3. Risk, Insurance and Solidarity – National and EU Perspectives

The economic consequences of the corona pandemic have prompted economic policy initiatives, including measures directly associated with lockdown restrictions and more traditional macroeconomic policies to reduce the risk of a prolonged economic crisis. A key element in this economic policy response is how to spread and diversify the consequences of the crisis both within and among countries.

Countries have taken steps to diversify the risks by extending existing and developing new tax financed arrangements.[1] While many details can be discussed, these initiatives build on the solidarity within the realms of the national state. Insurance across countries is equally important, but much more challenging, and this chapter discusses in some detail what the European Union and Eurozone institutions can and should do in relation to the corona crisis. The Eurozone has been successful so far in preventing the loss of investor confidence that characterized the Euro crisis. However, the Eurozone still faces the challenges that some of its member countries will emerge from the crisis with extremely high levels of public debt and deep economic problems.

The European Union (2020a) has recently launched an initiative dubbed "Europe's Moment: Repair and Prepare for the Next Generation." This is an effort by the European Union to take a more pro-active stance. The European Union was widely perceived to be a part of the problem and not the solution during the financial crisis, and this initiative is attempting to take a more pro-active stance not only in dealing with the immediate consequences of the corona crisis but also in linking it to a forward-looking perspective focusing on green and digital transitions. The proposal highlights solidarity, cohesion and convergence as key elements for Europe's recovery and future.

The EU challenge is its limited financial capability and flexibility. As a response to the crisis, the European Union has developed a "European Recovery Plan" with a planned budget of EUR 1.85 trillion. This includes the Multiannual Financial Frame-work (MFF), that is the EU budget for the period 2021–2027, and, as a new element, the establishment of the EUR 750 billion Economic Recovery Fund (ERF) based on borrowing. The size, financing, and mission of the fund are currently being debated. The member states have reached an agreement which implies that EUR 390 billion will be dedicated to spending programs supporting the economic recovery in Europe while EUR 360 bn will be handed out as loans to member states. The European Parliament has not yet approved this solution. This is accompanied by considerations on how the European Union can get "own resources" via e.g., a digital tax or environmental levies. The effects of this initiative, in particular the ERF, will ultimately depend on how the allocation of funds is designed and whether the European Union will succeed in incentivizing policies of the member states, which enhance economy growth.

[1] A listing can be found in OECD (2020).

3.1. LOCKDOWN AND INSURANCE

As a consequence of the pandemic, lockdown restrictions have been imposed. The restrictions were motivated by the externalities arising from the spread of the virus due to too many and close contact between people. The lockdown may thus be interpreted as an unanticipated "market-closure" shock, an event which is largely non-insurable.

In response to lockdowns, governments have launched emergency packages ranging from direct support to firms for loss of revenue, coverage of fixed costs, work-sharing arrangements, and liquidity and loan arrangements. These schemes are generally collectively financed via the public budget.

The measures can be interpreted as retrospective or ex post insurance of an unanticipated aggregate shock. Since firms and workers had no influence on the occurrence of this shock (no ex ante moral hazard), there is no direct incentive problem in providing the support. The same may be argued with respect to workers prevented from working, where the usual coverage offered by the social safety net may be considered insufficient for this particular type of shock (also here no ex ante moral hazard problem). Providing such insurance also serves to maintain the production capacity by avoiding excessive disruptions in job matches and bankruptcies, impairing the possibilities for a quick rebound of economic activity following the lockdowns. Retrospective insurance is not unusual and is seen in relation to natural disasters, terrorist attacks, etc. What is unusual in the current situation is the aggregate and global nature of the shock.

Current policy measures are national initiatives using or extending existing schemes like work-sharing arrangements, unemployment insurance, including launching new and very unusual measures such as support for fixed costs. The schemes are ultimately financed via the public budget, and therefore rely on the solidarity and collective responsibility embedded in already-existing institutions and policies.

Even though the pandemic affects all countries, the specific country effects differ, not only in the health dimension, but also in the economic dimension depending on economic structure, etc. The shock and its effects were not anticipated, and while national schemes may be powerful in providing insurance of aggregate shocks via the public budget and thus across time and generations, this is not exploiting the full scope for risk diversification. National initiatives may moreover have a "home bias" – see discussion in Chapter 4 – and to an insufficient degree take interdependencies between countries into account. Disruption of supply chains and loss of production capacity have effects for trading partners and are thus additional arguments for cross-country burden sharing. This leads to considerations regarding the need and scope for initiatives at the EU level.

3.2. THE EUROPEAN RESPONSE TO THE CRISIS

What is the role of the European Union and the Eurozone in the corona crisis as far as insurance across countries is concerned? In Europe, countercyclical fiscal policy is a task of the national governments. The EU budget is small (roughly 1 percent of EU GDP) and not designed for risk-sharing purposes. In particular in the Eurozone, the absence of institutions for fiscal risk sharing has been discussed for some time.

There are in particular two areas where European institutions have a potentially important role to play. First, a crisis as large as the corona crisis has a strong impact on financial markets. There is a risk that the sudden increase in risk aversion of investors creates liquidity problems for the more highly indebted countries in the Eurozone. Second, especially since the effects of the corona crisis are asymmetric, with some countries hit harder than others, the EU countries could set up an insurance mechanism to cushion the blow and share the risk. In principle, an insurance contract should be written before the damage happens, but even ex post there is reason for risk diversification, especially since there is still some uncertainty as to whether the virus is under control and which countries will be affected most severely.

In addition to narrow economic considerations, the view is widespread that for political reasons the European Union should come up with a sign of solidarity in this crisis. This suggests that an insurance mechanism should be created even if it is clear which countries will benefit most. Another aspect of solidarity is that there is a common interest of all European countries in stabilizing the economies of member states which are most affected by the crisis.

The difficulty is that the European Union, contrary to national states, cannot use existing schemes to provide insurance or support and rely on tax (debt) financing. If it wants to act in this area, new schemes and their mode of financing have to be developed. This introduces obvious delays in the response, but also raises difficult issues since any insurance arrangement also involves redistribution.

3.3. PREVENTING A CRISIS OF CONFIDENCE IN INTERNATIONAL CAPITAL MARKETS

In order to contain the risk of a crisis of confidence in international capital markets, the governments of the Euro area adopted a package of measures totaling EUR 540 billion on April 9. It contains three elements: First, all member states will have access to a precautionary credit line from the European Stability Mechanism (ESM) of up to two percent of their gross domestic product, a total of EUR 240 billion. They can draw on this if they have difficulties refinancing themselves on the capital markets. Second, the European Investment Bank (EIB) will receive additional funds of EUR 25 billion. This puts it in a position, supplemented by additional borrowing of EUR 175 billion, to finance investments of up to EUR 200 billion throughout Europe. Third, under the SURE program, the European Commission is offering all EU member states credit assistance to finance labor market measures, especially short-time working allowances. The volume of the SURE program is EUR 100 billion. The refinancing of these loans is made possible by guarantees from the member states.

To reduce the risk of a crisis of investor confidence, the ESM credit line is particularly important. The ESM is unpopular, in particular in southern European countries, because it was associated with tough restructuring programs during the euro crisis. But this time the conditions are supposed to be mild: The states should only commit themselves to use the funds they receive from the ESM to fight the pandemic and its economic consequences.

During the Eurozone debt crisis, the ECB also introduced the Outright Monetary Transactions (OMT) program. The OMT program enables the ECB to buy government bonds from a country that has submitted to the conditions of an ESM program, if necessary, in unlimited amounts. This program is controversial because the ECB's mandate is actually limited to monetary policy and playing the role of a lender of last resort is fiscal rather than monetary policy.[2] Irrespective of this legal debate, the combination of the ESM and the ECB is an effective lender of last resort. The fact that there has not been a crisis of confidence on the international capital markets during the corona crisis so far seems to confirm this.

At the same time, even a well-equipped lender of last resort can only help to a very limited extent if a country is over-indebted in the long term. The ESM may only grant loans to countries that are not over-indebted. It is not the function of the ESM, let alone of the ECB, to take the debt from over-indebted countries and transfer it to other member states. But

[2] The European Court of Justice has ruled that the OMT program is not a violation of the mandate of the ECB.

acting as a lender of last resort inevitably involves the risk that this would happen. The reason is twofold: First, it is difficult to draw a line between solvent and insolvent countries; everything depends on assumptions about future interest rates, economic growth and the ability and the willingness to produce primary surpluses. Second, there is a bias in political decision making toward denying that countries are insolvent even if they are. The case of Greece during the Eurozone crisis is an example.

3.4. INSURANCE AND SOLIDARITY OR TRANSFERS FOR PAST SINS? THE EUROPEAN ECONOMIC RECOVERY FUND (ERF)

The second element is the recently launched initiative to "repair and prepare for the next generation" for all EU countries. The program is an umbrella covering a long list of programs and initiatives – including some earlier proposals – but the key element is the introduction of a debt-financed European Economic Recovery Fund (ERF). So far, no final decisions have been made regarding the new fund, but the member states have agreed on key elements, and now negotiations with the European Parliament are underway.

The EU budget does not actually provide for debt. Now there is to be an exception. It is planned that the EU member states will provide guarantees that will enable the European Union to issue bonds to finance the ERF. The burden sharing in providing the guarantees is to correspond to the countries' share of gross national income (GNI). This is the usual financing key for the bulk of the EU budget. Initially, EUR 1500 billion (10.8 percent of EU GDP) were under discussion for the volume of the fund. Then, France and Germany presented a joint plan that envisages a volume of EUR 500 billion, or around 3.6 percent of the EU's GDP. This is slightly more than three times the previous annual EU budget. The European Commission published a proposal which provided for EUR 750 billion, to be spent over several years. There is an ongoing debate about how much of these funds will be handed out as loans to member states or as transfers. The EU member states have agreed that EUR 390 billion will be transfers and the rest will be loans. It is likely that the European Parliament will accept this aspect of the deal because it was the result of difficult negotiations.

How is the ERF project to be assessed from an economic perspective? One view is that the fund is simply an instrument for solidarity, suggesting that it should redistribute money from some member states to others, where the recipients decide how to best use it. Another view is that the fund should generate "European added value." What does this mean? First, the fund should generate a benefit for Europe as a whole, rather than just for the net recipients. Second, it is not enough for the fund to produce a benefit that exceeds the costs. It is also not enough for spending to focus on European policy priorities such as the European Green Deal. The difference between benefits and costs must be greater than for equivalent activities at the national level (Fuest and Pisani-Ferry 2019).

3.4.1. ERF as an Insurance Mechanism

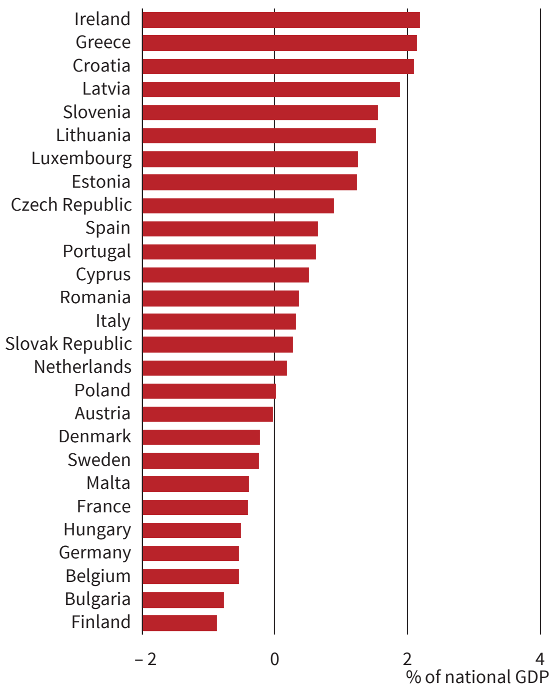
Added value could be created if the fund takes on an insurance function and helps the member states that suffer the greatest economic losses as a result of the corona crisis. Thinking of this from an ex ante perspective, the question is what such an insurance arrangement to cope with a health shock affecting all European countries would look like.[3] Ex ante there would be a common interest in setting up such an arrangement; there will be uncertainty both with respect to whether such an event will occur, and, if it occurs, what its implications would be. The implications include not only the health consequences but also the economic effects across countries, sectors and specific firms. The emergency packages implemented in various countries retrospectively replicate part of such an insurance contract, but leave risk diversification incomplete, in particular, across countries.

While the occurrence of the corona shock can easily be established, the consequences – and thus the insurable event – are less precisely defined. Today, countries such as Italy, France or Spain are expected to suffer major losses because the lockdown lasted longer there and the slump in growth in the first quarter of 2020 was deeper than in Germany, for example. However, it should be borne in mind that countries like Germany or the Netherlands are more involved in international trade than others. Since the international exchange of goods has been massively disrupted by the corona crisis, it cannot be ruled out that the economic costs of the crisis will ultimately be higher in these countries. The economic consequences also depend on the lockdown strategy and emergency packages introduced, and thus are to some extent policy-dependent.

Several facts, including the definition of the insurable event, contributions and compensations complicate retrospective insurance. To illustrate, consider the following simple model calculation. Assume that the volume of the fund is EUR 750 billion, as currently planned. The member states contribute to servicing the debt proportionally to their gross national income. Let the compensations from the fund depend on the decline in the gross domestic product of the EU states due to the corona crisis. Assume further the unantic-

[3] Cross-country insurance of e.g., health shocks may appear as a theoretical curiosity. However, such arrangements do exist. The World Bank organizes the "Pandemic Emergency Financing Facility" providing insurance to low-income countries against rapidly growing, cross-border disease outbreaks. In this specific arrangement, the insured are low-income countries, and donor countries (including Australia, Germany and Japan) pay the insurance premiums. See World Bank (2020).

Figure 3.1
Net Balances in the Economic Recovery Fund (ERF)
Scenario: European Commission Proposal



Source: EEAG calculations. © CESifo

ipated economic consequences of the corona crisis to be measured by the difference between the gross domestic product for 2020 as predicted by the IMF in its World Economic Outlook in October 2019 and the one that was predicted in April 2020. Clearly, the actual development in 2020 will differ from the forecast in April of that year, and more sophisticated metrics could be developed. But to understand the effects of the fund, this example of a concrete design of an insurance mechanism is helpful. Figure 3.1 shows the net balances of the individual EU states vis-à-vis the fund implied by this scheme.[4]

Net contributors will be Belgium, France, Germany and Sweden, as well as Bulgaria and Hungary. Net recipients would be Spain and Italy, the Netherlands, and Ireland. These financial flows reflect the fact that the Netherlands and Ireland are suffering a greater loss of economic output due to the crisis than the EU average. This underscores the difficulty of separating insurance and redistribution, which in turn makes it difficult to implement such arrangements. It is hardly conceivable that relatively poor member states such as Bulgaria and Hungary would pay transfers to wealthier member states. Italy would be a net recipient, but on balance the inflow of funds would only amount to 0.33 percent of gross domestic product. Such a sum would not bring about any noticeable change for the country`s economic development. It could be argued here that the fund is credit-financed and initially brings the country high inflows of funds, while repayments begin later. However, the country could also take out the loans itself. In view of these results, it can be assumed that the fund, if conceived as pure insurance against the costs of the corona crisis, will hardly be acceptable.

Many details on the specific design of the scheme can be discussed, but the example illustrates some fundamental issues, making it difficult to implement such retrospective cross-country insurance arrangements. It is also clear from the current discussion that the ERF cannot be interpreted as an insurance arrangement along the lines discussed here.

3.4.2. ERF Spending Rules to Promote Economic Reforms and Investments

If there is an added value created by the ERF, it is related to the expenditure side. How the money will be used is so far unclear. One controversial issue in the negotiations was whether the fund's resources should be spent as other money in the EU budget or whether it should go to member states in the form of loans. There are different views about this. Germany and France published a joint proposal for the ERF that talks about standard budgetary spending:

> *“500 billion economic recovery fund will provide EU-budgetary expenditure for the most affected sectors and regions at the basis of EU budgetary programmes and in line with European priorities. It will increase resilience, convergence and competitiveness of European economies, boost investment, in particular in digital and environmental change, and strengthen research and innovation.”*[5]

Some EU member states are opposed to this. On May 23, 2020, a few days after the publication of the Franco-German proposal, Austria, Denmark, the Netherlands and Sweden, who call themselves the “frugal four,” presented their own concept for the ERF. They want to use the money exclusively for loans.

The European Commission proposal foresees a volume of EUR 750 billion to be allocated as follows: EUR 500 billion are spending programs, EUR 250 billion are to be granted as loans. Now a compromise has been found, with a reduction of the spending programs to EUR 390 billion.

But more important than the volume and the composition in terms of grants and loans is how the money will be used. One way in which the ERF could create added value would be a contribution to stabilizing the economy in the current downturn. It is likely that it will take at least a year, maybe more, before any money starts to flow from the fund. It will therefore play no direct role in stabilizing the economy during the acute phase of the corona crisis. However,

[4] The net balance of country i is calculated as follows: (loss of country i in GDP due to crisis/sum of GDP losses for all countries – GNI share of country i in 2019)*Volume of the fund.

[5] See Franco-German Initiative for Europe’s Economic Recovery after the Corona Crisis (2020).

the fund can add value in terms of macro-economic stabilization through its impact on expectations. Interest rates on Italian and Spanish government bonds have fallen following the agreement between Germany and France on the fund. This can be interpreted as an increase in confidence in the economic future of these countries. Of course, this may also be a simple reaction to expected redistribution in their favor.

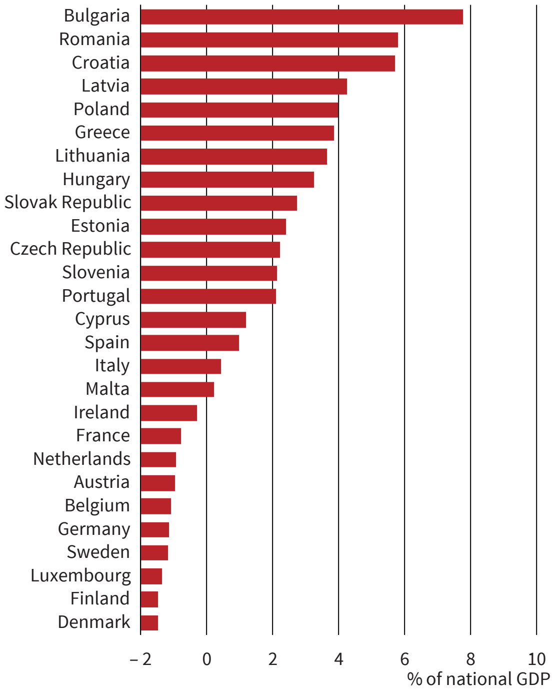
Another way of adding value with this fund would be to use it for investments that are productive, but which are not, or not sufficiently, undertaken by member states. This approach is more promising. Examples of such investments are cross-border transport, energy and communication networks such as railways, motorways, data networks or power lines. Investments in cyber security, European research and innovation programs, large technology projects such as the Galileo satellite navigation system are other examples of expenditures that have the potential to generate real European added value. Such projects would also have a positive impact on the European economy, but they would not be specifically targeted at the countries, regions or sectors that have been particularly hard hit by the corona crisis.

However, the issue of redistribution and solidarity comes to the fore again. The European Commission (2020) presented a preliminary analysis of the financial flows implied by the fund. It was still based on the Commission's original proposal, which is now outdated, but it is still of interest because it includes simulations of the distribution of the funds across countries, see Figure 3.2. The emerging patterns are well known from other redistribution policies in Europe: Germany, France, the Netherlands, Ireland, Finland, Luxembourg, Sweden and Denmark are net contributors, while all other countries are net recipients. Spain and Italy are the largest net recipients in absolute terms, receiving net inflows of EUR 82.2 and 56.7 billion respectively under the Commission scenario. For Spain this is 6.6 percent of the gross domestic product or EUR 1,760 per inhabitant, for Italy 3.2 percent or EUR 939 per inhabitant.

Germany, the largest net contributor measured in Euros, is responsible for a net outflow of EUR 133.3 billion, or 3.9 percent of gross domestic product or EUR 1,600 per inhabitant. France pays EUR 52.3 billion, or 2.2 percent of its gross domestic product or around EUR 800 per inhabitant. This pattern would imply that the ERF is primarily an extension of existing cohesion and structural policies in the European Union, rather than a specific response to the impact of the corona crisis.

If the transfer component of the ERF is reduced to EUR 390 billion, the financial flows and net balances of the member states will also be proportionally smaller but still significant. The 'frugal four' countries have also negotiated concessions in the form of higher rebates for them. In addition, it has been decided that the decline in GDP of member states until 2021 will

Figure 3.2
Net Balances in the Economic Recovery Fund (ERF)
Scenario: Pure Insurance Scenario



Source: EEAG calculations. © CESifo

play a more important role for the allocation of the funds than envisaged in the original Commission proposal, which implies that the insurance element will be strengthened. Moreover, it is striking that the funds dedicated to health policies and medical research are surprisingly small. The member states also decided that the debt incurred to finance the fund will be repaid fully until 2058.

3.4.3. The Need and Scope for the ERF

The ERF aims at addressing some of the problems created by the corona crisis at the EU level. Critics are concerned about various aspects of the ERF. First, they dislike the idea of introducing debt financing at the European level. They fear that this would set the course toward further increasing overall public debt in Europe and that it would not really be a one-off financing. Second, they reject the idea that there should be more redistribution across countries because they think that this will increase the dependency of the recipients on external help and create political tensions.

These concerns need to be taken seriously. That the fund will currently increase public debt in the European Union is intended. But it is not intended to permanently increase public debt in Europe and endanger the sustainability of public finances or force the ECB to finance public debt by printing money. The Franco-German proposal emphasized that the fund will be anchored in the European Union's own resources decision and bound by a "binding debt repayment plan." The current plans for the fund imply that the debt will be repaid until 2058. This is a long time, given that the next crisis, where fiscal space may again be needed, will probably take place within the next decade. Nevertheless the ERF does include a commitment to the one-off nature of borrowing – deficits are is not supposed to become a permanent feature of the EU bugdet. Of course, political pressure to use this instrument again can be expected in the next crisis at the latest. But no member state can be forced to participate.

A key issue is how it can be prevented that the fund's resources merely cement the dependence of the net recipient countries. Even if the money from the fund is used exclusively for investment, it is possible that the recipients will reduce their own investment efforts and channel the funds into consumption. It is difficult to prevent this through external supervision. Nevertheless, every effort should be made to ensure that the funds actually contribute to an increase in productivity and economic resilience.

Policies that aim at supporting the member states, regions or sectors most affected by the corona crisis face a fundamental dilemma: On the one hand, making sure that the money is used wisely suggests that funds should be linked to strict conditionality in terms of structural reforms or fiscal consolidation. On the other hand, conditionality builds on the problematic assumption that European institutions or other countries should impose their views about appropriate economic policies and reforms on the recipients. Conditionality can also be seen as reflecting a lack of trust or as undermining national democratic decision-making.

There is no easy way out of this dilemma. The European Commission pursues the idea that member states could present their own plans in the form of reform proposals from the European Semester and thus apply for funds. This would increase ownership of reform programs and help to alleviate incentive problems without, of course, completely eliminating them. However, it remains an open question how precisely such conditionalities can be implemented and monitored. Concepts for implementing this approach have been developed and discussed for some time (Dolls et al. 2019).

In order for this approach to work, it is important to ensure that individual member states do not receive ex ante commitments of allocations from the fund. It must also be guaranteed that at least part of the funds will not flow until reforms have not only been implemented but are also effective. One way of creating incentives to use the funds effectively would be to hand out ERF funds related to national reform programs as loans and transform them into transfers if and only if previously agreed objectives for economic growth or other variables are reached. Of course, creating these incentives comes at the cost of reducing the insurance effect of the funds. In addition, tight control of how the funds are used may be seen by the recipient countries as reflecting a lack of trust or respect for national sovereignty. The agreement among the member states regarding the fund do foresee that the member states submit national recovery plans, but it is unlikely that this will lead to strong conditionality or other strings attached to the funds they receive.

The corona crisis is putting the Eurozone and the European Union to the test. The economic downturn and the massive increase in national debt are creating high risks and tensions, especially for the Eurozone. There is much to be said for responding to the challenges of the crisis with steps of solidarity. Especially in view of resistance from some of the net contributor member states against an extension of transfers across countries, it seems important to consider that there are two sides to solidarity: Financial support is expected from the countries that are economically better off or less affected by the crisis. The countries receiving support are in turn expected to use the money productively to reduce the likelihood that they will need external help in the future.

In this respect, the agreement on the fund for economic recovery is not yet a breakthrough in overcoming the crisis. It is an important first step. The more difficult task now is to assure that the member states will use the money effectively. In addition, the European Union needs further reforms to increase its ability to provide European public goods, where common policies at the EU level add value, so that debates about net balances of individual member states lose relevance.

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