation measures address the *causes* of climate change (through decarbonisation, which involves investment in renewables and energy efficiency, among others), adaptation measures address the *impacts* (for instance, changing building codes taking into account future weather conditions, or building flood defences or dams against rising sea levels). With respect to pandemics, the National Academy of Medicine (2016) recommends that “countries should work to develop real-time detection and response systems, prioritising elements that reinforce prevention, provide early detection, and enable effective response”.

In this section, we briefly explain why neither market institutions (for example, insurance markets) nor an individual country's initiatives may be sufficient to achieve that purpose.<sup>9</sup>

<sup>8</sup> Cramton et al. (2020) also derive lessons from the performance of electricity markets that could be useful to tackle health crisis. They highlight the role of electricity markets as clearing houses in which prices contribute to matching supply and demand. We instead focus on the lessons that can be obtained from the design of explicit capacity mechanisms.

<sup>9</sup> See also National Academy of Medicine (2016).

## 2.1 GENERAL RESEARCH INFRASTRUCTURE AND HUMAN CAPITAL

Having the appropriate physical infrastructure in place to address health issues and a highly prepared labour force will help in general in all stages of a resilience strategy. Arguably, during the COVID-19 crisis, Germany's relative success rested on its dense network of healthcare facilities and chemical and bio-chemical labs,<sup>10</sup> together with its large number of intensive care units (ICUs). After the 2014 Ebola outbreak, the US National Academy of Medicine created the Commission on a Global Health Risk Framework for the Future in order to explore the potential for improving international management and response to outbreaks. In their report, they observed that "national public health systems are essential components of resilient health systems and the first line of defence against the threat of pandemic disease ... Public health objectives can only be achieved within a highly-functioning and resilient health care system with effective primary care delivery" (National Academy of Medicine, 2016: 23)

Likewise, the recent crisis has made manifest the importance of having genetic research centres and pharmaceutical laboratories in order to be able to sequence a virus, monitor its evolution, develop a vaccine and find an appropriate medication. (And of course, the capacity to mass produce the vaccine, once developed, would be equally fundamental.) However, similar arguments could also be made with respect to possible natural catastrophes. For instance, geologists and centres monitoring seismic activity are fundamental in detecting the danger of earthquakes.

With respect to research, and research infrastructure, we would like to emphasise two points. First, knowledge generated by basic research (and more generally, by research which is sufficiently far from the commercialisation stage) can often be considered a public good.<sup>11</sup> As such, it might suffer from under-provision – that is, markets would give rise to too little of it relative to what would be socially optimal, meaning public support is needed. Although this is certainly well known, it is still surprising to see low average R&D investment levels in the EU<sup>12</sup> (even though the EU is performing well in terms of public R&D spending as a percentage of GDP compared to other countries).

Second, some coordination at the EU level is important to ensure that there is enough research capacity in each area. Since we believe in the benefits of competition, we are not proposing the design and implementation of a centralised plan according to which only some labs (perhaps distributed with a quota system across member states) would be funded. Rather, we propose that the European Research Council, or a similar body, identify the areas where research on possible catastrophic events is most needed and fund labs on the basis of merit.

Infrastructure needs are accompanied by human capital needs. For instance, in response to pandemics, "outbreak planning requires skills outside the medical arena, such as logistics, security, and communications" (National Academy of Medicine, 2016: 28).

<sup>10</sup> The initial shortage of tests in some countries has been attributed not only to the lack of the tests themselves and of reagents, but also of trained staff, who may process those tests. The National Academy of Medicine (2016) argued that "an effective nationwide laboratory network is another key component of a highly-functioning public health system" (p. 28).

<sup>11</sup> See, for example, Stiglitz (1977). However, Callon (1994) argues that whether knowledge is a public good depends on the specific context. In particular, the absorption of knowledge may be rather costly.

<sup>12</sup> According to the European Commission (2020a: 263), R&D in the EU was around 2.2% of GDP in 2018, less than in China, Japan, South Korea and the US.

## 2.2 PREVENTION

Some catastrophic events (earthquakes, asteroid strikes, etc.) cannot be avoided. The only option then is to be sufficiently prepared to identify the occurrence of such events and mitigate their impact, as we shall discuss in the next section. In other cases, however, prevention might play an important role, even if we often fail to recognise it. Global warming is a case in point, and one which unfortunately shows the inability or unwillingness of humanity to prevent a man-made tragedy and its consequences. The COVID-19 pandemic is another example. The spread of infectious diseases is linked to the introduction of invasive species, the destruction of animal habitats, and the loss of biodiversity (e.g., Sehgal, 2010; UNEP and ILRI, 2020). The failure to respect simple hygiene rules might have also led to proximity with the wild species which hosted the virus and a delayed reaction after the virus had crossed the species barrier. Landslides are another example, often being the product of environmental neglect, deforestation or construction on unsafe grounds (due to inappropriate regulations or lack of enforcement).

### Private precautionary actions and the need for regulation

For prevention purposes, one may be tempted to believe that reliance on private precautionary actions may be enough. For example, one might think that people may not want to live in a high seismic-risk area and that if they do, they would have an interest in being able to anticipate an earthquake. However, asymmetric information and behavioural biases will contribute to risky conduct and the absence of precautionary measures by individuals. The behavioural economics literature has stressed the short-sightedness, over-optimism and tendency to procrastinate of individuals (e.g., Loewenstein and Prelec, 1992; Loewenstein et al., 2003). People do not wear helmets and protective gear when working in dangerous plants, they typically do not invest as much as they should in earthquake-proof materials when building their houses, they live too close to volcanoes, and so on.

Likewise, an individual's willingness to invest in an early warning system, if any, is lower than socially optimum (similarly for environmental goods). Thus, there are obvious externalities, which will lead to the well-known 'tragedy of the commons'.

### Public actors, institutions and coordination

Unfortunately, there are good reasons to believe that governments would act in a similar way to individuals. For instance, absent externalities, myopic actions may be taken by politicians due to agency problems and political economy arguments – they would often oppose an investment which helps the country in the long run (when they may no longer be in a position to get credit from that investment) and privilege instead actions which provide short-run benefits (and thus may increase their chance of getting re-elected). The 'behavioural bias' of institutional actors is a major worry.<sup>13</sup> We also observe that short-termism, for example, and behavioural biases in the population may be mimicked by some politicians who wish to appeal to the prevailing mood despite knowing better.

And when cross-country externalities exist or the provision of a public good is at stake – for instance, when several countries are likely to be affected by the same event (think of environmental disasters, but also pandemics) – no individual government will generally want to refrain from pursuing an individual interest simply because it may harm neighbours, or foot the bill for measures which may benefit others. Needless to say, there are examples of successful international cooperation (the fight

<sup>13</sup> Behavioural bias is in quotation marks because, as we argue above, it may be fully rational given that the incentives of politicians may be different from those of society.

against the Ebola epidemic, for example) and non-profit organisations that contribute towards global efforts (such as the Gates Foundation). However, such examples are the exception rather than the rule, particularly so in the face of global problems whose consequences will, to a large extent, be borne by future generations. Again, the fight against climate change is a case in point.

Whether at the level of individuals or of countries, therefore, it is unlikely that uncoordinated solutions will arise, which implies the need for coordinated actions. When it comes to individuals, it is crucial that government regulation is in place to prevent risk-taking behaviour (which will generally have consequences beyond the individual taking the action). And when it comes to countries, two types of institutions seem to be needed: (i) independent authorities that are entrusted with the task of investing in preventive measures, possibly endowed with a budget which is not conditioned to political changes (thereby avoiding the political economy problems indicated above as much as possible); and (ii) well-functioning supra-, multi- or international bodies which may be relied upon to coordinate actions.<sup>14</sup> Precautionary measures may then be publicly procured (and privately provided) or carried out by the different states, but in a coordinated manner.

### 2.3 EARLY DETECTION AND MEASURES TO MITIGATE THE IMPACT OF CATASTROPHES

#### Early detection tools

Resilience also includes early detection tools. This applies, for example, to the threat of earthquakes, volcano eruptions, or tsunamis. There is a network of ‘sensors/buoys’ throughout the oceans aimed at foreseeing the likely occurrence of tsunamis in real time, while seismology sensors and laboratories help identify the risks of earthquakes, thus helping to alleviate their effects. It also applies to health crises, with special reporting tools for unusual symptoms (in particular, detecting clusters) because they provide indications of dangerous infectious diseases or mass poisoning.<sup>15</sup> Related considerations also apply to livestock and staple foods.

#### Stress tests

As part of prevention measures, the government may want to carry out stress tests for critical sectors – such as pharmaceuticals, medical supplies, utilities (water, electricity, internet), and other essential goods – that address their provision in scenarios involving demand and supply shocks. Government actions can then aim at tackling detected inadequacies. Lessons can be drawn from the European experience in the banking sector, where stress tests performed by the relevant banking authorities have permitted the identification of problems within particular banks and appropriate remedies.

Civil protection drills or training measures may also help. If the population is trained in how to respond to a problem, its consequences are reduced. (Think, for instance, of civil drills aimed at preparing citizens in case of terrorist attacks or fire.)

#### Mitigation of the impact

Insurance can be seen as an instrument to react to events and reduce the negative impact on those directly and most severely affected (e.g., by covering the health care costs and by partly compensating for lost labour income); this issue is discussed in the following section. However, in some cases, proper insurance or other means to

<sup>14</sup> For a concrete proposal in the context of pandemics, we refer again to National Academy of Medicine (2016).

<sup>15</sup> In this context, a well-functioning and integrated primary health care system is key as “outbreaks are typically first detected through primary health care” (National Academy of Medicine, 2016: 29).

provide support in case of health issues or income losses can also mitigate the impact of catastrophes. The ongoing COVID-19 pandemic is a case in point. Reducing the spread of the virus requires proper testing and isolating those who test positive. People who will lose their income if they test positive clearly have less incentive to get tested when they show symptoms or are likely to have been infected than those whose income is not at risk. Thus, insurance against an income drop can reduce the spread of the virus.

## 2.4 PREPARING FOR AN EFFECTIVE REACTION TO EVENTS

When a health crisis or other disaster hits, people need products or services that they would not need in normal times. Furthermore, they continue to need essential goods whose supplies may have dried up. The same problem arises for any individual who is hit by an unexpected event. For example, if someone suffers an accident, she may need emergency care and the ability to deal with the aftermath (car repairs in case of damage, foregone earnings, etc.).

### Insurance

A solution to this problem may be insurance markets. However, due to adverse selection, a purely private solution may be highly inefficient (in the extreme, no private insurance market will develop). One response has been to require mandatory insurance, whereby everybody has to buy insurance with some minimum coverage. Such insurance even exists for disaster relief (e.g., fires and inundation). Another reason why some insurance markets do not work properly are uniform pricing restrictions: if insurance companies are not allowed to charge a higher premium for insuring houses located in areas that are particularly prone to floods, for example, people are not discouraged from constructing in such high-risk areas.

Overall, private insurance may work well if individual risks are not highly correlated. The problem with pandemics and other large-scale catastrophes is that the risks are highly correlated. Furthermore, it is not only those directly affected who need some of the essential goods and have to bear the economic cost (think of COVID-19 and how whole populations have been hit by the consequences though relatively few have suffered contagion). Private insurance, even if mandatory, does not seem an appropriate instrument to address the need for adequate supplies in case of non-localised catastrophic events.

As the National Academy of Medicine (2016: 58) observes, providing insurance against a pandemic is challenging: “Pandemic insurance is certainly worth pursuing, and considerable progress has been made in developing this option. The key will be whether it will prove cost-effective and practical. To be cost-effective, disaster insurance of this kind typically needs an objective parametric trigger (e.g., an earthquake, or rainfall below a certain amount). Discretionary triggers tend to result in much higher premiums. Given the uncertainties that inevitably surround the early phases of an infectious disease outbreak, this is somewhat problematic. By the time it is objectively clear that a pandemic is taking place (e.g., via a clear impact on mortality data), it may be too late. We are aware that considerable progress has been made in defining and agreeing potential triggers, but the test will be how these work well in practice.”

Given the limitations of pandemic insurance, government programmes that essentially provide public insurance for high expenditures due to health issues and negative income shocks can be seen as an adequate measure. Regulation of mandatory insurance can partly serve as a substitute: certain health-related costs may well be covered through mandatory private insurance (the insurer may then be compensated by the government or has to raise the premium).

### Procurement of essential goods

Different from insurance, public authorities may want to ensure that essential goods will be available in sufficient quantity and quality. A strategy to guarantee provision of essential goods and services in exceptional circumstances should contain a combination of different elements, consisting of (i) the precautionary accumulation of essential goods; (ii) clear rationing protocols for those goods and for periods in which production is not sufficient to meet demand; and (iii) measures to guarantee that when catastrophic events occur, supply will be ramped up (if, as is likely, the stock of goods is insufficient).

### Storage and spare capacity

Storage facilities and replenishment may be publicly provided or privately provided through public procurement.<sup>16</sup> The accompanying monitoring activities are aimed at ensuring that stockpile volumes and quality are maintained. This means that some products need to be replenished regularly. For products that are used at a lower volume, a well-managed ‘first in, first out’ system can avoid, or at least reduce, wasteful disposal as stored products could still be used before they pass the expiration date. To state the obvious, storage facilities should be selected based not only on maintenance costs but also taking into account the logistics of the eventual distribution of the stored products.

A related consideration that applies to human capital is that there must be a group of people (with particular skills and functions) who receive continuous training so they are prepared in case of need (similar to what is done with army reserves in several countries). The EU should extend its civil protection mechanism training programme and similar initiatives should be taken to prepare, for instance, healthcare workers (in many countries, the lack of protocols on how to deal with the pandemic meant that hospitals, emergency rooms and residences for the elderly became major sources of contagion).

### Rationing criteria

Ahead of a crisis, it is important to set out clear criteria for how to ration demand and avoid hoarding and panic buying in order to reduce the gap between demand and supply. In most countries and for most products, the food supply chain has worked remarkably well, but there is no guarantee that a crisis of a different nature – say, one which affects agricultural production or transportation networks – will not lead to scarcity of food or other products. During the COVID-19 crisis we have also witnessed something similar to bank runs for some (fortunately less important and certainly well-stocked) goods, such as flour, yeast and toilet paper. As soon as word of their scarcity spread, people rushed to buy more of them. In some places, retailers introduced caps on the number of units a single customer could buy, but this ‘improvised’ rationing is certainly inferior to public protocols of priority purchases, which were absent. Much more importantly and with crucial consequences, the absence of such protocols also meant that in many countries the few facemasks that were available did not end up in the hands of those most exposed to the risk of contagion, such as doctors and nurses. As this last example shows, not having a well-thought rationing protocol may be highly inefficient from a societal perspective. Allocation based on willingness to pay is a bad mechanism for essential goods in times of excess demand.

In addition, under severe scarcity of supply, faulty, fraudulent and sometimes even dangerous versions of the products in need may appear on the market. This requires well-functioning consumer protection institutions and rigorous quality control.

<sup>16</sup> There is a rich literature on procurement that addresses the incentive problems that may arise in such contexts (e.g., Dimitri et al., 2011).

### Ramping up production

When a shock hits and creates a situation of excess demand, the market should normally react to match demand with supply. Higher prices will push firms already active in the market to increase their production; other firms may convert their production facilities or enter the sector; privately stored supplies may be put on the market; (international) trade with goods and services will move from less affected to more affected areas. As we have explained above, however, there is no guarantee that market forces alone will be able to deliver, or at least not sufficiently rapidly, which may have huge social costs in cases of prolonged crises such as the COVID-19 pandemic. Therefore, a resilience strategy calls for mechanisms that can guarantee that the availability of essential goods and inputs goes beyond storage. It is important to think of lead times to activate these goods and inputs.

For storable goods and inputs, the question is what fraction should be stored and what fraction could be provided through ramped-up production capabilities. Regarding the share of essential goods that is to be stored, the government has the option to do this itself or it can procure the service from private parties. Since this service is provided continuously, standard procurement practices can be used, accompanied by appropriate monitoring to ensure that the contracting parties comply with the requirements laid out in the contract. The contracting party may only offer storage facilities (with the government holding ownership of the stored goods) or the procurement contract may specify that certain goods have to be kept in stock; payments can then be a mix of payments for storage and for activating the delivery of the stored goods.

For the essential goods and inputs that are not stored and will need to be produced at the onset or during a crisis, capacity to provide the essential good up to some quantity within a certain time window will have to be maintained. This can be either unused capacity or capacity that can be quickly converted from its use in normal times to the production of the specified essential good.<sup>17</sup> Since this issue has long been debated in the context of electricity markets, it is worth looking at their experience to possibly draw broader lessons. We will do so in the following section.

Regarding the institutional setting, a European agency that coordinates precautionary and response measures to pandemics and other major threats may be advisable. In the US, for example, the Biomedical Advanced Research and Development Authority (BARDA) is intended to do this.<sup>18</sup>

Whatever the mechanism used, there is the risk that disruption in the supply chain prevents a firm from providing the committed production. Imagine that a firm has a valid procurement contract with another company to obtain inputs at short notice. If the shocks are correlated across countries, and the input provider is forbidden from exporting (see the examples of China and Germany above), the contractor will not be able to supply the product. Is there a good answer to this problem? We would argue that the monitoring mechanism has to ensure that the contractor will continue to be able to supply over time at short notice. One could possibly introduce a certification instrument for all of the critical parts of the supply chain to assess whether the supply chain is resilient.<sup>19</sup> It is possible to think of territorial restrictions because of the difficulty of enforcing certain agreements in some parts of the world.

<sup>17</sup> As the National Academy of Medicine (2016) puts it in case of pandemics, “spare manufacturing capacities may be needed to accommodate mass manufacturing of products, as well as testing investigational products” (p. 77).

<sup>18</sup> See <https://www.phe.gov/about/barda/Pages/default.aspx>. Aghion et al. (2020) also propose the creation of a European BARDA and elaborate on BARDA's role to coordinate and support vaccine research.

<sup>19</sup> The management literature on supply chain resilience addresses the issue how to make the supply chain resilient in case of the risk of disruption from a managerial perspective. For a survey see, for example, Mandal (2014).

One may think that possibilities to ramp up supply in Europe would be preferable to such possibilities in other parts of the world. In general, however, multiple sources offer better prospects to significantly expand production. To the extent that possibilities for ramping-up are strongly positively correlated in case of geographical proximity, contracting such capacities in other parts of the world may be the preferred European strategy. The essential products produced in this way would need to be transported over long distances, and shipping port and airport infrastructures must be capable of accommodating such transport. Regional agricultural crises, for example, require the transport of food by ship or aircraft.

## 3 Security of supply: Lessons from the electricity market

### 3.1 SECURITY OF SUPPLY IN ELECTRICITY MARKETS

Electricity markets provide an extreme example of the need to have excess capacity to meet expected peaks in demand net of the expected changes in supply conditions (for example, due to changes in weather affecting the available wind, solar or hydro production). The main reason is that, absent sufficient storage solutions, electricity demand and supply have to be equalised at all times; failure to do so can trigger the collapse of the entire system. Demand rationing is rarely a feasible option in electricity markets, and even when it is (say, because system operators can curtail consumers in an orderly manner) the costs are large.<sup>20</sup> To give some idea of this, the ‘value of lost load’ – a measure of the value of security of supply – has been estimated to be 400 times greater than the marginal cost of producing electricity under normal conditions.<sup>21</sup> Security of supply has a private value (i.e., how much each consumer is willing to pay to avoid disconnection) but also a social value as an increase in generation capacity reduces the probability of a system collapse. When a firm invests in new generation capacity, it reduces the risk that the lights go off in hospitals, schools, streets, homes and factories, thus creating positive externalities in health, education, safety, living standards, and the economy as a whole.

### 3.2 THE PUBLIC GOOD NATURE OF SECURITY OF SUPPLY

The parallel with the necessity to guarantee the supply of certain goods in situations of emergency is evident, as it is the fact that failure to provide such goods would have not only private, but also social costs that far exceed the private costs. For instance, as argued before, failure to access critical inputs may entail a halt in the production of a wide array of goods and services. Through a domino effect, this might endanger the profitability of businesses and the continuity of many production processes. Another example is provided by the health sector, where failure to access critical medical equipment reduces the ability to quickly respond to a health emergency. During the COVID-19 crisis, lack of facemasks has increased the risk of contagion while lack of tests has made it difficult to control the spread of the disease and – by forcing the authorities to adopt more severe lockdown measures – has led to even greater economic and social distress.

<sup>20</sup> During the hot summer of 2020, millions of Californians faced rolling blackouts as there was not enough capacity to satisfy the state’s high electricity demand due to the increase in temperatures and the use of air-conditioning. This avoided a system collapse but did not prevent prices from rising to \$400 MWh (well above the \$30 MWh average) (“Californians face dark, hot summer as green energy is sapped”, *Financial Times*, 19 August 2010).

<sup>21</sup> For instance, as reported by Newbery (2015), the National Grid Company calculated the 2018 value of lost load to be €21,250/MWh, which is more than twice the direct estimates of the willingness to pay to avoid disconnection (London Economics, 2013).

In these examples, just as in the case of energy supply, the availability of essential goods and services benefits users but also creates positive externalities that mean the whole economy is better off. The conclusion is well known: the public good nature of security of supply implies that market forces alone would not address it efficiently, potentially leading to under-provision and, in the extreme, a lack of provision. Some sort of public provision or government regulation that ensures private provision is therefore needed.

### 3.3 CAN SECURITY OF SUPPLY BE PROMOTED THROUGH SCARCITY PRICING?

In the context of electricity markets, some economists argue that scarcity prices provide adequate incentives to induce the optimal investments in generation capacity (Hogan, 2017). Letting prices rise so that producers can fully capture the private value of their investment aligns firms' and consumers' incentives. In many countries, however, regulators have introduced price caps to prevent prices from exceeding socially acceptable levels, which undermines firms' incentives to invest. Hence, according to this view, if electricity markets fall short of delivering the optimal investments, it is due to price caps, not to market failures. Removing price caps should therefore be sufficient to induce markets to provide the right amount of investment, with no need to resort to additional mechanisms. Again, the analogy with the question of how to better procure essential goods in times of scarcity is straightforward.

Despite the influence of this view in the policy arena,<sup>22</sup> several countries in Europe and elsewhere have introduced regulatory mechanisms, known as 'capacity mechanisms', to promote adequate investments in generation capacity.<sup>23</sup> The capacity mechanisms that have been introduced in electricity markets differ along various dimensions, as we describe below. However, they all have one common characteristic: the choice of capacity is not left to the market.<sup>24</sup> Rather, the regulator decides how much capacity needs to be made available to guarantee security of supply. A capacity mechanism is then put in place to determine which firms will provide such capacity and the rewards for doing so ('capacity payments').

Would it be efficient to rely on scarcity pricing to promote adequate investments in other sectors? Or would it be necessary to resort to some sort of capacity mechanisms? The answer depends on the specificities of each sector. In particular, it depends on the intensity of competition, on the nature of uncertainty and the degree of firms' risk aversion, on the elasticity of supply that determines whether market participants are able to increase supply in response to high prices, and on the social acceptability of high prices and scarcity pricing.

In any case, when thinking of the sort of catastrophic events we are discussing in this Policy Insight, it would be misleading to assume that regulators could credibly remove price caps in order to allow for scarcity pricing as a way to promote capacity investments. When it comes to essential goods, regulators are rarely willing to accept that prices skyrocket in times of crisis. We have seen this during the COVID-19

<sup>22</sup> Notably, the EU Target Electricity Model relies on scarcity pricing as a way to promote investments. For instance, the European Commission (2016) advocates them under the premise that "there will be more and more occasions when prices could reach very high levels (in times of scarcity) but for very short periods of time. It is these peaking prices that can provide the signals and stimulate the investment needed in flexible capacity so long as investors have the confidence that they will be able to recoup their money based on such prices." However, almost all member states have introduced explicit capacity mechanisms.

<sup>23</sup> Fabra (2018) provides a formal analysis for the rationale of capacity mechanisms.

<sup>24</sup> Some capacity mechanisms rely instead on price regulation, i.e., the regulator sets a capacity price and lets investors choose how much capacity they want to make available at such a price. However, the European Commission has declared that this approach is not compatible with the state aid regulation.

pandemic, with most countries regulating the price of masks, hand sanitisers, tests, and other goods considered essential (Motta, 2020). Even if under normal conditions these goods are not subject to explicit price caps, the expectation that they would eventually be regulated after a demand or supply shock would seriously undermine firms' incentives to invest in building up excess capacity. It is therefore unlikely that the market alone, through scarcity pricing, would be able to guarantee continuity of supply of essential goods during catastrophes.

### 3.4 WHICH PRODUCTS SHOULD RECEIVE CAPACITY PAYMENTS?

Once the general principle has been established that capacity payments are justified in some cases, one still has to decide which goods or services should be entitled to receive them. For instance, although the common view is that there is a rationale for capacity payments in electricity markets, this does not mean that capacity payments should be granted in all cases, particularly in cases in which enough capacity already exists or in which energy market prices already provide enough incentives for firms to invest. In the sector inquiry launched by the European Commission in 2015, which was based on the analysis of 35 mechanisms in 11 member states, it was found that most member states had introduced capacity mechanisms without properly assessing the need for them. The Commission concluded that *“cost benefit assessments and evaluation of capacity mechanisms are the exception rather than the rule”*.<sup>25</sup>

Beyond electricity markets, the challenges of defining the set of goods that should be subject to capacity mechanisms might be even more acute. How do we know whether there is going to be a shortage of a specific good under future circumstances that we cannot even predict? After the COVID-19 crisis, it might seem natural to conclude that we need to secure supply in *“crucial markets for e-mobility, batteries, renewable energies, pharmaceuticals, aerospace, defence and digital applications”*, as put forward by the European Commission during the presentation of its Recovery Fund.<sup>26</sup> But which are the critical raw materials and intermediate and final products in these “markets”? Is it all of them, or only a subset, and at which layer of the supply chain? And what about other goods and services such as food, transport, utilities, and so on?

As part of its Recovery Fund, the European Commission aims at strengthening its response capacity: *“Creating an additional reserve of crisis response capacities (including e.g. medical equipment, medical evacuation planes, field hospitals, fire-fighting planes and helicopters) at EU level that can be mobilised quickly in case of health emergencies, forest fire outbreaks, chemical, biological, radiological, or nuclear incidents or other major emergencies”* (European Commission, 2020b). The exercise of defining the goods that should be subject to capacity mechanisms requires a high degree of fine-tuning, which calls for input from experts from different fields. It also requires an overall assessment of risks and a system of societal objectives that prioritise some outcomes over others. Here, the calculation of consumer willingness to pay (see Section 3.1) is likely to be a poor guide for determining the domain of security of supply considerations.

There could be type I as well as type II errors, i.e., failure to secure the production capacity for goods that will turn out to be essential, as well as securing the supply of goods that turn out to be not needed or needed in lower quantities than initially

<sup>25</sup> As a consequence, the EU state aid guidelines now require that countries have to demonstrate that capacity mechanisms are necessary, identify the underlying causes of the capacity adequacy problem (e.g., market failures or regulatory barriers), and examine alternatives to introducing a capacity mechanism. Capacity markets are considered to be incompatible with the state aid regulation when necessity is not demonstrated.

<sup>26</sup> See the European Commission's Recovery Plan for Europe at [https://ec.europa.eu/info/live-work-travel-eu/health/coronavirus-response/recovery-plan-europe\\_en](https://ec.europa.eu/info/live-work-travel-eu/health/coronavirus-response/recovery-plan-europe_en)

expected as the crisis unfolds. As has sometimes been the case in electricity markets, a hidden rationale for introducing capacity mechanisms might be to grant state aid to firms going through rough financial conditions, or for those that are close to the ears of politicians. Justifying the need to introduce capacity mechanisms should be a cornerstone of any policy aimed at securing supply that the market would not necessarily provide at lower cost. Seeking the advice of independent experts may at least partly address the political economy worries.

### 3.5 WHAT AMOUNTS SHOULD BE SECURED?

Once it has been established that the supply of a certain good or service needs to be secured, another critical issue is what amount is needed. In electricity markets, the choice of how much capacity should be secured has been a cause of concern. The standard approach is to delegate this task to the system operator, as it is best placed to forecast future electricity needs and the future supply of intermittent resources. However, since its duty is to avoid supply interruptions in order to keep the system in balance, the system operator is typically biased towards excess procurement (Newbery, 2015).

In other sectors, there may instead be a bias towards too little procurement, but for a fairly similar reason: a principal-agent problem. As already discussed in Section 2.2, public institutions might not be willing to pay for the costs of securing supplies that will only be used in the future and with some small probability, to the benefit of their successors. For instance, we would all have been better off if the authorities had decided to stock masks and other medical equipment before the COVID-19 outburst. However, authorities in the past overlooked the probability of this event (despite warnings from the scientific community) and gave priority to other expenditures that might have appeared more urgent or expedient to them at the time. Past experiences could be an underlying cause. For instance, as mentioned above, some governments had been heavily criticised for buying enormous quantities of the H1N1 vaccine, which were then not used.<sup>27</sup>

Needless to say, it is easier for electricity system operators to forecast future electricity demand and supply than it is for authorities to predict the likelihood of future crises (including infectious diseases, cyber attacks, nuclear accidents, disasters triggered by natural hazards such as droughts, earthquakes, volcano eruptions, and others that we might not even be able to identify), making this issue even more difficult to address in sectors other than energy. While the former can be considered ‘known unknowns’, some of the others may be labelled ‘unknown unknowns’.

### 3.6 CENTRALISED OR DECENTRALISED CAPACITY MECHANISMS?

The experience with electricity capacity markets might also provide lessons regarding the design of such mechanisms. The first design dimension is whether capacity markets should be centralised or decentralised. Under a *centralised mechanism*, the regulator sets up a central auction that serves to determine the plants that will commit to provide security of supply, and the price at which they will do so. Under a *decentralised mechanism*, the regulator imposes a capacity obligation on the electricity retailers, who need to buy capacity credits from capacity providers, either bilaterally or through exchanges. Failure to do so is penalised through fines.

<sup>27</sup> See, for example, “Sarkozy under fire on flu vaccine ‘fiasco’”, *Financial Times*, 5 January 2010.

How could this choice be reflected in other set-ups? Think, for instance, of flu vaccines. A centralised mechanism would see the government procure all the vaccines needed for the whole population, while a decentralised mechanism would have the regulator impose this obligation on the hospitals according to the share of the population in their catchment areas. Depending on the good or service that is being considered, each option has its pros and cons. Typically, buying power and risk-sharing considerations would suggest centralised mechanisms. In contrast, information issues might favour a more decentralised approach. A drawback of decentralised systems is the need to put in place a system of penalties and monitoring (in cases in which violations may be detected *ex ante*) to avoid non-compliance. Yet, penalties might not always be credible given the nature of the agents involved (would it be credible to penalise a hospital that fails to provide essential supplies during a pandemic?) and given the scale of the penalties that in some cases might be needed to make the incentive system work. Furthermore, if violations are only detected *ex post*, the costs of non-compliance may be so large that the risk that incentives do not work may largely exceed any potential benefits of decentralisation. Under such circumstances, a centralised system is likely to work better. Still, centralised systems are not immune to implementation problems. Providing capacity owners with the incentives to perform is particularly challenging given that they are paid for the obligation to supply something with some probability in the distant future. We will return to this issue when we refer to reliability options below.

### 3.7 MARKET-WIDE OR TARGETED CAPACITY MECHANISMS?

The second dimension is whether capacity mechanisms should be market-wide (i.e., all existing firms are entitled to receive capacity payments) or whether they should be targeted to a subset of firms (to new plants, to plants located in a certain region, to certain technologies, etc.).

Electricity markets provide examples of both systems. The UK and France both rely on market-wide capacity mechanisms: the former's is run through a centralised auction, the latter's is organised through bilateral exchanges. One alleged benefit of market-wide mechanisms is that they are better at selecting the firms that are more efficient in providing capacity. However, their main drawback is that they might give rise to infra-marginal rents, as some plants might be willing to make their capacity available even without capacity payments (e.g., a plant that is already in place that makes enough profits by selling its energy). This is particularly the case if there are strong technology differences. Hence, even if the most efficient capacity providers are selected, market-wide capacity mechanisms do not necessarily provide the least costly way of securing capacity from consumers' perspective.

*Targeted mechanisms* are intended to avoid this problem by only granting payments to existing plants that would otherwise shut down, or to new investments that would not otherwise be made. This is the case for the *strategic capacity reserves* in Germany, Belgium, Poland and Sweden, under which some plants are paid to stay on standby and are only used in case of output shortfalls, according to criteria that are determined *ex ante*. A reserve auction is used to determine the compensations and also to achieve an ordered closure of plants. The auctions for *reliability options* used in Italy and Ireland are also an example of a targeted mechanism. The regulator (or the system operator) enters into an option contract that gives the right to buy electricity at a pre-determined strike price. Hence, reliability contracts provide a secure source of payments for the new investments (i.e., the option price that is set through the auction process) in exchange for making them subject to price caps (i.e., the strike price). Reduced uncertainty over cost recovery reduces investment costs, while consumers

are protected against excessive prices in times of scarcity.<sup>28</sup> Furthermore, a producer subject to a reliability option has strong incentives to be available when it is most needed (which typically coincides with periods of high prices). Otherwise, if the producer were unavailable, it would have to buy the energy that it does not produce at a high price to sell it back to the regulator at a lower strike price.

Reliability options are appealing in the context of electricity markets, but their implementation may not be straightforward in other sectors in which liquid markets to which these options could be indexed do not exist. Furthermore, just like insurance, reliability options essentially serve to hedge price risks, but do not necessarily secure physical availability. Finally, market-wide mechanisms only make sense in sectors in which technology is fairly homogenous, as otherwise inframarginal rents may be too costly. Despite these caveats, capacity mechanisms for electricity are – as far as we are aware – one of the few examples that can provide us with hints for this new endeavour of securing the supply of a wide array of essential goods and services.

To conclude this section, we have discussed capacity mechanisms for electricity as these can provide us with a good example of how to secure the supply of a wide array of essential goods and services. In particular, we believe that a centralised and targeted mechanism, such as a system of strategic reserves to be procured through competitive mechanisms, might help guarantee the supply of several products and services which would be essential in case of catastrophic events.<sup>29</sup>

## 4 Conclusion

A key lesson from the COVID-19 crisis is that it pays to be better prepared for the next crisis – be it a variation of the COVID-19 crisis or a shock of very different nature (including ‘black swan’ events).

Responding to a crisis can be seen as a key role of the state, given its “universalistic duty to protect its inhabitants (and not only its citizens) in times of disaster and to bring relief to its victims.... This duty includes the assessment of risks and the calculation of chance...and investment in preventive measures of all kinds” (Ophir, 2007: 127). The state plays the key role by its very nature, but also because private incentives are often insufficient to prepare for rare events with large negative externalities. In this Policy Insight, we have tried to shed light on the question of how the state can satisfy this ‘universalistic duty’.

From an economist’s perspective, we have discussed the issues raised when designing a resilience strategy based on prevention, early detection and mitigation. While one size does not fit all, certain solutions are valuable in responding to all sorts of events (be it a disaster triggered by natural hazards, another pandemic, or a nuclear accident, to name just a few). These include a robust primary health care system, a strong logistics network, emergency decision-making bodies that combine legitimacy (elected politicians) with expertise (expert advice), and institutions that promote cooperation among countries or regions. It is also worth emphasising the relevance of ‘social capital’ in facing disasters, a broad term under which we can include trust in

<sup>28</sup> See Cramton et al. (2013) for a description of reliability options.

<sup>29</sup> A targeted mechanism need not be technology-specific. ‘Targeted’ means that capacity payments are paid only to a subset of plants (e.g., those who win the auction or only the ones that come online after an indicated date), not to all plants in the market. This is in contrast to market-wide mechanisms in which all plants in the market receive capacity payments. The latter tend to be unnecessarily costly.

public institutions, the well-functioning of the administration, society's willingness to follow public recommendations, trust in science against conspiracy theories, and so on.<sup>30</sup>

We have argued that a strategy based on private (even if mandatory) insurance is likely to be insufficient, difficult to implement, and inefficient. Furthermore, in the best case, insurance hedges against the cost but does not necessarily reduce the *incidence* of the crisis; nor would it guarantee the physical availability of the essential goods when they are needed most. Instead, a resilience strategy should rely on public authorities securing the provision of essential goods in sufficient quantity and quality. This requires putting in place competitive mechanisms to accumulate the essential goods, establishing rationing protocols, and facilitating the ramping-up of production when the crisis hits.

Since these issues have long been debated in electricity markets, we lean on their experience to draw broader lessons. As a general principle, it is likely that a centralised and targeted mechanism, such as a system of strategic reserves to be procured through auctions, would perform well in most cases.

Overall, while catastrophic events are difficult to avoid, society should strive to be better prepared for the next one. This is a challenging task, but one which should be a priority for all members of society. This Policy Insight is an attempt to contribute to the discussion of how to be more resilient when the next crisis hits.

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<sup>30</sup> Relatedly, the World Health Organization observed that the COVID-19 pandemic "affects all spheres of life. It therefore requires a comprehensive response, encompassing health, mental health and psychosocial support, education, and other aspects of the social and economic sectors. Many sectors lacked plans to mitigate not only the public health risks but also the potential socioeconomic impact of the pandemic ... This lack of multisectoral preparedness left many societies scrambling to figure out how to maintain essential services and mitigate economic disruptions. The potential impact of pandemics on non-health sectors and the private sector has been a known risk for years." (WHO, 2020, p. 33).

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