7

The Political Economy of Reinsurance

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7.1 OVERVIEW

The Economic and Monetary Union (EMU) and the experience of the euro area crisis have created expectations that the EU would act as an insurer of last resort to Member States. An insurer of last resort supports Member States when their national capacities to protect citizens are overwhelmed, but not in standard cyclical downturns, for example. Demand for mutual support was clearly expressed in the wake of the COVID-19 pandemic. The letter sent by nine heads of state to Council President Michel put it most clearly: '[The severity of the situation] requires the activation of all existing common fiscal instruments to support national efforts and ensure financial solidarity, especially within the eurozone' (Wilmès et al., 2020). The signatories proceeded to demand above all a common debt instrument, soon dubbed 'Coronabonds'. Even their most vocal opponent, Dutch prime minister Rutte, conceded in an interview with an Italian newspaper: 'We owe solidarity to the countries most affected by the pandemic, knowing, however, that we too have been seriously affected. This means that states that need and deserve help must also ensure that in the future they are capable of dealing with such crises on their own in a resilient way' (Valentino, 2020, Google translation). Surveys show that EU citizens endorse such a solidaristic response, though distinguishing between different types of crises and the nature of support requested (Cicchi et al., 2020; Ferrara et al., 2023). For instance, respondents are on average more willing to support other Member States in the case of natural disasters than when there is a surge in unemployment, presumably because natural disasters are shocks that cannot be attributed to past policy mistakes. If a crisis is common to all Member States, like a pandemic, this has a positive effect on solidaristic attitudes only if the mutual support does not consist of transfers but credit.

The expectation of EU support is remarkable in a policy area like public health in which the EU had hardly any mandate and Member States can still exercise protection, like border closure and discrimination against foreign suppliers, which are taboo elsewhere. Early in the pandemic, the Commission had limited legal and financial means to prevent this or come to the rescue of the hard-hit Member States that called for EU support (Herszenhorn and Wheaton, 2020). The EU encountered a typical 'capability–expectations gap' that Chris Hill (1993) noted in the EU's

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foreign policy many years ago. Many observers concluded that just like the reforms introduced during the euro-area crisis of 2010–14 (Matthijs and Blyth, 2015), measures taken during the COVID-19 pandemic in 2020–21 were incomplete and too little too late (Howarth and Quaglia, 2021; Jones et al., 2021).

This contribution will characterize these reforms as an evolving macroeconomic system of reinsurance. It is different from both fiscal federalism and optimal currency area ideal-type models that these critics have as implicit benchmarks.[1] Reinsurance compensates insurers for losses from a contingency for which they have to compensate their insurance holders but that could wreck their business. A standard example is private health insurance companies that seek such reinsurance against the risk that medical progress forces them to cover new high-cost treatments that they cannot finance out of regulated premia.

In the present context, we can look at the EU as reinsuring members' welfare states, as the ultimate social insurers of citizens, when crises overwhelm national policy capacities in a systemic crisis or a common shock like a pandemic (Schelkle, 2017, pp. 316–22; Bénassy-Quéré et al., 2018). Reinsurance is not merely a lowest common denominator policy that begs further steps towards fiscal integration until a complete set of co-insurance arrangements at the state and EU level does all the work of federal stabilization. Reinsurance is a form of fiscal integration in its own right. Moreover, it is a political compromise towards which a diverse union of democratic nation states has repeatedly gravitated. This chapter tries to explain how and why. The main argument will be that reinsurance for out-of-the-ordinary contingencies is democratically less demanding than a federal fiscal system and is therefore more pertinent for the present state of European political integration.

The Section 7.2 will analyse how new institutions were created and existing ones adapted since 2009 that can be understood as providing reinsurance. They constitute a system in the sense that the parts complement and respond to each other. This is all the more surprising since this recognizable system of reinsurance has not been designed by any identifiable collective of EU actors. Rather, it is the result of piecemeal reforms under the pressure of crisis escalation as well as the political imperative of keeping contingent liabilities of the insurance arrangement inconspicuous. We should therefore not be disappointed by realizing that this system of reinsurance has defects and does not fit a neofunctionalist account (Fabbrini and Capati, Chapter 20 in this volume). But any conceivable alternative also has defects, notably the US federation that is often the EU's implicit comparator (Rhodes, 2021). Section 7.3 shows why and how a reinsurance role for the EU constitutes a political compromise among Member State governments with very different views about how much fiscal integration is desirable and palatable. The conclusion is that we have to understand the EU not as an optimal currency area with a fiscal federation in the making but as an experimental union (Kriesi et al., 2021). Only time can tell whether European citizens recognize and appreciate that the EU provides mutual insurance, but only of last resort.

7.2 AN EMERGING SYSTEM OF REINSURANCE

This section briefly recalls how the major reforms followed each other and then interprets them as an emerging system of reinsurance for member states. Reinsurance is insurance for insurers,

[1] I come back to these models in Section 7,4. Fiscal federalism is a public finance theory that tries to determine which budgetary function, for instance stabilization or redistribution, should be financed and provided optimally by which level of government, federal, state, or local. Optimum Currency Area theory claims that only currency areas that are very similar in economic structure should forgo a flexible exchange rate, or have effective substitutes like labour mobility that can replace the exchange rate when an idiosyncratic shock hits one region but not others.

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not individuals and communities directly (Ross, 2021). Typically, reinsurance is sought by the primary insurers in order to cover excess losses from tail risks,[2] which would overstretch their capacity of keeping their contractual promises to insurance policy holders. It can take many forms and can be categorically different from the primary insurance; notably, it is not confined to budgetary transfers.

7.2.1 *Evolution since 2009*

The reforms in the EU and in the euro area since 2009 evolved in response to the 'North Atlantic' financial crisis that started with the collapse of Lehman Brothers in September 2008. The European Central Bank (ECB) stepped up its liquidity operations massively from summer 2007 (ECB, 2007, pp. 30–34), before even the Federal Reserve Bank (Fed) became active in the USA, where worrying signals of the impending disaster were visible from 2006. European (or more precisely German) banks became early victims of imploding subprime US mortgage markets. The ECB had an early warning sign and was able to intervene so quickly because it was more directly active in money markets than the Fed, refinancing up to 2,000 banks on a daily basis compared to the twenty central counterparties with which the Fed interacts (Lenza et al., 2010, p. 298).

The first consequential reforms concerned the creation of a Single Rulebook for EU banks as well as sectoral regulatory authorities, as recommended by the de Larosière report of February 2009 (Report, 2009; see also Acharja, 2009). This legal harmonization later allowed a banking union to be built in an incredibly short time span of a few years that included elements of reinsurance for national banking systems.

The financial crisis entered its sovereign debt phase outside the euro area as early as 2008–9 with IMF–EU bailout programmes for non-euro countries in Hungary, Latvia, and Romania (Schelkle, 2017, pp. 167–70). Under EU rules, they could get credit as Balance of Payments Assistance. These bailouts went largely unnoticed until the crisis affected euro area members for which a no-bailout clause was in place. When the Greek government finally requested support, in May 2010, the call for tightening the existing fiscal rules became overwhelming. By late 2011, the so-called Six-Pack reforms came into force and were followed by an intergovernmental Fiscal Compact, signed in March 2012, meant to reinforce the message of fiscal discipline. Both intended to harden commitments to budgetary prudence and make sanctions for breaking the rules more automatic. While the latter did not happen, the reforms triggered a phase of pro-cyclical retrenchment ('austerity') that slowed down the recovery and may even have contributed to a double-dip recession in some countries (IMF, 2011; Heimberger, 2016).

This spooked financial markets. Between 2010 and 2013, five euro area countries needed extraordinary support because bond investors shunned national government debt denominated in the common currency. While the problems of Greece and Portugal could be seen as predominantly fiscal, the cause of sovereign debt crises in Ireland, Spain, and Cyprus was private debt, of households and banks, which governments underwrote or assumed before financial markets turned the table on them and effectively shut them out of affordable bond finance. Bailout capacity was built up in several stages, ending with a permanent European Stability Mechanism (ESM) that came into force in late 2012. The turning point of the euro area crisis came in mid-2012, with ECB President Draghi's famous speech to London

[2] Tail risks refer to realizations of a random outcome that are very unlikely and occur at the ends (in the tails) of a normal probability distribution.

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investment bankers that the central bank would 'do whatever it takes to save the euro' (Draghi, 2012). His open-ended promise was underpinned by a new instrument, so-called Outright Monetary Transactions (OMT), but above all the decision of the European leaders' summit shortly before to introduce a banking union for the euro area.[3] By 2014, the core of the banking union, a Single Supervisory Mechanism, was in force and European economies had started to recover.

In 2020, the recovery ended abruptly. The COVID-19 pandemic was a public health crisis to which governments all over the world responded with shutdowns of entire sectors in the economy. The recessions that resulted were on average deeper than those during the financial sovereign debt crisis and nowhere deeper than in Europe. The fiscal fallout was dramatic. Governments compensated for their restrictions with massive job retention schemes, business subsidies, and guarantees vis-à-vis banks, while tax revenues imploded. The ECB accommodated the shock by stepping up its Quantitative Easing (QE) programme that had been in place from 2015 to stimulate recovery (De Grauwe and Diessner, 2020). The Pandemic Emergency Purchase Programme (PEPP) flooded the financial system with liquidity of up to €1.85 trillion, putting a floor under asset prices, in particular of government bonds. The innovation of PEPP was that the ECB could be more flexible in the amount of bonds it bought from each country, which gave it the flexibility to buy more issued by governments that were harder hit by the pandemic. Another instrument, the Targeted Long-term Refinancing Operations, made the lavish refinancing of banks conditional on their lending to business; a negative interest rate actually paid banks for doing so.

The Commission installed a hub-and-spoke system through which it coordinated the use of public health care resources in the EU, from repatriation flights to spare intensive care units and the procurement of vaccines. The landmark reform of the pandemic was a massive Recovery and Resilience Facility (RRF) that can hand out grants and loans to the tune of more than 6 per cent of the EU's 2018 GDP. Member States must submit detailed plans on how they want to spend the grants, of which a specified share must be for green and digital investments (Begg, Chapter 6 in this volume).

Other, less spectacular reforms were, first, the introduction of an ESM credit line of up to 2 per cent of each members' GDP, to a total of €240 billion. It is financed by bonds that the ESM issues and the Member States guarantee, which ensures extremely cheap financing costs. This ESM Pandemic Crisis Support prescribes a certain use of the loans at below market interest rates, notably to cover public health care costs. This is an innovation insofar as this contingent credit line does not require a government to fulfil 'strict conditionality' for drawing on it. Finally, the temporary 'Support to mitigate Unemployment Risks in an Emergency' (SURE) is a loan programme with an envelope of €100 billion by which EU Member States can finance job retention schemes, including support for self-employed businesses. SURE was mobilized very quickly while the ESM credit line has not been applied for by any Member State.

7.2.2 *The Building Blocks of a System*

The policy shift towards propping up overstretched Member States directly can be captured by the notion of reinsurance, defined as coverage of other insurers, to compensate for excessive or

[3] The banking union is arguably more important because the ECB cannot activate the OMT at short notice as it is predicated on an ESM programme. It is telling in this context that the ECB has not activated the OMT, not even in summer 2015 when market panic ensued during the discussions around the third bailout programme for Greece.

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catastrophically high losses. In the euro area crisis, this tail risk was a fiscal collapse triggered by a sell-off of the government bonds that made debt issue or rollover prohibitively expensive. Even the Greek and Portuguese cases, which were on unsustainable fiscal trajectories before, can be seen as hit by a contingency eligible for reinsurance insofar as the unprecedented recession was a suddenly aggravating factor that pushed them over the edge. The catastrophic event was the drying up of affordable credit to national fiscal authorities that had huge deficits to finance. A bailout fund that can give affordable credit in such a situation amounts to reinsurance.

The contrast to reinsurance is co-insurance. Co-insurance is the principle on which a fiscal federation is typically based. The federal and the state level have complementary insurance schemes for residents and communities that come into play whenever contingencies materialize, simultaneously or in a division of labour, e.g. when transfers are largely financed by the federal budget while they are administered by the state. Co-insurance presupposes a budgetary system that links all levels of government.

To characterize a reform as reinsurance for catastrophic losses rather than co-insurance, the following features are relevant:

- The scheme that the reform introduced comes into play only as a secondary safety net to cover the downside tail risk, i.e. catastrophic or excess loss. It protects the primary scheme against overstretch or counterproductive responses like pro-cyclical expenditure cuts.
- The scheme does not require standardization of the primary insurance provision as it entails coverage of losses beyond a certain threshold only; the bulk of losses falls on the primary insurer. In turn, the reinsurance can also take a categorically different form and does not require harmonization with the primary insurance.
- The stipulations for receiving reinsurance should therefore also not reveal an overriding concern with moral hazard, i.e. risk-taking incentivized by available insurance. The primary (state) insurance is a stand-alone safety net and not merely a co-payment as in fiscal federations with a dominant centre.

The system that evolved has three relevant building blocks: (1) a supranational central bank, the ECB, that takes financial stability as seriously as price stability; (2) a banking union for the euro area; and (3) extension and differentiation of fiscal capacities like the ESM, the RRF, and SURE. All three elements are embedded in comprehensive regulation and legislation, including the ECB Statute, huge Directives on financial regulation, and the European Semester, an annual exercise in coordinating Member State policies through the Macroeconomic Imbalances Procedure and a complex set of fiscal rules. The latter were suspended in the pandemic[4] and are likely to be reformed again before their reactivation, officially planned in 2023.

7.2.3 *The European Central Bank as Reinsurer*

The ECB can produce liquidity in open-ended quantities and thus assume tail risks. It fulfilled this role from the start in 2007–8, as lender of last resort for the banking system. For instance, '[b]y relaxing collateral requirements for lending programs, central banks insure against the tail event in which the borrower and the collateral fail to cover the borrowed amount' (Brunnermeier and Sannikov, 2012, p. 3). But it took the ECB a while to acknowledge officially

[4] The suspension of fiscal rules means that no Excessive Deficit Procedure would be started if a Member State exceeded the 3 per cent deficit limit.

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this role in a catastrophic financial collapse, more precisely a system-wide liquidity shortage. In fact, the early liquidity measures, which lent to banks at a fixed (low) rate as much as they wanted to borrow, took only the downside tail risk, with the collateral requirements determining the amount (Brunnermeier and Sannikov, 2012, p. 26). The previous holders of the collateralized assets, banks, were the main beneficiaries of this intervention because it put a floor under asset prices. By stopping the fall of asset prices that dragged even solid banks into the abyss, they were functionally equivalent to early bond purchasing programmes by other central banks.

The first programme of bond purchases in secondary markets, the Securities Market Programme, was adopted after the dramatic May 2010 summit that decided the bailout of Greece. While straight asset purchases still largely benefited their previous holders in that they put a floor under their price, it also benefited member state governments like Italy and Belgium. They were vulnerable to herding behaviour of bond investors that sold first the public debt of Greece, then Ireland and Portugal. Every ECB intervention brought down the risk spreads on their bonds and thus made new issues and the rollover of bonds considerably cheaper. If the catastrophic event is a self-fulfilling financial panic, the promise of reinsurance can prevent the need for its activation.

More importantly, the ECB's intervention took momentum out of the 'doom loop'. This is the popular term for a negative feedback mechanism by which weak banks require support from government that then leads to downgrading of government bonds, which, to the extent that a lot of bonds are still held on banks' balance sheets, further weakens even the previously sound banks; and a new round ensues. It drags the insurer, the national tax state, into the abyss and it is exactly such a situation that reinsurance is meant to prevent. The strings attached to any of the ECB programmes are soft and general, because the central bank wants to encourage ample use of liquidity to stabilize the system.

However, there were also features of the ECB's interventions that were incompatible with the provision of reinsurance. Above all, the participation of the ECB in the Troika was subject to a conflict of interest: its hard-line stance on fiscal conditionality in the negotiations of bailout programmes suggested that the reinsurer wanted to minimize its exposure. The ECB's constant lecturing of governments to return to the path of fiscal prudence as defined by the EU's fiscal rules created the impression that the ECB was a very reluctant reinsurer and asked the insured primary insurer to mend its ways and reduce tail risks in a counterproductive way. The significance of ECB President Draghi's commitment to do 'whatever it takes' is that it made the reinsurance promise less provisional and qualified.

7.2.4 *The Banking Union and Its Elements of Reinsurance*

The European Banking Union got reinsurance capacity for Member States with the Single Resolution Fund. Bank resolution is necessary when banks' solvency problems become manifest and do not go away with liquidity support. It is an emergency fund that can be called upon in times of crisis, i.e. after national resolution capacity has been deployed and becomes overstretched. After its phasing in, this Fund is financed by the banking industry itself, which is also common in other jurisdictions such as the USA.

The fund is small, however, and covers only an amount equivalent to at least 1 per cent of the deposits that the member banks hold. Its negotiation took a long time since governments wanted to ensure that national bank supervisors have a say when called upon, that small domestic banks do not have to pay insurance for transnational banks, and that the fund really remains a

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secondary, exceptional safety net.[5] Too small a fund can precipitate crises because whenever it is called upon, panic may ensue for fear that it may run out soon. After much wrangling, it was decided in January 2021 that the ESM would provide an additional 'backstop' to the Fund from 2022 onwards. The ESM's contingent credit doubles the insured amount of the Single Resolution Fund by another 1 per cent of covered deposits, although it is capped at €68 billion.

This reinsurance is still very limited. A blog by ESM staff makes this obvious:

> The backstop will better shield governments from being forced to rescue failing banks, causing major disruption to their economies. Although it is tricky to draw parallels between crises, the last one saw governments inject around €360 billion into banks' capital over the ten years following the crisis, thus excluding asset relief interventions and guarantees (amounting to an additional €3.5 trillion in state aid. (Mascher et al., 2020)

While the ESM staff do not comment on this discrepancy, it is clear that the ability to reinsure governments when banks collapse is small.

The European Deposit Insurance Scheme (EDIS) is ready to be phased in but has not been finally approved by the EU Member States; in particular, Germany under finance minister Schäuble reneged on the promise to introduce such a backup for national deposit guarantee schemes. These schemes are already harmonized under EU legislation (Directive 2014/49/EU). The character of EDIS as a reinsurance scheme for national programmes is made quite clear in the Commission's justification of its proposal: 'EDIS would provide a stronger and more uniform degree of insurance cover in the euro area. This would reduce the vulnerability of national DGS to large local shocks, ensuring that the level of depositor confidence in a bank would not depend on the bank's location and weakening the link between banks and their national sovereigns' (European Commission, n.d.). The discussion is ongoing and it seems quite clear that EDIS will be introduced in the foreseeable future.

It is noteworthy that both reinsurance schemes, the SRF and EDIS, have to be paid for eventually by the financial industry itself. The EU's contribution to providing reinsurance is making it compulsory for banks operating in the euro area, i.e. as a regulator. Because of the limited amounts, however, the EU will have to back up the mandated private reinsurance with more tangible compensation, for instance with an ESM contingent credit line.

7.2.5 *Fiscal Capacities for Reinsurance*

The ESM (and its predecessors) was the first fiscal capacity that could help governments to sustain spending when they were shut out of bond markets. In 2010, it was not an *ex ante* insurance mechanism but risk-sharing *ex post*, which might explain the punitive strings attached as measures of deterrence. Even so, the support was massive, roughly three times as much as the IMF lent to countries at its peak in 2012. The Greek programme was the biggest in the history of sovereign bailouts (Pisani-Ferry et al., 2013; Schelkle, 2017, pp. 168–70). Yet the punitive conditionality tied to its low-cost loans has made the bailout fund so controversial that the Italian government, supported by a majority in parliament, pre-announced that it would not take the bailout with such conditions even if the pandemic hit them hard (Schelkle, 2021). The Pandemic Crisis Support, mentioned earlier, was the result, earmarking its use for high direct and indirect public health expenditures rather than making the receipt conditional on implementing far-reaching reforms.

[5] Nicolas Véron (2019) provides an insightful and informative account of the debate.

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Earmarking is in line with a reinsurance contract. It tackles the vulnerability to the incident specifically, for instance by financing additional health-care capacities or training of additional staff. It assumes that the losses borne by the beneficiary are so high that excessive risk-taking can be excluded as a cause of the contingency. Strict conditionality, by contrast, is at odds with reinsurance in that the stipulated reforms effectively challenge the entitlement to reinsurance. Its proponents argue that the conditionality of reforms may reduce the need for reinsurance next time, but this insinuates typically that it was not (re)insurance for a catastrophic event beyond a government's control but self-inflicted harm.

The Recovery and Resilience Fund is a fund that promises support to those members that were either particularly hard hit by the pandemic or are too poor to finance an ambitious investment programme that can jump-start the recovery. The first eligibility criterion, but not the second, can be compatible with the interpretation of reinsurance. Its temporary and specific nature makes the RRF a reinsurance against the uncertainties of recovering from a pandemic that puts some countries at higher risk of lasting damage without some outside support. For Member States that are eligible on the second criterion, the RRF grants and loans resemble more co-insurance from a dominant federal centre. The primary insurance is hard to distinguish from a relatively small co-payment, e.g. in the guise of maintaining public expenditure, in some recipient Member States. The highly redistributive nature of the RRF in this case makes it also more like a transfer programme than insurance paid out when a particularly severe contingency arises.

SURE was from the start designed as reinsurance. It tries 'to address sudden increases in public expenditure for the preservation of employment'. The forced shut-down of entire sectors of the economy had no precedent; most unemployment schemes would have been overwhelmed and the uncertainty from unemployment would have made households consume even less, with further damaging effects on economies. In essence, SURE provides favourable loans to help finance job-retention schemes. Job preservation on this scale and with such a scope have never been financed by Member States before (OECD, 2020). SURE incentivized governments to introduce those schemes in the first place, thus preventing a massive rise in unemployment in countries that can predictably not afford it and would thus have raised the prospect of sovereign debt crises. SURE in turn is financed by bond issues of the Commission, guaranteed proportionally by each Member State.

7.2.6 *The System*

Table 7.1 summarizes the elements of reinsurance that developed from 2008, starting with the ECB. Financial markets are also considered as insurers, which they are supposed to be. They allow savers and investors to put their eggs in different baskets and thus diversify risks. This is not to deny that financial markets produce tail risk themselves, i.e. bring them about through their own failure (Brunnermeier and Sannikov, 2012). However, while this is true for the financial system as a whole, it is not true for every bank that got into trouble. In this, systemic financial failure is not categorically different from tail risks of climate change to which every consumer and producer contributes while becoming a victim of global warming and pollution at the same time.

It still remains to be seen that the three building blocks form a system in which the parts back each other up. The resolute interventions of the ECB created a loneliness problem in the Padoa–Schioppa sense (Mabbett and Schelkle, 2019): the central bank was forced to provide liquidity to banks indiscriminately because it could not force governments to recapitalize and

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TABLE 7.1 *Reinsurance of tail risks of public and private insurers*

'Insurers' *Reinsurance providers*	Sovereign public finances	Financial markets
European Central Bank	Open-ended support (OMT announcement) in case of financial market panic	Lending and market making of last resort
Single Resolution Fund [European Deposit Insurance Scheme]	Circuit breaker for doom loop of bank-sovereign balance sheets; coverage of excessive losses to national schemes	Restructuring of too-big-to-fail banks, zombie banks
European Stability Mechanism	Bailout with conditionality, earmarked lending for pandemic	Backstop for an industry-financed resolution fund
Recovery and Resilience Facility, SURE	Substitute for bond market to finance public investments and job retention after major health crisis	n.a.

restructure national banking systems, which is fiscally costly. The collective of fiscal authorities in the Council could exploit their joint decision trap to free-ride on the ECB's stabilization efforts. The apparent cure of ever larger and bolder central bank interventions made the underlying problem of an oversized financial system, prone to boom–bust cycles, even more virulent. Asset bubbles, burgeoning shadow banking, and dubious financial innovations like crypto assets, chasing high yields with extremely speculative instruments, have been clear symptoms. In order to get out of this, the ECB insisted on institution-building that would ensure cooperation from fiscal authorities: both the bailout capacity that became the ESM and the banking union with its resolution capacity were stipulations by ECB Presidents Trichet and Draghi, respectively, in return for rolling out yet another programme (Mabbett and Schelkle, 2019).

The resolution capacity directly addresses the legacy problem of the euro area crisis, notably identifying and closing down so-called zombie banks. They are insolvent banks, in a commercial sense dead but still able to walk among the living, thanks to the central banks' liquidity support that put a floor under asset prices. The SRF (and EDIS, once in place) can help fiscal authorities to act by helping them with excess losses from bank restructuring.

The pandemic was a different crisis still labouring under this legacy problem. The RRF now provides respite for the ECB in that it is designed to reduce member states' need for national debt finance during their recovery and therefore their exposure to market panic. Despite its reform, the ESM has played only a secondary role, indicating that the legacy of its association with 'strict conditionality' has made it incompatible with reinsurance in the eyes of some governments.

But the ESM's Pandemic Crisis Support could still be useful for covering a tail risk of QE by the ECB (Schelkle, 2021). The ECB can buy government bonds from banks only after a prescribed time lag, so as not to encourage Member States to issue debt in the knowledge that the ECB will buy the bonds immediately; this would go against the prohibition of public debt monetization under Article 123 TFEU. Therefore, a situation could arise in which financial investors sell off a government's new bond issue soon afterwards, but the ECB could not stabilize the price of these bonds because they do not qualify for its asset purchase programme. Previously, such a government could only get a Troika programme from the ESM. Now, a government can avoid acute liquidity problems by drawing on the contingent credit line for

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Pandemic Support, without the strict conditionality and lengthy negotiation of a Memorandum of Understanding that accompanies other precautionary ESM credit lines with similar purposes. The Pandemic Crisis Support is therefore a complementary reinsurer when the ECB cannot act in this way. This allows the ECB in turn to be more selective and robust in its reinsurance role if it is of the opinion that a fiscal authority is not cooperating.

In short, the reforms reduce the loneliness of the ECB as the reinsurer of first resort during a financial crisis. Some of these capacities act quite clearly as reinsurance, e.g. the ESM pandemic support, and the RRF for particularly hard-hit Member States, notably those with a large tourism sector. These public schemes are complemented by compulsory private reinsurance for national schemes in the banking union, although they are probably too small for a systemic crisis.

7.3 REINSURANCE AS A POLITICAL COMPROMISE

Why have reforms converged on a system of reinsurance, rather than incrementally introduced a budget that can be enlarged over time? Legal scholars would point out that there are considerable legal hurdles to introducing a federal budget into the EU Treaty (Tuori and Tuori, 2014, p. 255). This observation can be complemented with a political-economic argument about why reinsurance of Member States is so much more conducive to political agreement than co-insurance through a common budget. The main reasons are, first, the state of democratic development of the union and, second, the EU's diversity, not least between members of the euro area and EU members outside.

Reinsurance and co-insurance are forms of fiscal integration. Reinsurance is, first of all, a concession to those Member States, typically in the north and east of Europe, that do not wish to integrate fiscally via a central budget with taxing powers at the EU or euro area level and joint public debt management. They are in favour of more limited forms of fiscal integration, notably fiscal surveillance, a modicum of transfers for disadvantaged regions, and possibly minimum tax harmonization. The euro area crisis has demonstrated that, given integrated financial markets, this was not sufficient to prevent a financial crisis from morphing into a sovereign debt crisis for some, with the potential to affect a large number through a self-fulfilling bond market panic. A crisis resolution mechanism had to be added in the guise of the ESM. But Member States still resisted a full-fledged fiscal union as co-insurance through a federal budget as well as intertemporal pooling of fiscal powers through joint public debt management.

Reinsurance is democratically less demanding than co-insurance. Permanent co-insurance requires taxing powers for all levels of government and thus democratic legitimation at all those levels. Reinsurance can be financed by the pooling of guarantees that underpin the issue of debt at low interest rates. This is the principle of the ESM, analogous to the IMF for the world economy. Depending on whether the primary insurer in need of reinsurance receives low-cost loans or grants, the non-affected Member States may have to pay a greater or lesser share of the debt service. This can be done rather quietly and fiscal costs accrue only in a distant future. It works like any contribution to an international organization.

Reinsurance can be more targeted and bespoke than federal fiscal co-insurance. We have seen that the three fiscal schemes created over a decade address specific contingencies. The ESM is a permanent bailout fund when sovereign debtors lose access to euro-denominated bond markets, which threatens to become contagious. The RRF is a temporary fund to facilitate uncertain recovery from the deepest post-war recession that Europe has ever seen. Finally,

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SURE helps Member States to finance job retention when unemployment and insolvency would affect so many workers and businesses that the political fallout would resemble the Great Depression. SURE could easily be recreated in future pandemics; after all, it has the politically attractive feature that it is self-terminating if and when public health measures like travel restrictions and lockdowns are eased.

As a secondary safety net, reinsurance does not require as much harmonization with the primary insurance scheme as a co-insurance arrangement. The latter has to have a complementary design so as to avoid free-riding and cumbersome administration, for instance the same categorical eligibility criteria for benefits. Reinsurance for tail risks, as in the EU, can be categorically different. Loans or grants to governments in exceptionally dire circumstances can be structured differently from the national income support system that it helps to finance. This is a significant advantage for a union that is extremely diverse and comprises members with very different (welfare) state traditions and generosity levels.

Closely related is the political advantage of reinsurance for the EU specifically, which comprises eight non-euro members. A common budget for the euro area would bring a membership crisis of the EU in its wake since it is inconceivable that Denmark, Sweden, Czechia, and Poland would accept this step. For instance, it would raise the question of how such a common euro area budget could be run alongside the Multi-Annual Financial Framework, which is the EU's budget. The European Parliament would have to get a new mandate that creates MEPs with different rights of representation for euro area and non-euro area citizens. By contrast, the reinsurance schemes can be flexibly extended to all, for which SURE is the most obvious example in practice.

This means that the Member States with a preference for the status quo, and thus a stronger bargaining position, can be moved towards more fiscal integration. They are assured that reinsurance operates only in exceptional circumstances and is specific to the contingency. In turn, those who favour more fiscal integration obtained large schemes that can quite significantly augment nation state capacities in a targeted way.

Last but not least, the primary insurers can claim political credit for any success of reinsurance. Reinsurance can act effectively as protection against contagion in those Member States which are not in the midst of the fire; the ESM is officially referred to as a 'firewall'. It can also act as the water and fuel supply to the fire brigade in countries which are directly affected. Reinsurance is only a backstop for those that are seen to come to the rescue, be it protecting residents from a crisis elsewhere or ameliorating the crisis at home; while not essential, it is reassuring to have.

Reinsurance therefore is not merely support of the lowest common denominator variety. This is an overly functionalist perspective that considers politics only as an obstacle to economically optimal solutions. That policies find political support is not merely a necessary condition; in democracies, it is more essential than finding a first-best solution, to the extent that they exist at all. Reinsurance has repeatedly proven to be a default position of interest constellations that can be captured by the battle of the sexes. While the partners, here democratically accountable governments, have quite different preferences on many policies, they prefer to do them together, even if it means at least for one side to make serious concessions on the preferred outcome. The problem of this game is to make sure that a consensus is reached, which is to determine who has to compromise this time. It requires trust that each side has to compromise from time to time. Scharpf (1997) argued that the battle of the sexes configuration is a more pertinent characterization of the 'games real actors [in the EU] play' than the overused prisoner's dilemma.

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7.4 FISCAL INTEGRATION IN AN EXPERIMENTAL UNION

This chapter has outlined how a sequence of reforms, driven largely by unprecedented and rapidly spreading crises, led to institution-building that can be seen as a system for the reinsurance of Member States. These newly created institutions protect these Member States, i.e. the primary insurers of domestic residents, against extreme demands on their capacity to cope with a crisis. These reforms were not designed as a system but complemented each other in a systemic way. Notably, the ECB could not prevent sovereign default on its own but needed a fund to indemnify it if government bonds on its books fail. The ESM was eventually created as a permanent bailout fund for sovereign debt problems beyond the control of the affected government. But the prescribed reforms and budget consolidation made the post-crisis recovery a problem, even before the pandemic struck, with its temporary suspension of economic activity from which entire countries have to recover. A massive recovery package responded to this in summer 2020, although its immediate driver was the perceived need to have a politically conciliatory substitute for the Coronabond instrument. A scheme to support job preservation and a bank resolution fund provide reinsurance for short-term measures with long-term benefits.

This is an alternative to looking at reinsurance as covering up the incompleteness of the euro area in terms of an optimal currency area and a fiscal federation. The optimal currency area approach supports a homogenization and streamlining of Member States so as to prevent them being struck by 'asymmetric' (nation-specific) shocks for which they no longer have an exchange rate to deal with. Even its own starting point, shocks that need to be stabilized, do not justify this reasoning, as Asdrubali et al. (1996) argued long ago (see also Cimadomo et al., Chapter 22 in this volume). If shocks and crises are key problems, diversity is an advantage for the risk pool that a monetary union constitutes (Schelkle, 2017).

Fiscal federalism also acknowledges that a polity may benefit from the diversity of its constituent members and assigns an optimal division of labour in fulfilling the fiscal functions of stabilization, redistribution, and allocation (efficiency-enhancing public goods provision). But this literature has no interest in how one could get to such a division of labour if one does not start out with it. Or how optimal it still is if we consider Member States to act in their own interest and have incentives to exploit the centre's capacities. The comparative research of Rodden and Wibbels (2002, 2010) has cast doubt on the desirability of fiscal centralization. In the USA, states switch off their automatic stabilizers and shift the costs to the federal level, only then to complain about the reckless public finances of the centre.

Refraining from all centralization comes at a cost, however. The EU cannot and must not force fiscal centralization on Member States for which this would have very different consequences. Ultimately, there is no magic wand that can create the political integration required before a central budget can become a democratically viable institution. Reinsurance for extreme, contagious, and potentially EU-wide emergencies can strike a compromise between meaningful diversity and the ability to join forces in hard times. This is all the more important as some contingencies may include all EU members, while others affect primarily those in the euro area. And EU schemes widen the risk pool, which enlarges the insurance benefit.

Our research programmes therefore need adapting to the fact that the EU may constitute a new type of polity (Kriesi et al., 2021). Future research may want to explore the mechanisms at work that forge a system out of uncoordinated piecemeal reforms. It should solve the puzzle why the relatively well-off Member States and their governments are apparently less willing to reinsure massive bank resolutions for which they also might be eligible, compared to other contingencies, such as a bank panic during recovery. And research could explore the politics of

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reinsurance, which is missing in a literature that excels in the mathematics of insurance economics, ever since Karl Borch (1961) discovered reinsurance for academic study. The elected representatives of citizens so far seem to agree each time on schemes that do not provide an entry point into a centralized budget. But what about their voters? Do they resent that the EU only assists as a reinsurer, i.e. supporting their government when national losses are considerable and the situation has already become quite desperate? Or will voters in EU Member States appreciate that, with the recent reforms, the EU has committed to come to a Member State's rescue in the extreme but leaves it fiscal sovereignty otherwise? The prevailing attitudes of electorates towards risk-sharing in the EU are not necessarily aligned with those of executives in crisis-fighting mode (Cicchi et al., 2020). More research needs to be done, not least because the answers to these questions will decide the political success of experimental fiscal integration in the EU.

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