Social developments in the European Union 2013

Fifteenth annual report

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Euro area-wide unemployment insurance: useless, desirable, or indispensable?

Ferdinand Fichtner[1]

Introduction

The European Monetary Union (EMU) is still struggling with its severest crisis since the introduction of the common currency in the 1990s. While financial markets have recently seen a substantial decline in tensions, the economic situation is still difficult in several countries. Economic conditions are particularly hard in countries such as Spain, Italy, Portugal or Greece, where pre-crisis capital inflows have created massive overcapacities in certain sectors – be it the housing sector in Spain or the government sector in Greece. Since the global financial crisis in 2008/2009, a reversal of capital streams has been observed. Formerly attractive target countries – including today's crisis countries – have seen massive outflows of capital and are facing the need to reduce the overcapacities previously financed by financial inflows. This has resulted in a substantial deterioration of labour market conditions and in considerable worsening of the social and political situation in some of the crisis countries. While the European Central Bank (ECB) has contributed significantly to the improvements on financial markets, the central bank's capacities for dealing with the difficult economic conditions in the crisis countries are limited.

With different currencies (and flexible exchange rates), the countries' autonomous central banks could have reacted independently to emerging imbalances. For example, an independent Spanish central bank would probably have increased interest rates much earlier than the common European Central Bank, making it less attractive to invest

1. DIW Berlin, ffichtner@diw.de. This contribution is based on previous work with and by Sebastian Dullien, HTW Berlin. See Dullien and Fichtner (2013). The author would like to thank an anonymous referee for helpful comments.

in Spanish housing and thereby dampening the developments in that sector. On the contrary, an independent German central bank would probably have kept its monetary policy rates lower than the ECB chose to, providing an expansionary impulse to the sluggish German economy in the previous decade. Thus, the absence of autonomous monetary policies contributed to the build-up of imbalances in the monetary union – and the lack of independent monetary policy makes it more difficult to deal with the current situation.

For this reason, extensive literature suggests that a monetary union should go hand in hand with strong cooperation on fiscal policy between the Member States. With monetary policy unable to react to country-specific developments, fiscal policy is the preferred means to stabilise economic fluctuations and to compensate for – from a national perspective – the overly restrictive or overly expansionary monetary policy of the supranational central bank. In this situation, the creation of a fiscal transfer mechanism can support national fiscal policy institutions in fulfilling their objective of macroeconomic stabilisation, because it provides additional scope for national policy makers to react to weak economic developments with an expansionary monetary policy.

Thus, it is only logical that the recent policy debate in Europe should consider calls for strengthened fiscal policy coordination and the establishment of a fiscal transfer mechanism[2]. For example, the report made to the December 2012 European Council, ‘Towards a Genuine Economic and Monetary Union’ (‘Van Rompuy-Report, European Council 2012), calls for an integrated budgetary framework to ensure sound fiscal policy making, possibly combined with some form of fiscal solidarity.

The present contribution outlines a European fiscal transfer system in the form of a European unemployment insurance scheme for the short-term unemployed. As the article will argue, the common unemployment insurance has some advantages compared to other forms of fiscal transfer systems. By putting the focus on unemployment, an automatic link is ensured between payments and the cyclical situation of a Member

2. Recent policy documents typically use the term ‘fiscal capacity’, to avoid the politically charged term ‘fiscal transfer’.

State, making the system relatively robust against political manipulation. Furthermore, this set-up will most likely prevent a situation where countries systematically become net recipients or net contributors; therefore, the risk of permanently making transfers to single countries is low. With a European unemployment insurance scheme, cyclical imbalances within the monetary union can be effectively dampened, at not much additional administrative cost. Such a system could thus become an important stabilising element for the Member States of the European Monetary Union and the Union as a whole.

This contribution continues as follows. Section 1 explains, in more detail, why a fiscal transfer scheme is a useful complement to monetary integration. Section 2 develops the concept of a European unemployment scheme. Section 3 highlights the advantages over other forms of fiscal transfer schemes and discusses the risks associated with the introduction of such a system. Section 4 looks into the distributional effects of such a system; the effects on disposable household incomes are discussed and conclusions are drawn with respect to political support for such a scheme. Finally, the last section contains concluding comments.

1. The necessity of fiscal transfers in a monetary union

The Optimum Currency Area (OCA) theory, a strand of the macroeconomic literature pioneered by Mundell (1961), has identified the central problem of monetary integration as follows: the unified monetary policy of a supranational central bank cannot take into account the country-specific economic fluctuations in the member countries of the monetary union and, in particular, interest rates are set by the central bank according to the average economic conditions in the currency union. More specifically, the central bank has no possibility to stimulate the economy with low interest rates in one part of the union while, at the same time, dampening economic developments by means of a high rate in other regions. As such, business cycle fluctuations in the member countries of the monetary union will typically be more volatile than in a situation with an independent monetary policy. So, for example, the labour market situation – i.e. the level of unemployment – can become less stable than under flexible exchange rates.

With the formation of the European Monetary Union, the theoretical problem became obvious in practice: instead of entering into a convergence phase, the economies of the Member States of the EMU started to drift apart. The existence of the monetary union contributed to this divergence. For fast-growing countries with high inflation (such as Spain, most of the previous decade), monetary policy was too expansionary and contributed to an overheating of the economy and additional inflationary pressures. On the other hand, Member States that were in a recession and faced with low inflation (Germany, at the same period of time) were confronted with the overly, for them, restrictive policy of the European Central Bank, resulting in continuously weak growth and increasing unemployment[3]. It is thus widely debated whether additional stabilisation mechanisms are necessary in order to compensate for the lack of a stabilising monetary policy[4].

An obvious instrument to stabilise economic developments would have been the use by national governments of a counter-cyclical fiscal policy. Unfortunately, the effectiveness of fiscal policy in stabilising the economy – fairly limited in general due to time lags – is hampered by an incentive problem in the monetary union. The high degree of trade integration in the euro area leads to a leakage of fiscal stimulus to neighbouring countries, since a significant part of the stimulus-generated income is spent on imported products (Goodhart and Smith 1993); this makes fiscal policy comparably unattractive in the monetary union. To make things worse, the flexibility of national fiscal policy is reduced by the European rules applicable to national budgets, such as the Stability and Growth Pact, limiting national governments' leeway in pursuing a stabilising fiscal policy.

In this environment, it seems advisable for monetary integration to go hand in hand with strong fiscal policy coordination, which ensures that national governments actually use their fiscal policy to stabilise their

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3. The traditional OCA literature highlights labour mobility between the member countries as a stabilising device (Mundell 1961); specifically, it is argued that an integration of the labour markets can lead to stabilising movements of labour from countries which are facing high unemployment to countries in a more favourable economic situation. The cost – in terms of unemployment – of giving up a stabilising monetary policy can thus be reduced by increasing labour mobility between the countries.

4. See Fichtner (2008) for an overview of the traditional and recent debate on the costs, benefits and prerequisites of monetary integration.

respective economies. In addition, national governments must have enough fiscal leeway to do so. Kenen (1969) argues, in an early contribution to the OCA literature, that supranational fiscal transfer schemes can be helpful in this regard. In particular, fiscal transfers between the member countries can provide the governments of countries in a recession with additional leeway to engage in a counter-cyclical fiscal policy. Ideally, such a transfer system would be designed in such a way that the governments of countries which are in a good economic situation have to pay more into the system. This reduces their ability to implement expansionary fiscal measures, but these should be unnecessary in this situation[5]. Historical evidence presented by Bordo *et al.* (2011) indicates that supranational transfer schemes are one of the crucial components of successful monetary unions: the monetary unions, for example, in large federal countries such as the USA or Germany.

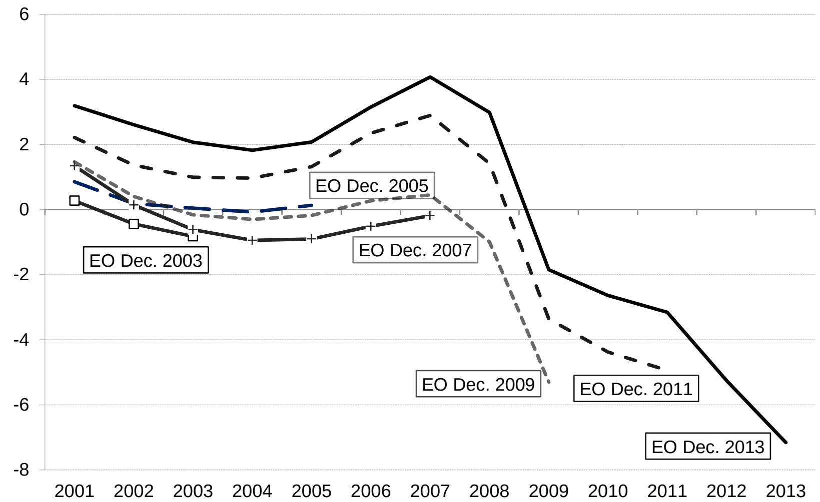
The necessity of such a mechanism for Europe was already highlighted by Delors (1989). Several proposals have been made to this effect[6]. A number of these call for the setting up of a European fund to transfer payments between the Member States' national governments, depending on the respective country's output gap, i.e. the difference between actual and potential GDP (Enderlein *et al.* 2013, Wolff 2012). Member States with a negative output gap would then use these payments to stimulate demand to support their economies. This would be financed by payments from Member States enjoying strong economic growth – or, more specifically, a positive output gap – at that particular time.

However, these proposals have a number of serious weaknesses. First, it is not clear whether the transfers from this stabilisation fund to the respective national government would be used promptly to stimulate demand. Given the typically long planning and implementation horizons of public investment or other public expenditures, it seems likely that the transfers from Brussels might not be used efficiently and effectively to stabilise the economy; there is even a non-negligible risk that these transfers would have a pro-cyclical effect on economies, due to time lags.

5. A detailed overview of fiscal transfer schemes in the monetary union is given by von Hagen and Wyplosz (2008).
6. Early proposals include Majocchi and Rey (1993) or Pisani-Ferry *et al.* (1993). An overview of recent proposals is given by Vetter (2013).

Secondly, there are substantial methodological uncertainties associated with calculating potential GDP and, thus, the output gap. If one considers OECD estimates of the output gap in, for example, Spain over the past ten years, there have been significant retroactive revisions (Figure 1). Linking sizeable financial transfers to such an uncertain form of measurement is not likely to gain political acceptance.

Figure 1 **Output gap estimates over time (% of potential GDP)**

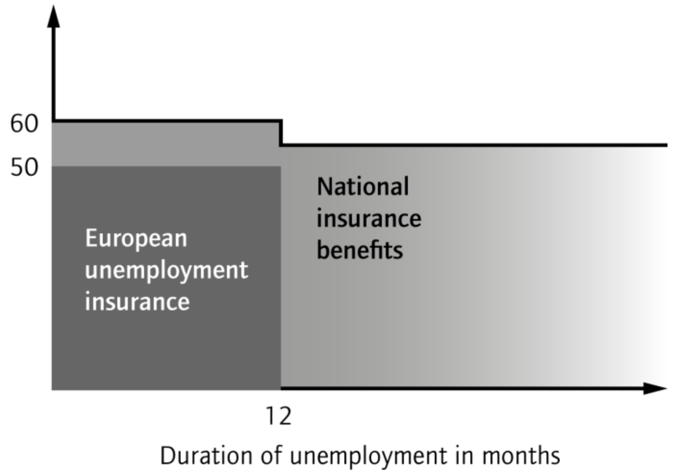


Source: OECD Economic Outlook (EO), several issues.
Last observation: 2013.

2. The concept of a European unemployment insurance scheme

A clearly preferable alternative to the stabilisation fund discussed above would be a transfer mechanism that automatically redistributes resources from the citizens of countries with a stronger economy to citizens of countries with a weaker economy. A European unemployment insurance scheme lends itself naturally to this purpose. The system would take over part of the member countries' national social security responsibilities; transfers would take place on the individual level; unemployed persons in all member countries of the monetary union would receive benefits from the system, and employed persons in all member countries would pay a contribution to the insurance scheme. On the aggregate level, the system would automatically lead to counter-cyclical transfers: countries with higher unemployment, i.e. with a weaker economy, could expect to receive positive net payments (aggregate benefits less aggregate contributions) from the insurance scheme, while countries with a stronger economy would face negative net payments, i.e. net contributions to the system. Since payments would be made directly to and by citizens – as opposed to the government receiving or paying the funds – it is likely that these payments would swiftly lead to the desired increase or decrease of demand for consumption goods. This is particularly true since recipients of unemployment benefits typically have a comparably high propensity to consume – that is, they spend a relatively high share of their income on consumption goods and have a low savings ratio.

Figure 2 **Diagram of a European unemployment insurance system as a percentage of previous income**



Source: Author's illustration.

For reasons to be discussed below, it would be sensible for the benefits of this European unemployment insurance scheme to be paid out only for a limited time period, to cover only short-term unemployment. In addition, the amount of the insurance payments (as a percentage of the wage before entering into unemployment) could be relatively low. It would be left to the individual countries to offer payments beyond this basic level of protection, funded by national contributions or taxes. Thereby, the amount or duration of total unemployment benefits could be adjusted according to the respective country's political and societal expectations and values. Effectively, the European unemployment insurance scheme would offer basic coverage, beyond which all politically desirable payments would be covered by social security institutions in the member countries themselves. Figure 2 shows the relationship between the European unemployment insurance scheme and a more generous national system.

Therefore, the introduction of such a European unemployment insurance scheme would not decrease the level of social protection in the member countries, nor would it necessarily lead to a situation of equal social protection across member countries. There is a possibility, however, that social protection in some countries would increase. This would be the case if the degree of protection offered by the European scheme – in terms of eligibility criteria, replacement rates, or the maximum period of entitlement to unemployment benefit – were higher than the degree of protection offered by the national insurance regime in the respective country.

Finally, the European unemployment insurance system would not replace national unemployment insurance. This would be true for two main reasons: Firstly, the national systems would – in most cases – be needed to fill the gap between the level of protection offered by the European system and the politically and socially desired level of protection in the respective country. Secondly, the national systems would continue to play an important role as distributors of benefits, both from the European system and from the national system, and as the institution administering contributions both to the European and to the national system.

3. Risks and opportunities of a European unemployment insurance scheme

A European unemployment insurance scheme, such as the one outlined in the previous section, would have several advantages. Primarily, as discussed above, an international transfer system would help the

European Central Bank to fulfill its role as the common monetary authority; it would cushion destabilizing developments in single member countries which otherwise could potentially damage the monetary union as whole. In addition, there would be several further advantages of a transfer system in the form of an unemployment insurance scheme:

— Unemployment and, in particular, short-term unemployment are closely linked with the business cycle. Just as a normal (national) unemployment insurance regime helps persons who become unemployed to keep up their consumption level (Gruber 1997), an internationally redistributing unemployment insurance scheme would help to automatically stabilise economic developments on an aggregate level: countries experiencing an economic downturn would have increased inflows in terms of benefits from the insurance, and countries in an economic upturn would pay higher contributions due to increasing employment and a higher wage bill.
— The transfer payments could be expected to have a substantial impact on aggregate demand. Since unemployed persons typically spend a comparably large part of their income (including transfers) on consumption, the transfers would be likely to have a prompt and noticeable impact on the economy. In fact, it can be shown that a reasonably sized European unemployment scheme such as the one proposed above would have significantly dampened the decline of Spanish GDP during the global recession in 2008/2009[7].
— If the insurance scheme were reasonably sized, it would come at no additional costs to workers or firms in the monetary union. Since the system would replace parts of the national schemes, it would merely imply a redistribution of funds between national funds and the European system. This would also mean that the incentive for the unemployed to look for a new job would remain unchanged – with potentially positive effects on the duration of unemployment.

Certainly, there are risks associated with the creation of a common European unemployment insurance scheme. As in every insurance system, there is an imminent risk of moral hazard. That is, the motivation of national governments to bring down unemployment – e.g. through

7. See Dullien and Fichtner (2013) and the literature cited therein.

labour market reforms – would be reduced by the fact that some of the cost of unemployment (specifically, the cost of benefits to the unemployed) would be taken over by a supranational institution. This does not seem to be too much of a risk, however. Firstly, the social burden of unemployment goes far beyond the pure cost of unemployment benefits; in their own interests, national governments will always try to solve labour market problems as fast as possible, since social tensions resulting from unemployment will have an impact on their political support. This effect would be reinforced by the suggestion of having the European unemployment insurance scheme focus on short-term unemployment. This might, in fact, even increase the motivation of national governments to help the unemployed to find new jobs within the first twelve months of unemployment: they would wish to avoid long spells of unemployment, since, after twelve months, the full cost of benefits would be borne by the national system.

4. Public and political support: the distributive effects of a European unemployment scheme

The introduction of a European unemployment insurance scheme requires strong political support. Considerable costs would be involved in the creation of this system. The distribution of benefits from and the administration of contributions to the European system could be handled by the existing national institutions in charge of administering national benefits, thereby limiting the additional institutional burden created by the European insurance scheme. The introduction of European unemployment insurance would not even require a harmonisation of social security standards across countries – given that the European system can be designed to reflect the 'lowest common denominator' of existing national insurance systems.

However, some harmonisation of the social security systems in participating countries could be useful. Reference wages for unemployment benefits, for example, can be calculated on the basis of gross or net wages; both approaches are currently used in Europe. The European unemployment insurance scheme needs to be based on one particular system, be it net or gross wages. While there would be no immediate need for participating countries to harmonise their national system with the system used by the European unemployment insurance scheme, it would create an additional administrative burden to have to record data on both gross and net wages. Harmonisation would therefore be sensible.

Changes would also be likely in cases where the national system is largely funded from taxes. The European unemployment insurance scheme would function better as an automatic stabiliser if it were financed with contributions[8]; it would thus be sensible to use such an approach for the scheme. This would require countries not currently using a contribution-based approach for their national systems to establish a separate institution to collect contributions to the European system – a considerable additional administrative burden. Again, this would make harmonisation advisable, albeit not imperative.

In addition, some effects on international and intranational income distribution cannot be precluded. As regards the international dimension, there is a risk that the creation of a European unemployment insurance scheme would lead to a persistent – and not only a cyclical – redistribution of funds between participating countries. For example, countries which have systematically higher (short-term) unemployment will benefit more from such a system than a country that has a comparably low level of unemployment. In fact, there have been substantial differences in short-term unemployment rates between European countries in the past. For example, countries with high seasonal unemployment (e.g. due to the greater importance of agriculture or tourism) can be expected to have a higher share of short-term unemployment and will therefore benefit more from the system than others. While some of those problems can be solved by formulating suitable eligibility criteria for benefits from the European unemployment insurance scheme, the risk remains – as in every insurance system – that some participating countries benefit more than others. For the political support of the system it will be of crucial importance to address this issue and to preclude permanent transfers as effectively as possible.

8. Tax-financed payments into the system would typically be independent of the respective country's economic situation. As a consequence, the country's net payments (i.e. the payments into the insurance scheme minus transfers out of the scheme) would be less cyclical than if financing were based on contributions, the latter depending on the labour market situation of the member country.

In addition, there might be effects on income distribution within the participating countries. The European unemployment insurance scheme, as outlined above, is designed to avoid effects on income distribution in the participating countries. This would be the case as long as the European insurance provided a lower level of protection (e.g. in terms of the level of benefits or in terms of the maximum period of entitlements to unemployment benefits) than all national insurance schemes. In this case, European unemployment insurance would simply replace a part of the respective national insurance; the total benefits received by the unemployed would remain unchanged in all countries, since national insurance payments would be used to top up the (comparably low) benefits paid out by the European unemployment insurance scheme, adding additional benefits so that the protection level corresponded to that observed before the creation of the European unemployment insurance scheme.

However, European policy makers are facing a trade-off: if they wish to avoid any change in income distribution associated with the establishment of the European unemployment insurance scheme, they should design the European component to be as small as possible. Thereby, effects on income distribution would remain limited. However, the lower the level of protection provided by the European insurance scheme, the lower would be the stabilisation effect resulting from the establishment of this scheme. Presently, there are some countries in the euro area where unemployment benefits are fairly low; in Ireland, for example, the net replacement rate is approximately 35%[9]. A European unemployment insurance scheme designed not to exceed the level of protection provided by the most restrictive national system might fall short of expectations in terms of stabilisation effects. Therefore, it seems likely from a practical perspective that a European unemployment insurance scheme would provide a protection level somewhat higher than the protection provided by the least generous national systems. As a consequence, effects on income distribution might arise, possibly leading to political opposition against the system.

9. For a comparison of unemployment benefits in EU Member States see European Commission (2013).

Let us be clear: while effects on income distribution cannot fully be ruled out with a sensibly sized system, the effect on the level of social protection in the participating countries would be unambiguously positive. The European unemployment insurance scheme would effectively establish a minimum standard, and national governments would top up the benefits at national level with national payments. Fears that a European unemployment insurance scheme would set a benchmark and lead to a 'race to the bottom', – i.e. lead national governments in countries with higher social protection to cut down benefits – do not seem justified. The European Union has established minimum standards with respect to several aspects of working conditions – think of the working time directive or the Council directive on health and safety at work – with no evidence that national legislation would converge down to this minimum standard from a more protective stance.

Conclusions

The present article outlines the system of a European unemployment insurance scheme. The introduction of such a system could effectively cushion cyclical imbalances in the euro area and have substantial advantages over a more traditional fiscal transfer system, e.g. a system based on measurements of the output gap. Firstly, transfer payments are automatically linked to the business cycle, thus largely preventing countries from becoming permanent net contributors or net recipients. Secondly, the system is transparent and easy to understand for policy makers and the general public, and it is less susceptible to political influence than other transfer systems. Finally, such a system is socially and politically desirable, since it would set a minimum standard for the level of social protection in the participating countries without necessarily enforcing harmonisation of unemployment insurance schemes across Europe.

As such, a European unemployment insurance system of this kind could be an effective stabilising element for the Member States of the European Monetary Union. Expectations should not, however, be set too high. With a reasonably sized system, the stabilisation effects would be limited. Some dampening of economic cycles – both in upswings and in downswings – could be expected. But it is clear that an automatic stabiliser such as that proposed in the present article would not have fully avoided, for example, the unwinding of overcapacities leading to massive economic problems in the European crisis countries. Even more so, the establishment of a European unemployment insurance scheme could not even out structural differences between the participating economies. Persistent asymmetries, e.g. those emerging from institutional conditions such as the regulation of labour markets or wage negotiating systems, could still lead to persistent and large structural imbalances and would need to be monitored and eliminated through other mechanisms.

Large uncertainties remain with respect to such a European unemployment insurance scheme. The reliable quantification of the international transfers arising from such a scheme, and the estimation of the stabilisation effects of such a system, require data – such as the work history of unemployed persons – not available in an easily accessible and internationally comparable form. Any assessment, therefore, of the implications of the introduction of European unemployment insurance relies heavily on guesswork and assumptions, and substantial further research is required to shed light on the effects to be expected. In addition, the required institutional and, in particular, legal changes – including, possibly, changes to the EU treaties – would take a long time to implement.

With the crisis acting as a trigger and a starting point, recent years have brought substantial improvements to the European institutional framework. Some of the monetary union's problems have been addressed with the creation of the European Stability Mechanism (ESM) or the Macroeconomic Imbalance Procedure (MIP), and the ongoing process of forming a banking union is establishing an overdue common regulatory framework for European financial markets. A further centralisation of fiscal policy is still, however, on the agenda.

A European unemployment insurance scheme could be an important element of such a further centralisation of fiscal policy. Without reducing national policy makers' flexibility in setting the nationally desired level of social protection, it would help the participating countries to deal with asymmetric shocks and thereby ensure greater economic stability in the monetary union. The basic principles and underlying ideas are easy to understand and to communicate, hopefully leading to a high degree of political acceptance. Finally, and most importantly, the European unemployment insurance scheme could be an instrument that would strengthen Europe's social profile, thereby helping to overcome the negative reputation which the European integration process has acquired in the years of the crisis.

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