Stabilisation, solidarity or redistribution?

Does the eurozone need a common unemployment insurance scheme – and if so, for what?

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The euro crisis has shown how difficult it is to achieve effective macroeconomic stabilisation in the event of asymmetric shocks in a pure-play monetary union. This insight has led to lively debate over whether the eurozone should be enhanced with fiscal elements.

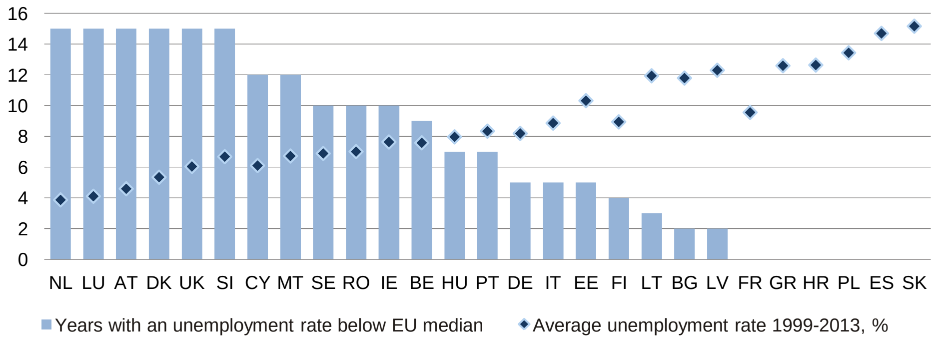
One proposal has been to launch a common unemployment insurance scheme. This would bring financial relief to a country suffering temporarily from high unemployment. Conversely, a country would be required to make higher payments into the system when the number of jobless falls. At the national level, countercyclical stimuli via this "automatic stabiliser" generally function very well. However, the underlying logic cannot simply be extrapolated for the supra-national level. Several design issues would have to be resolved first.

Despite frequent objections that such a solution would inevitably create a permanent transfer union it would be possible – in principle – to devise a fiscally neutral European unemployment insurance scheme. Nonetheless, a sustainable model that does not automatically result in redistribution between countries would be a complex undertaking. A fundamental problem is that any elements meant to prevent moral hazard will automatically reduce the stabilisation impact.

A conceptually different proposal is a type of reinsurance for "catastrophic" shocks. This would not be a fiscally neutral solution, since some countries are seldom if ever confronted with extreme unemployment. Nonetheless, it would have the advantage of bundling resources at reasonable costs and being able to provide effective stabilisation in times of very severe recession. Moreover, aid could be disbursed in tranches and linked with reforms. Currently, however, no broad political consensus is in sight for either of the two proposals.

A long-term comparison of European labour markets

Reference period 1999-2013



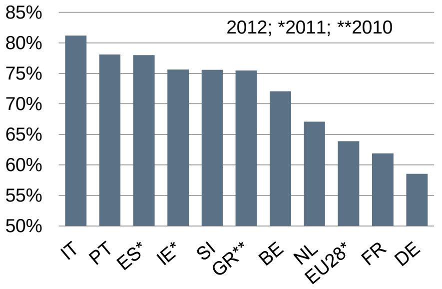
Sources: Eurostat, Deutsche Bank Research

An unemployment insurance for the eurozone?[1]

The sovereign debt crisis in Europe unleashed lively debate over the necessity of changing the eurozone's fiscal architecture (the buzzword was "fiscal union").[2] In its current manifestation the eurozone does not have the same type of instruments to absorb asymmetric macroeconomic shocks (i.e. locally confined recessions) at its disposal as federally organised countries such as the United States or Germany (with 50 and 16 sub-units, respectively) do. Possible options for enhancing a monetary union with elements of a fiscal union include not only a budget for the eurozone or common debt instruments but also a cross-border unemployment insurance scheme.[3]

Unemployment benefits constitute the biggest labour market expenditure item — 1

Unemployment benefits and early retirement as % of total expenditure on employment policy



Sources: Eurostat, Deutsche Bank Research

At the national level, statutory unemployment insurance is an important instrument to cushion the impact of recessions since it acts as an "automatic stabiliser". In times of low unemployment the system generates surpluses as a large number of contributors is set against a small number of recipients. During a recession there is a growing number of people who lose their job and temporarily receive financial support. Unemployment insurance makes sense not only from an individual's point of view but also from a macroeconomic perspective. It protects people who are only temporarily out of work against the risk of losing their savings and being forced to dispose of (possibly illiquid) assets. Macroeconomically, it helps to prop up domestic demand in downswing phases. Therefore, it is not only an achievement of social policy but also an economically sensible mechanism thanks to its automatic stabilisation impact.

The proposal of a common European unemployment insurance scheme occasionally triggers almost knee-jerk rejection of the concept – on the grounds that it would inevitably introduce a transfer union. This assumption is erroneous, for this type of insurance could, in principle, have a fiscally neutral design, i.e. not necessarily lead to permanent transfers. However, a design that achieves this objective would be much more complex. In any event, it is correct to say that false implementation or inadequate scope for monitoring and sanctions would make the scenario of institutionalised redistribution quite realistic.

A concept that takes a different approach to the national insurance model at the European level would be unemployment insurance in the event of a "catastrophic" shock. All the participating countries would pay into a fund in normal years. An insurance event would only be triggered if a country experienced extremely high unemployment (e.g. a rate of over 15%) or a sharp increase in a very short period. Such a solution would certainly not be fiscally neutral because given differing economic structures the likelihood that the unemployment rate increases by several percentage points during a short period of time has historically been much lower in some countries (e.g. Austria, the Netherlands and Luxembourg) than in others. An instrument that grants additional disbursements only in extreme cases would be based squarely on the idea of solidarity. Simultaneously, this solution would have the advantage of being able to bundle resources at relatively low costs and provide effective stabilisation if a country were to be hit by a very severe recession. In this model, though, it appears vital to ensure that funds are disbursed in tranches and every additional tranche be linked with specific structural and labour market reforms. This could at least improve the functioning of the labour markets in affected countries and lower the risk of extreme unemployment in future.

1 Valuable research assistance by Max Lyssewski is gratefully acknowledged.
2 Van Rompuy (2012). Towards a genuine economic and monetary union.
3 See inter alia Vetter (2013). Do all roads lead to fiscal union? Deutsche Bank Research. Pisani-Ferry et al. (2013). Options for a Euro-area fiscal capacity. Bruegel Policy Contribution. Wolff (2012). A budget for Europe's monetary union. Bruegel Policy Contribution. Enderlein et al. (2012). Completing the Euro. A road map towards fiscal union in Europe. Notre Europe.

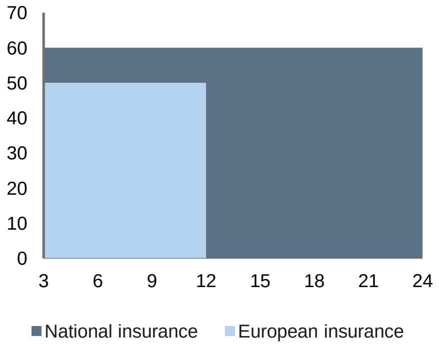
In the US there is a two-pronged federal system enabling states with very high unemployment to obtain aid from the national system.[4] In Europe, the debate about the necessity of having a European unemployment insurance scheme refers in most cases to the eurozone. Such a construct could conceivably also be established at the EU level. However, a country such as the United Kingdom that can pursue its own monetary policy has much less justification for a pan-European stabilisation instrument. Given the British attitude of rejecting deeper integration in Europe it would not seem realistic to count on the UK's consent anyway. If at some juncture the political will to seek a solution at the eurozone level should emerge, though, it would not be a problem to grant the non-EMU members of the EU a voluntary opt-in clause.

The basic model: National insurance systems under a European umbrella

The proposal referred to in the following as the "basic model" provides for the creation of a European umbrella scheme that would assume some of the tasks covered by the national unemployment insurance systems.[5] All workers would have to pay a portion of their contributions into the European system which would guarantee a basic safety net (e.g. 50% of the last net wages for 12 months, as illustrated in chart 2). The remaining part of the contribution would be paid into the national unemployment insurance system, which would continue to exist and be able to offer additional benefits exceeding the level of the basic safety net (e.g. an additional 10 percentage points (pp)). This would ensure that differing national preferences would be respected and that not all countries would be compelled to agree an identical unemployment benefit level.

Principle of a European unemployment insurance scheme 2

X-axis: Duration of unemployment in months
Y-axis: Wage replacement rate (%)



Simulations show that a Europe-wide unemployment insurance scheme can, in principle, provide substantial support against asymmetric shocks.[6] However, such a system would have to be endowed with effective intervention and sanction options. Otherwise governments might have an incentive to establish or maintain overly generous transfer systems or refrain from implementing sensible yet unpopular measures to combat unemployment, since the costs of unemployment would have to be borne partly by other countries anyway. Advocates of such a solution therefore suggest that only short-term unemployment (e.g. up to a maximum 9 or 12 months) be insured via the European facility. Benefits for the long-term unemployed would still have to be funded from the national system, meaning that governments should continue to have an incentive to pursue effective employment policies. However, such a restriction also reduces the stabilisation impact of the scheme.

[4] For an explanation of the US system see European Parliament (2014). Cost of non-Europe of the Absence of an Unemployment Insurance Scheme for the Euro Area; and European Commission (2013). On automatic stabilisers.

[5] An explanation of how such a model would function can be found in Dullien (2014). The macro-economic stabilisation impact of a European basic unemployment insurance scheme. Inter-economics 2014/4. For a detailed discussion of the main options for the design of such a model see European Commission (2013). On automatic stabilisers.

[6] For an estimate of the potential funding flows and stabilisation effects see, inter alia, the following reports: European Parliament (2014), op. cit. Dullien (2013). A euro-area wide unemployment insurance. Bargain et al. (2013). Fiscal Union in Europe? Redistributive and stabilizing effects of a European tax-benefit system and fiscal equalization mechanism. Economic Policy, Vol. 28. Jara and Sunderland (2014). The implications of an EMU unemployment insurance scheme for supporting incomes. EUROMOD Working Paper.

Problems for the implementation of the basic model

Practical implementation of the basic model would require at least partial harmonisation of country-specific rules. Every national unemployment insurance scheme is characterised by three main parameters: the wage replacement rate, the duration of benefits and the prerequisites for drawing benefits.

If the basic level is set relatively high, countries with a comparatively low replacement rate would initially have to raise it to the European minimum level. The matter is made more complicated by the fact that in some countries (e.g. Germany) disbursements are geared to current net income, while in others (e.g. France) to latest gross pay. Moreover, there are differences in the maximum period for drawing benefits – a duration of 12 months in Germany, 24 months in France and Spain, and no limit at all in Belgium. In about half of the EU countries the benefit duration increases with age, while in the other half it is the same for everyone. On top of this, there are also major differences in the prerequisites for receiving government benefits. Germany, Austria, Portugal and Romania require that in order to obtain unemployment benefits the person in question must have paid in contributions for at least 12 of the preceding 24 months. It is easier, by contrast, to meet the prerequisites in France, Spain and Italy. This parameter would also have to be either harmonised or taken into account when contributions are calculated. If every country were to have a different contribution rate and different group of eligible beneficiaries, the system would become much more complex and much less transparent. Moreover, regular revisions of the basis for calculation would also be necessary.[7]

One critical issue regarding convergence of national rules is whether the countries with the best functioning labour market institutions would be the applicable benchmark or whether countries with very generous systems would insist on maintaining them. In the latter case, the entire system would, logically, become more difficult to finance. László Andor, the EU Commissioner for Employment, Social Affairs and Inclusion from 2010 until October 2014 and an advocate of a European solution, has called for a defined basic safety net that should represent a "relatively low common denominator between the rules of the various national systems".[8] At the same time, he argues that "member states would be required to upgrade their employment services and labour market institutions to the best EU standards".[9] But if the countries with the biggest deficits and opposition to reform have sufficient negotiating clout, this could soon prove to be wishful thinking. In any event, best practice is not easy to identify in this policy field since the functioning of labour market institutions depends to a considerable extent on a country's economic and socio-economic structures.

One additional problem occurs in the situation of a very severe recession with unemployment rising throughout all euro area countries. In such a case the countries with a relatively lower increase in their unemployment rate might be compelled to transfer funds to those with the largest increase, even though they themselves are grappling with a difficult situation. Probably the only way to solve this problem would be to create a borrowing capacity (see box 3).

Intertemporally balanced scheme possible via creation of a borrowing capacity? — 3

One of the main design issues for a possible European unemployment insurance scheme is whether the system has to be in financial equilibrium every year or whether a borrowing facility allows for intertemporal balancing.

The justification for a borrowing facility in the basic insurance scheme is that in the event of symmetric shocks the net contributors are also subject to severe fiscal limitations. In this case, those countries which post a below-average increase in their jobless rate will not only have to spend more on unemployment benefit themselves but at the same time also have to subsidise their even harder hit neighbours. This would make it more difficult for countries facing mild recession to pursue an appropriate countercyclical fiscal policy themselves.

To maintain its ability to function the reinsurance model would need to offer a borrowing option if the volume of the fund proved too small (e.g. in the starting phase) or if employment crises were to occur simultaneously and/or in rapid succession in several countries and utilise the fund's resources to the limit. Without a borrowing capacity, the volume of the fund would quite simply soon be exhausted.

In the US system, the individual states can borrow from the federal unemployment insurance agency, but they have to repay this loan at a later date. Otherwise, the contribution rate of the state will be automatically raised. In the European context the question arises of course as to whether the countries with precarious debt sustainability would be able to square substantial deficits within the system.

The possibility of systematically running up debts within the scheme would probably create more problems than it might solve. Above all, the already minor chances of reaching a political consensus to establish such an instrument would very rapidly tend to zero.

[7] Information on the national unemployment benefit systems was sourced from the European Commission's MISSOC (Mutual Information System on Social Protection) database.
[8] See http://europa.eu/rapid/press-release_SPEECH-14-455_en.htm?locale=en
[9] Andor (2014). Basic European unemployment insurance – The best way forward in strengthening the EMU's resilience and Europe's recovery. Intereconomics 2014/4.

Restricting eligibility to long-term unemployment counteracts intention and effectiveness

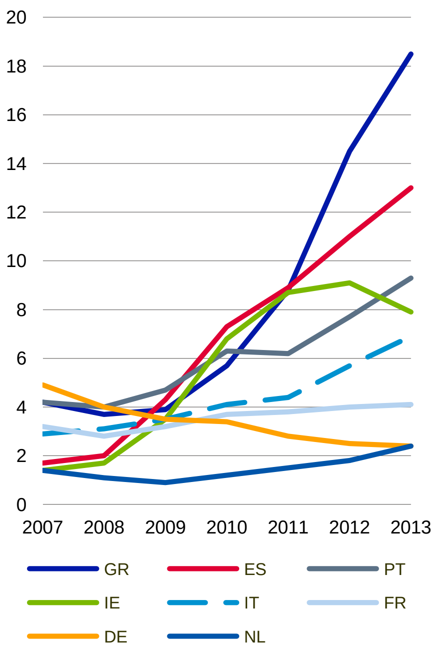
The experience gained since the launch of the eurozone has demonstrated that it is illusionary to believe that all members always adhere to the rules or that existing sanction mechanisms can always be applied effectively. Therefore, a system with obvious scope for redistribution should be equipped with mechanisms to prevent moral hazard if there is no consensus on establishing further institutionalised redistribution instruments. The proposal in the basic model of insuring only the short-term unemployed at the European level would reduce the incentives for undesirable behaviour. The problem is that this restriction would simultaneously reduce the system's stabilisation capacity, too.

In 2013, some 18% of Greece's total working-age population was unemployed for longer than 12 months. In Spain the figure was 13% (see chart 4). In a protracted economic slump the share of long-term unemployed typically continues to grow steeply until finally a sustainable trend reversal sets in. This growth is impressively evidenced by the examples of Ireland and Spain. By European standards, these two countries each had a very low share of long-term unemployed before the crisis – only about 20% of all the unemployed in Spain were jobless longer than 12 months in 2008, and slightly less than 30% in Ireland. Since then the share of the long-term unemployed climbed to 50% in Spain and 60% in Ireland; it reached no less than 67% in Greece. These numbers demonstrate that countries with high unemployment are suffering above all from an increase of the "chronically" unemployed population. If a European insurance scheme only covers the first 9 or 12 months of an unemployment spell, especially those countries that are hit by particularly high unemployment over a longer period are the very ones that will have to support a steadily growing group of unemployed persons themselves.

The bottom line is that the stabilisation effect would be relatively high at the beginning of a heavy recession – at a time when economically sound countries should still have scope for countercyclical stimuli. In a long-lasting crisis, though, this scope will be rapidly exhausted. At precisely the juncture when support from a European facility would be particularly welcome, a regulation restricting eligibility to the short-term unemployed could in fact trigger a decline in fiscal relief although the total number of unemployed persons is still on the rise. This is not only illogical but it could also induce governments to employ those dropping out of the 12-months window on a pro forma basis for a few months so that they could subsequently resume funding their benefits from the European facility.

Long-term unemployed as a percentage of working-age population 4

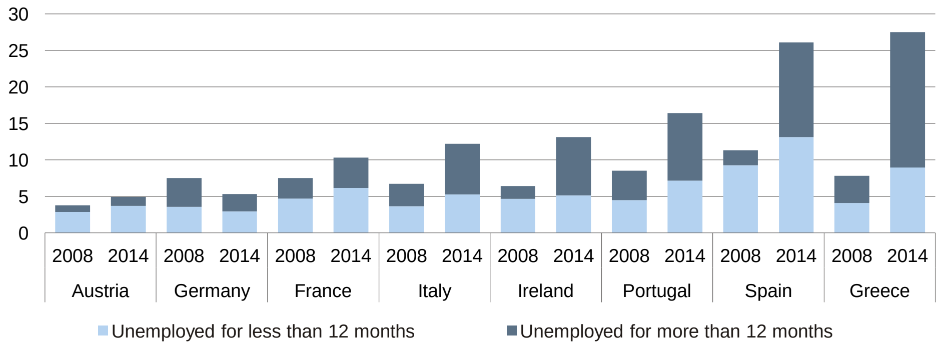
In %



Source: Eurostat

In countries with high unemployment more than half are long-term unemployed 5

Unemployment rate in %, by duration of unemployment



Sources: OECD, Deutsche Bank Research

The "reinsurance model": A crisis fund for extreme hardships

We will now look at an alternative proposal referred to as the "reinsurance model".[10] It provides that a country has to overcome most cyclical slumps without assistance. Only in the case of an extreme jump in unemployment a European emergency fund would kick in with temporary transfers. The most important adjustable parameter in such a model is the definition of an extreme situation that triggers disbursement. Three cases appear conceivable:

— A country's unemployment rate exceeds a set limit, e.g. 12% or 15%.

— The unemployment rate far outstrips the European average, e.g. 5 pp over the eurozone average or median.

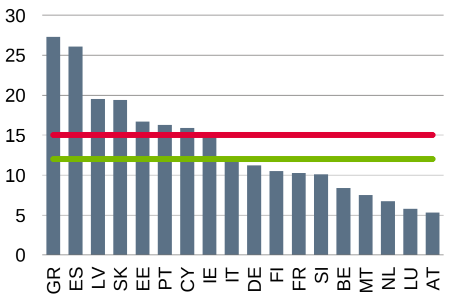
— The unemployment rate deviates strongly from the long-term equilibrium (e.g. an increase of 20% or 30% in two consecutive years, or an increase of 3 or 5 pp above the long-term average in a period of two years).

Would such a model be fiscally neutral, or would it lead to permanent transfers?

The first case would certainly not be fiscally neutral, as many EU countries have never had an unemployment rate of over 12% let alone 15% in recent history (see chart 6). Therefore, the group of beneficiaries would be small – while the available funds in every individual case would be substantial. The second case would turn out exactly the same, since the unemployment rate of some countries has never even touched the EU average, let alone exceeded it to the extent that one could speak of an emergency.

Highest annual unemployment rate by country recorded since 2001 6

In %



Source: Eurostat

In the last case, all the countries could at some point become eligible for financial aid. Nevertheless, the level of unemployment should also play a role, with a stronger increase entailing a higher disbursement but not when it is low in absolute terms. Otherwise, the Netherlands might have had to receive financial support between 2008 and 2010 when its unemployment rate jumped from 2.8% to 4.6% – an increase of over 60% – or Luxembourg, when the unemployment rate doubled between 2001 and 2003, from 1.8% to 3.7%. However, if such cases are excluded there are countries that pay more into the system or receive less from it than others.

The upshot is that a reinsurance model will always involve transfers and thus not be fiscally neutral. However, it should not be judged only from a distribution standpoint. After all, the macroeconomic stability of the entire euro area benefits if particularly vulnerable members are supported. Moreover, an extreme increase in unemployment is usually not exclusively the fault of the country itself, but also influenced by unfavourable external factors beyond the responsibility of national policy. Therefore, there is some justification for the idea of solidarity in such a case as long as two key conditions would be guaranteed:

— To prevent misuse of others' solidarity the threshold must be so high that the insurance event is as rare as possible and that countries with high structural unemployment do not breach the threshold at frequent intervals.

— Since high unemployment is at least partially due to poorly functioning labour market institutions or a misguided employment policy the beneficiaries of the insurance should be compelled to institute substantial reforms. If they fail to implement these reforms they should not receive any further support and should be denied future disbursements until they have complied with the requirements.

[10] See for example Gros (2014). A Fiscal Shock Absorber for the Eurozone? Insurance with Deductible. Intereconomics 2014/4.

This conditionality could help to lower the risk of moral hazard and encourage a country to implement measures that reduce the probability of such emergencies going forward. However, this naturally raises the question of who should monitor whether the reform requirements have been met.

GDP or unemployment – which indicator is better suited for a reinsurance solution?

In principle, the reinsurance model is nothing more than a variant of the "output insurance" model, which would be based on a country's output gap (the deviation of real GDP growth from the country's potential growth rate).[11] If a country were hit by a sharp cyclical slump and its GDP growth fell far below its potential (e.g. by more than 2 pp), the respective country would receive support from a European fund at short notice to prop up its economy.[12]

In principle, a negative deviation from potential GDP would be better suited as trigger for financial flows, since the unemployment rate reacts to an economic slump only with a time lag. After all, companies do not dismiss their staff immediately at the onset of a recession, for institutional reasons (e.g. statutory job protection, possibility of short-time work), but also in order to retain the human capital of high-skilled workers. Hence, an insurance scheme geared to extreme GDP fluctuations disbursements would be made more rapidly and measures to stimulate growth could be launched immediately. However, the practical feasibility of such an idea is invalidated by the fact that potential output of an economy is a theoretical construct and not measurable per se. While it is possible to make econometric estimates these often differ considerably depending on the method chosen, and they often have to be revised substantially in retrospect. This means that the output gap is hardly suitable as justification for measures with immediate financial consequences, and certainly not as a trigger for a system with substantial redistribution potential.[13]

EU Youth Guarantee: Similar principle, low impact

The "Youth Guarantee" scheme announced in June 2013 is also based on the principle of providing temporary support in an emergency, but is nothing more than an ad hoc experimental trial. A youth unemployment rate of over 25% is considered an extreme event worthy of support under the EU Youth Guarantee. Regions reporting such rates may claim EU aid which they are required to use for measures to support young job seekers. However, this instrument is not useful for macroeconomic stabilisation, because:

— It was installed outside a fixed institutional framework, so countries were not able to anticipate these funds nor can they budget for them in future.

— It is confined to youth unemployment, whereas a functional instrument should not arbitrarily differentiate between younger and older unemployed.

— And last but not least, its volume of EUR 6 bn is much too small (not to mention the slow disbursement process).[14]

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[11] For a detailed discussion and assessment of an insurance concept based on the output gap see e.g. Pisani-Ferry et al. (2013). Options for a Euro-area fiscal capacity. Bruegel Policy Contribution; and Vetter (2013). Do all roads lead to fiscal union? Options for deeper fiscal integration in the eurozone. Deutsche Bank Research.

[12] Even the use of this instrument would give rise to the problem that it would be virtually impossible to fund a severe symmetric shock such as the euro crisis without a borrowing capacity.

[13] See also Deutsche Bundesbank (2014). On the reliability of international organisations' estimates of the output gap. Monthly Report, April 2014.

[14] By mid-2014 less than one-third of the earmarked funds had been disbursed. France and Italy have called up EUR 620 m and EUR 1,100 m, respectively, and thus exhausted their entitlement,

When should an insurance scheme kick in?

An unemployment insurance system at the EU level would have the advantage of functioning virtually "automatically" and ideally without major discretionary scope on the part of the participating agents (of course, only after presumably lengthy negotiations between the member states about the main parameters).

From the viewpoint of stabilisation policy there is no obvious reason why a country should have to receive automated transfer payments on small dips in economic growth. On the contrary – for reasons of incentive compatibility every country should initially bear the costs of cyclically induced unemployment itself. On the one hand this strengthens the incentive to swiftly correct a flawed economic policy environment and, on the other, rewards those countries that have accumulated a sufficient buffer during years of good performance. In this sense, (conditional!) relief should only be offered if the costs of a recession undoubtedly exceed the financial capacities of the affected country.

Every country ought to be able to deal with a 2-3 pp increase in the unemployment rate over the long-term average on its own. Even in cases such as Germany between 2001 and 2004, when the average annual unemployment rate rose from 7.8% to 11.2% (according to the Eurostat definition), or France, where the rate has increased from 7.8% to 10.5% since 2008, the call for financial support from other countries appears justified or necessary. Instead, such developments point to structural weaknesses which, in Germany's case, were finally addressed under the Agenda 2010 programme after having been postponed for many years. Indeed, subsidisation by other countries would rather buy more time before actually sensible – though not always popular – reforms are finally rolled out.

Outlook

The idea of an automatic stabilisation instrument for the eurozone is economically sensible but not without caveats. At present there does not seem to be any political consensus for a "grand solution" anyway. Most member states have not yet expressed a clear stand on the issue. France is an exception and has expressed support for the concept of a European unemployment insurance scheme.[15] Within the EU Commission it had been mainly the former Commissioner Andor, who had promoted this idea. In the newly appointed European Commission, Pierre Moscovici is one prominent supporter of this idea, but he is not responsible for the given portfolio. It remains to be seen whether President Jean-Claude Juncker and the new Employment Commissioner, Marianne Thyssen, will want to push ahead with this issue.

Supporters of the European model often assert that such an approach would strengthen social cohesion in Europe across national borders and create a feeling of solidarity. To cite László Andor: "It would provide an answer to the simple question of a disillusioned European voter: 'Where is Europe when we need it most?'"[16] Yet it is precisely the basic solution preferred by Andor which is conceived in a way that for most citizens virtually nothing would change. After all, unemployment insurance systems already exist in all the member countries. If national systems were to supplement the basic safety net to match their

but most of the member states have seen only sluggish implementation of specific projects. To achieve more efficient processing the European Commission invited the member states to meetings in July and September 2014. Specific results were not made known at first.

15 For more see the position paper "An unemployment insurance scheme for the euro area". Trésor-Economics, No. 132, June 2014.

current levels, neither employee contributions nor benefits for the unemployed would change substantially.

A solution analogous to the unemployment insurance systems at the national level has the advantage that the resultant funding streams would flow "automatically" – that is, without the necessity or possibility of political influence – and provide quite predictable and budgetable assistance for the governments of recession-burdened countries. By contrast, the problem remains that elements necessary to prevent member countries from succumbing to moral hazard would automatically reduce the stabilisation impact. This inherent conflict is probably virtually impossible to solve.

A reinsurance scheme to combat a "catastrophic" shock would require the creation of a large fund with annual contributions. The lower the disbursement threshold, the larger these contributions would need to be. However, since there is very little prospect in such a system of establishing an equilibrium between net contributors and net beneficiaries in the long term, this proposal is currently also unlikely to have much chance of being implemented politically.

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[16] Andor (2014), op. cit.

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