Risk Sharing in the Euro Area

Risk sharing mechanisms are essential for economic federations. They spread the burden of unforeseeable, adverse economic developments across the states of the federation. As such they may increase efficiency, further acceptance and societal cohesion, or may reflect moral principles of fair burden sharing. But almost inevitably, cross-country risk sharing conjures up concerns about moral hazard and legitimacy. The European integration process involved the formation of risk sharing mechanisms, but of very limited reach, as major risk sharing mechanisms were deliberately kept outside the realm of the treaties.

For a currency union such as the euro area this can be fatal, because member countries lack monetary independence and exchange rate flexibility – as illustrated forcefully during the recent crisis. In response to this crisis, and to make up for the lack of an adequate risk sharing mechanism, adjustments to existing governance arrangements, both institutional and procedural, have deviated *ad hoc* from previously agreed principles. Although rather effective at times, this approach has given rise to legitimacy concerns, highlighting a potential tradeoff between effectiveness on the one hand and legitimacy on the other hand. After all, a perceived lack of legitimacy has arguably been one of the reasons for the recent rise of populist movements across Europe.

The future development of the legal, institutional and procedural underpinnings of European integration should therefore not aim at a mere perpetuation the arrangements agreed upon during the crisis. Going forward, the quest is instead for institutional and procedural frameworks that facilitate effective responses to unforeseen circumstances while at the same time avoiding the (perceived) lack of legitimacy that was characteristic for the crisis responses. Pre-agreed risk sharing mechanisms are a key element in this regard. Against this background, we propose to develop a conceptual framework that permits a comprehensive analysis of risk sharing in the euro area.

The innovative nature of our project is its truly interdisciplinary nature: we build on both legal and economic theory – which is essential given the issue at hand. Our project thus provides a scientific basis for the on-going policy debate. Economic theory provides the tools to analyze the equivalence of alternative institutional risk sharing arrangements in terms of economic outcomes. Legal theory allows us to spell out the limitations and the full implications of these arrangements, not least in terms of democratic legitimacy and control.

The questions addressed in our project include: What are the possible mechanisms of cross-country risk sharing? Which risk sharing mechanisms are quantitatively important? What are the relevant policy measures pertaining to these mechanisms? What are obstacles and legal barriers that prevent full risk sharing in the euro area? Can certain ad hoc policies serve as a substitute for explicit risk sharing mechanisms? Are there adequate legal foundations for current policies? To what extent do EU treaties imply a commitment to risk sharing among member states? What, going forward, are necessary measures to enhance both the efficiency and the legitimacy of risk sharing in the euro area?

Our team has seven key participants – three legal scholars, four economists – from Germany, Greece, and Italy. These countries have experienced the recent crisis in the euro area in fundamentally different ways, and this is likely to shape academic perspectives. For our approach to be truly comprehensive, the composition of our research team is thus essential. As a group, we will be able to make a distinct contribution to the literature as well as the ongoing policy debate about appropriate risk-sharing. This debate is essential for securing the future of the euro area: only if a sense of fair burden sharing can be established – both in countries providing and in countries receiving financial support – will the euro area enjoy the legitimacy required to withstand future crises.