A Common Unemployment Insurance System for the Euro Area

by Sebastian Dullien and Ferdinand Fichtner

A European transfer system could contribute to stabilization of the euro area by synchronizing business cycles in the monetary union, thus simplifying the common monetary policy. Such a system is proposed here in the form of a European unemployment insurance scheme. Compared to other forms of fiscal transfer systems, this has some advantages: by putting the focus on short-term unemployment, an automatic link between payments and the cyclical situation of a member state is ensured, making the system relatively robust against political manipulation. Furthermore, this set-up will most likely prevent a case in which countries systematically become net recipients or net contributors. Therefore, the risk of permanently creating transfers to single countries is low. While a European unemployment insurance system would not be suitable for removing or eliminating structural discrepancies between countries (such as those that caused the euro crisis), cyclical imbalances within a monetary union would be effectively dampened, at not much additional administrative cost. Such a system could thus become an important stabilizing element for the member states of the European Monetary Union.

Once again, awareness for the impact of economic fluctuations and divergences has increased worldwide, particularly in the European Monetary Union, not least because of recent experiences with the global recession of 2008/9 and the debt crisis with its real economic impact in the form of massively declining production and rising unemployment. Of course, the current crisis observed in the euro area is not a simple cyclical downturn, but has structural origins. Thus, such a crisis can only be counteracted long-term by structural changes and institutional reforms. For example, macroeconomic wage increases in the member states should reflect productivity growth plus the central bank's inflation target. Given the extent of economic imbalances, it will take EMU member states many years to correct the adverse developments. A fiscal transfer mechanism reacting to the cyclical situation of the member states such as the one discussed in the present article is not suitable for preventing structural imbalances or ending the crisis quickly.[1] But it could help ensure that such large imbalances as seen prior to the crisis in the euro area do not occur in the future. For example, if Spanish households' purchasing power prior to 2007 had been reduced by a transfer system, its real estate boom would not have been so pronounced and when the bubble burst, it would not have been such a burden to Spain's overall economy. Germany, on the other hand, suffered from economic weakness in the first few years of European Monetary Union. Additional aggregate demand created by payments from a European transfer mechanism would certainly have been helpful at this stage.

One reason for imbalances like the ones described is the joint monetary policy in the union: economic fluctuations and the divergence of member state economies are further reinforced in the currency union. If a member state is in recession and is faced with low inflation (as Germany was at the beginning of the previous decade),

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1 See Bernoth and Engler in this DIW Economic Bulletin on economic transfer systems.

the common central bank interest rate can be too restrictive. From the point of view of a fast-growing country with high inflation (Spain at the same time), it would, however, be too expansive and could lead to overheating and additional inflationary pressures. In addition, the effectiveness of fiscal policy in the monetary union is limited. Theoretical considerations and the results of numerous empirical studies suggest that fiscal policy in Europe has magnified rather than dampened cyclical fluctuations in recent years—leaving aside the coordinated fiscal stimulus packages in the global financial and economic crisis of 2008/9.[2] In part, this is a result of the general low effectiveness—possibly due to time lags—of discretionary fiscal policy. In addition, there is an incentive problem for fiscal policy stabilization in the monetary union: a high degree of trade integration in the euro area leads to a leakage of fiscal stimulus to partner countries because significant parts of the additional incomes are spent on foreign products. This makes the use of fiscal policy as a stabilization tool unattractive for national policy makers. Efforts to synchronize national business cycles in the euro area could help the European Central Bank pursue a monetary policy suitable for all countries and thus reduce economic volatility. This would also decrease investment risks for companies or employment risks for workers that might even compromise the long-term growth prospects of the national economy, for example, due to companies' reluctance to invest or hysteresis effects in the labor market.

Different stabilization mechanisms have been discussed in earlier debates on the institutional framework of the European Monetary Union.[3] A number of proposals are aimed at setting up a European compensation fund to transfer payments between the member states' national governments depending on their respective output gap (i.e., the difference between actual and potential GDP). 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 who were enjoying strong economic growth at that particular time.

However, these proposals have a number of serious weaknesses. First, it is not clear whether the allocations from this type of stabilization fund would actually be used promptly by national governments to stimulate demand. Public expenditure normally has long planning and implementation horizons so it may not be possible to swiftly redirect the Brussels transfers into new government spending or public investment. There is also the danger that, in political practice, once support measures have been adopted they are not reversed when the economic situation changes.

Second, there are substantial methodological uncertainties associated with calculating potential gross domestic product and, therefore, the output gap. If one considers estimates by the European Commission of the output gap in Spain over the past ten years, for example, there have been significant revisions made retroactively.

Third, one should consider whether such financial arrangements would gain any political support. In fact, mechanisms like the one outlined above would mean that a small group of economists in Brussels would decide on billion-euro payments, such as from Germany to Spain, based on econometric models that were virtually impossible for the general public to understand.

This report proposes a mechanism to largely avoid these problems, and yet still bring to bear all the benefits of a European economic stabilization mechanism.

Unemployment Insurance as a Joint Stabilization Mechanism…

As an alternative to the stabilization fund discussed above, a transfer mechanism is needed that would transfer funds directly to the citizens of countries with weak economies, without any complicated econometric calculations, and be designed so that the money was used quickly for consumption purposes. Ideally, such a transfer mechanism could rely on existing systems of automatic stabilizers, i.e. on provisions in the taxation system or the social security system to ensure that net payments from the private sector to the government react countercyclically to the business cycle. Automatic stabilizers have the advantage that they have virtually no time lag and remain normally undistorted by the political decision-making process.

2 See J. Galí and R. Perotti, "Fiscal Policy and Monetary Integration in Europe," Economic Policy 18, (2003): 534–572; S. Dullien and D. Schwarzer, "Bringing Macroeconomics into the EU Budget Debate: Why and How?" Journal of Common Market Studies 47 (2009): 153–174; K. Bernoth, A. Hughes Hallett, and J. Lewis, "Did fiscal policy makers know what they were doing? Reassessing fiscal policy with real time data," CEPR Working Paper, no. 6758 (March 2008); E. Balázs, "Fiscal Policy Reaction to the Cycle in the OECD: Pro- or Counter-Cyclical?" CESifo Working Paper, no. 3777 (2012).

3 See A. Majocchi and M. Rey, "A special financial support scheme in economic and monetary union. Need and nature," European Economy – Reports and Studies, no. 5 (1993): 457-480, and J. Pisani-Ferry, A. Italianer, and R. Lescure, "Stabilization properties of budgetary systems. A simulation analysis," European Economy – Reports and Studies, no. 5, (1993): 511–538.

A European unemployment insurance scheme might be such a possible automatic stabilizer for the euro area.[4] In a system of this kind, employees would pay a part of their wages into a European unemployment insurance scheme and would receive compensation payments from this fund in the event of unemployment. These compensation payments would be limited to a particular time period and be set according to their earnings prior to becoming unemployed. The duration of the payments should be set to only cover short-term unemployment and might be limited to just one year, for instance. Also, the amount of the European insurance payments might be below the protection level of current national insurances.

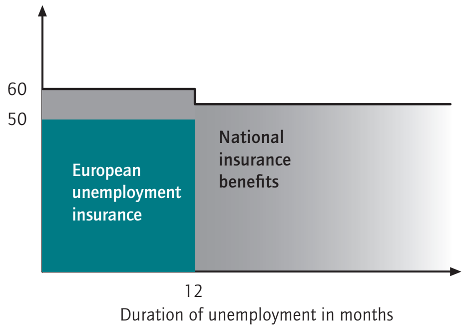
It would be left up to the individual countries to offer payments beyond this basic level of protection. The member states would then be able to top up the transfer payments—funded by national contributions or taxes—and/or extend the duration of transfer payments beyond the first year. In a similar fashion, various eligibility criteria could be applied to the European unemployment benefits, such as placing age-related conditions on the recipient of the transfer payments.[5] Effectively, the European unemployment insurance would offer basic cover up to a lowest common denominator beyond which all politically desirable payments would be covered by social security institutions in the relevant countries.

The combination of a national system and a European unemployment insurance scheme is shown in the diagram using a fifty-percent wage compensation over a period of one year from the European insurance, as an example.

Figure

Diagram of a European Unemployment Insurance System

As a percentage of previous income



Source: the authors.

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The European unemployment insurance provides only comparatively low wage compensation, but may be supplemented by national insurance payments.

...Would Have a Number of Advantages...

A proposal of this kind would have a number of advantages:

1. The number of short-term unemployed is strongly linked to the economic cycle. In addition, the number of unemployed rises sharply in deep recessions where the need for stabilization is greatest. As a consequence, the European unemployment insurance would act as an automatic stabilizer between several countries with asynchronous economic cycles: If one country were experiencing an economic downturn, that country would receive net payments from the fund. If another country were experiencing an economic upturn with high employment and strong wage bill growth, that country would make net payments into the fund.[6]
2. At the same time, it would be ensured that the transfer payments actually had a significant effect on demand: a rise in unemployment in one country would result in transfer payments being made directly to private households in that country. Since the unemployed typically spend their income almost entirely on consumption, this ought to have a prompt and significant impact on gross domestic product.
3. Such a system could be introduced without imposing an additional burden on Europe's workers and firms because the new insurance would partly replace both payments from and contributions to existing national systems. The additional non-wage labor costs for the European unemployment insurance correspond to a reduction in non-wage labor costs for national unemployment insurances. Additional bureaucratic burdens could be kept to a minimum by processing

4 See S. Dullien, »Eine Arbeitslosenversicherung für die Eurozone,« SWP Studie S1 (2008), www.swp-berlin.org/fileadmin/contents/products/studien/2008_S01_dullien_ks.pdf; or for an earlier proposal on European unemployment insurance, see R. Deinzer, Konvergenz- und Stabilisierungswirkungen einer europäischen Arbeitslosenversicherung, (Berlin: 2004).

5 The age limit for receiving unemployment benefits in the euro area varies due to the different retirement ages.

6 In principle, this kind of automatic stabilization effect can also be achieved by operating a national unemployment insurance system with unchanged contribution rates and benefits during that period, and completely separating it from core public budgets. However, in the past and, in particular, during crises, this approach could not be implemented in practice. On the contrary, the sharp rise in unemployment during a crisis would lead to an increased burden on public finances which would have to be compensated by more public borrowing and tax hikes.

the European unemployment insurance via existing national social security institutions.

4. Insuring only short-term unemployment would prevent national governments neglecting necessary measures to reduce structural unemployment. There might be a risk of this happening if countries could assume that the costs of unemployment would be borne by all participating countries jointly, they would then refrain from tackling unemployment themselves (moral hazard problem). In the proposal put forward here, this fundamental problem would only remain for short-term, cyclical unemployment for which the moral hazard is likely to be of less practical relevance. First, short-term unemployment cannot be tackled by politically unpopular structural reforms, anyway. Second, the political cost of rising unemployment from the perspective of national governments is so high that they have a vested interest in finding a solution to the problem.
5. Incentives for the unemployed to look for a new job would not change because payments from the new unemployment insurance would take the place of domestic national payments.

...and Significant Stabilization Effects...

Simulations indicate that the stabilizing effects of such an insurance scheme would be significant.[7] Had there been a common insurance scheme in place since the beginning of European Monetary Union in 1999, economic fluctuations in some countries would have been much less pronounced.[8] Under plausible assumptions,[9] the decline in Spain's gross domestic product during the global recession following the collapse of US investment bank Lehman Brothers would have been reduced by almost a quarter. The downturn in Ireland and Greece could have been restricted by about ten percent during this period. At times, Germany would also have been a net recipient of the system, such as during the pre-crisis period (from 2003 to 2005) when the German economy was much weaker than the rest of the euro area. At that time, transfer payments would thus have also supported the German economy.[10]

The stabilization logic is as follows: With a downturn in an economy and a rise in unemployment, the contributions from the country to the European unemployment insurance would decrease because, as unemployment rises, aggregate wages fall. At the same time, payments from the unemployment insurance to the affected country would increase because of a rising number of short-term unemployed. Compared to national unemployment insurance alone, an additional stabilization of economic activity occurs because national public finances are relieved; therefore, not as much effort is required for consolidating these finances during the downturn. Without the payments from the European system, national social security contributions would have to be increased during the downturn or unemployment payments or other government spending would have to be cut to meet consolidation requirements. With the European system, the respective national government could forego these activities and allow the automatic stabilizers to work fully.

Based on the assumptions made here, the European unemployment insurance would mobilize an average of 55 billion euros per year, less than 0.75 percent of the euro area's GDP. These payments could be funded by a contribution rate of just below 1.7 percent of gross wages if it is assumed that total insurance contributions and payments would balance out over a period from 1999 to 2011 (see table).

Similar to provisions in the US unemployment insurance model, the duration of unemployment benefits supported by the system could be increased during downturns either automatically (by a pre-defined rule) or discretionarily by decree of the European Commission. The stabilizing effect of such an unemployment insurance scheme would be strengthened significantly by allowing for such an adjustable duration of benefit payments. In the US, the duration of a state's unemployment benefits is automatically extended when the unemployment rate worsens significantly according to pre-defined threshold values (extended benefits).

Furthermore, US Congress may introduce emergency benefits by which the period of entitlement to unemployment benefits is extended regardless of the triggers

7 Certainly, it must be acknowledged that the simulation results only provide a starting point for assessing the effects. No information about the employment history of the unemployed in the various euro area countries is available, so only rough estimates can be made as to the percentage of unemployed that actually received benefit payments and as to how much they were entitled.

8 It would be interesting to simulate the stabilizing effect of such an unemployment insurance scheme on the debt crisis in the euro area. However, since the downturn only occurred in the crisis countries in 2011, such a simulation is not yet possible due to the lack of sufficient data.

9 It is assumed that half of those unemployed for less than twelve months would have been entitled to payments from the system. It is also assumed that the insured wage bill accounts for 80 percent of average wages in the relevant national economy. Further, a transfer multiplier of one is assumed, i.e. an increase in government transfers by one percent leads to an increase in gross domestic product of one percent. The transfer payments from the European unemployment insurance match those shown in the diagram: Recipients would receive unemployment benefits amounting to 50 percent of their previous income for one year.

10 See also S. Dullien, "Eine Arbeitslosenversicherung."

for extended benefits. With the exception of a very brief recession in the early 1980s, this option has been adopted in all recessions since the early 1970s.[11] Simulation calculations show that such extended or emergency benefits could significantly increase the stabilizing effect for Europe without the need to massively increase the transfer volume.[12] However, the system would also be more susceptible to political influence.

...But Has Its Risks

If a European unemployment insurance scheme were to be introduced now, it would be important to ensure that the required adjustment processes of the current crisis were not delayed. For example, the introduction of transfers now could reduce the willingness for labor market reforms since the financial burden of unemployment would not fall on the crisis countries alone but on Europe as a whole. However, this is not particularly likely. Short-term unemployment easily becomes structural unemployment. Consequently, there is no real incentive to postpone systematic efforts to reduce unemployment. In any case, the adjustment processes are already in full swing in most crisis countries.[13] Since the introduction of a European unemployment insurance scheme would require an extensive preparation phase, one can expect at least some of the imbalances to have been resolved by then.

What is more important is the concern that the introduction of a common unemployment insurance would create permanent transfers between individual countries within the monetary union that would not balance out over the economic cycle. For example, it is conceivable that certain countries would benefit more from the system than others. This would be the case for countries more affected by seasonal unemployment due to their economic structures (with relatively large proportions of, for example, agriculture or tourism to national gross value added). This could be avoided, however, by introducing a condition in the system that in order to draw benefits from the European unemployment insurance there would have to have been continuous contributions paid in to the system for an extended period (e.g., contributions from 22 of 24 months prior to receipt of benefits). However, it cannot be completely ruled out that the structural characteristics of the economies involved may lead to transfers going in one direction for extended periods. This danger can be prevented by implementing specific eligibility criteria; but an insurance system always has the inherent risk that some participants will benefit more than others.

In order to ensure political acceptance of the proposal outlined here, it would be vital to reduce such asymmetries as much as possible. Indeed, there is a relatively large amount of scope to do this: Restrictions on the eligibility criteria for the European unemployment insurance could, in principle, be very extensive since national insurance schemes cover insurance claims going beyond basic coverage.

Conclusion

The introduction of a European short-term unemployment insurance would not reduce imbalances currently being observed in the euro area. Structural differences can—and should—not be evened out by the mechanisms outlined here. The member states of the monetary union must develop other mechanisms to ensure that persistent asymmetries, for example regarding the competitiveness of the individual economies or institutional conditions such as labor market regulation and wage negotiating systems, are eliminated so as to prevent the creation of large structural imbalances, as far as possible.

However, cyclical imbalances—economic fluctuations and the divergence of national business cycles—could be curbed effectively with a European unemployment insurance system. Compared to a standard fiscal transfer system, this system would provide several key benefits:

First, transfer payments would be automatically linked to the economic cycle. This also largely prevents countries from systematically being net contributors or net recipients. Second, a system of this kind is transparent for policy-makers and the general public, and is comparatively immune to political influence. As a result, a European unemployment insurance system of this kind could be an essential stabilizing element for the member states of the European Monetary Union.

11 S. Dullien, "Improving Economic Stability in Europe. What the euro area can learn from the United States' unemployment insurance," Working Paper FG 1, no. 2012-07, 26 (Berlin: Stiftung Wissenschaft und Politik, 2008).

12 S. Dullien, "Eine Arbeitslosenversicherung."

13 See also F. Fichtner et al. for progress being made on structural adjustments in the crisis countries. "Herbstgrundlinien," Wochenbericht des DIW Berlin, no. 40 (2012): 16 ff.

Table

Financial Flows of European Unemployment Insurance

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	All years
Payouts														
(1) Number of short-term unemployed (in thousands)	8,044	7,211	6,447	7,552	8,163	8,297	7,829	7,117	6,477	7,136	10,269	9,847	9,197	
(2) Assumed number of benefit recipients (in thousands)	4,022	3,605	3,223	3,776	4,081	4,149	3,915	3,559	3,238	3,568	5,135	4,924	4,598	
(3) Gross wages per employee (in 1,000 euros/year)	29,8	30,6	31,4	32,2	33,0	33,7	34,4	35,2	36,1	37,3	37,9	38,6	39,4	
(4) Assumed average unemployment benefits (in 1,000 euros/year)	11.9	12.2	12.5	12.9	13.2	13.5	13.8	14.1	14.4	14.9	15.2	15.4	15.8	
(5) Total payments (in millions of euros)	**47,960**	**44,073**	**40,439**	**48,615**	**53,900**	**55,968**	**53,864**	**50,157**	**46,771**	**53,238**	**77,910**	**75,929**	**72,506**	55,487
Revenue														
(6) Number of employees (thousands)	109,536	112,397	114,194	115,490	116,304	117,095	118,362	120,382	122,743	123,853	121,802	121,286	121,618	
(7) Assumed average tax base (in 1,000 euros)	23.9	24.4	25.1	25.8	26.4	27.0	27.5	28.2	28.9	29.8	30.3	30.8	31.5	
(8) Total revenue (in millions of euros)	**44,240**	**46,536**	**48,522**	**50,362**	**52,021**	**53,503**	**55,160**	**57,465**	**60,041**	**62,590**	**62,593**	**63,347**	**64,950**	55,487
Balance (in millions of euros)	–3,720	2463	8,083	1,747	–1,879	–2,465	1,296	7,308	13,270	9,352	–15,316	–12,582	–7,556	0

Source: authors' calculations based on Eurostat and AMECO data.

The European unemployment insurance would accumulate surpluses in periods of economic growth. If average unemployment rises over several years, this will lead to deficits.

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