DIW Economic Bulletin

ECONOMY. POLITICS. SCIENCE.

1 2013

Bringing Europe's Business Cycles Closer Together ... But How?

DIW BERLIN

DIW Berlin—Deutsches Institut
für Wirtschaftsforschung e. V.
Mohrenstraße 58, 10117 Berlin
T +49 30 897 89 -0
F +49 30 897 89 -200

Volume 3, No 1
4 January, 2013
ISSN 2192-7219

A Transfer Mechanism as a Stabilization Tool in the EMU

by Kerstin Bernoth and Philipp Engler

With the crisis in the euro area, the issue of the institutional structure of the monetary union has gained in significance. One problem with regard to the longer-term stability of the euro area is the absence of mechanisms to adequately absorb asymmetric cyclical shocks in the individual member states. Such an instrument is essential in order to be able to implement a single monetary policy suitable for all countries. Consequently, the European Monetary Union should be equipped with an economic transfer mechanism—for instance, in the form of common unemployment insurance. This is not an instrument to solve the current crisis but rather to provide more stability to the European Monetary Union in the medium and long term.

In historical terms, the European Monetary Union (EMU) is a unique currency area. The member states have committed to a common monetary policy, while fiscal policy remains the responsibility of the individual governments. As a result, monetary and exchange rate policy cannot be used as a stabilizing tool in the event of asymmetric shocks in the individual member states. Only national fiscal policy remains as a tool for stabilizing economic fluctuations.[1] The experience of recent years shows that national fiscal policy does not fulfill this function sufficiently. A lack of fiscal discipline and high levels of public debt since the banking crisis of 2008/09 or the bursting of the housing bubble have resulted in governments pursuing pro-cyclical fiscal policies that amplify rather than dampen business cycles at national level.[2]

Another consequence of the common currency is that business cycle divergences among the various economies within the EMU are exacerbated.[3] If, for example, an individual member state is faced with a demand-side economic slump, the common Central Bank will respond by cutting interest rates. But, since these are oriented to average inflation and economic development in the currency area, the interest rate change is lower than in the case of a nationally oriented monetary policy. As a result, the monetary policy is too restrictive for a country in economic downturn, but too expansi-

1 According to Mundell's (1961) theory of optimal currency areas, asymmetric economic shocks can also be counterbalanced by open international labor markets and flexible pricing and wage policies, see R.A. Mundell, "A Theory of Optimum Currency Areas," The American Economic Review, 51(4), (1961): 657–665.

2 Bernoth et al., (2008) demonstrate that another reason for pro-cyclical fiscal policy is that policy-makers receive false information about the economic situation when making decisions, see 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 (2008).

3 While countries like Germany, the Netherlands, or Finland achieved relatively strong economic growth in the last two years, countries on the European periphery such as Greece, Spain, and Portugal are in recession. However, precisely the opposite was the case immediately after the introduction of the euro.

ve for other member states where the economic situation has not changed. From a national perspective, a uniform monetary policy is less than optimal for asymmetric economic developments; it will in fact exacerbate both the volatility and the divergence of the business cycles.

Economic Compensation Payments Can Stabilize a Currency Union

Various economic policy measures could promote greater synchronization of business cycles in a monetary union, with the aim of facilitating a single monetary policy. Fiscal policies play an important role here. Greater fiscal coordination among the euro area countries ought to make an important contribution to converging their business cycles. Even stricter fiscal discipline, as is the aim of the Fiscal Pact and the debt ceiling, plays a major part in giving national fiscal policy more scope for intertemporal measures aimed at stabilizing business cycles.

Consequently, in order for fiscal policy to assume an even greater role as an economic stabilizer, the introduction of an international transfer system, which serves as insurance against asymmetric cyclical income fluctuations, should be considered.[4] If we look at the various successful monetary unions within federal states—such as the US and Germany—they all have, in various forms, not only intertemporal but also cross-regional fiscal instruments for balancing out regional asymmetric shocks.[5] This kind of mechanism is lacking in the EMU's current structure.

The basic idea is to introduce financial transfers from booming countries to those that are in recession. If a country is in a favorable economic situation compared to the average for the euro area, that country is a net contributor which means it receives fewer payments than it pays into the compensation system. However, if a country has an unfavorable economic climate, compared to the other member states, then it is a net recipient, meaning it receives more transfer payments than it pays into the system. As a result, in the former case, the economy is dampened, and in the latter case, it is stimulated. Economic development in both countries is therefore stabilized.

It should be emphasized that the goal of these types of compensation payments is to balance out business cycles, not to achieve a balance of income and general living standards among the individual countries. In the latter case, individual member states would become long-term donor or recipient countries, and the incentive for implementing necessary structural reforms would be severely impaired. Assuming that country-specific shocks, which can cause production levels to fluctuate, are random and not systematically distributed among the countries,[6] in a purely cyclical transfer mechanism, each country would be both recipient and donor over the entire business cycle, so that over time payments made and payments received would eventually be balanced out.

It should be noted that the increased convergence of business cycles reinforced by a cyclical transfer system could lead to an amplification of these cycles, particularly in countries where they are normally very stable. International fiscal policy transfers do not necessarily represent a direct Pareto solution for all countries. The long-term stability of the currency area, however, ought to outweigh these drawbacks for individual countries.

Engler and Voigts analyzed how such a compensation instrument would affect an economy using a dynamic stochastic general equilibrium (DSGE) model.[7] The model consists of two countries, a small country (domestic) and a large country (foreign), practicing a moderate level of trade with one another. The degree of real economic integration of these countries is therefore still relatively low. Taking into account the macroeconomic interaction of goods, labor, and capital markets, we can analyze how a decline in aggregate domestic demand below its long-term level affects the two economies.[8] Four different scenarios are considered. In scenario 1, both countries pursue an independent monetary policy and have flexible exchange rates. In scenario 2, both countries form a monetary union. Scenario 3 describes the adjustment assuming that the two economies have become more integrated in real economic terms. Scenario

4 The idea that fiscal transfers between member states of a monetary union should take the place of shock absorption through exchange rate adjustments was first suggested by Kenen (1969). See P. Kenen "The Theory of Optimum Currency Areas: An Eclectic View," in Monetary Problems in the International Economy eds. Mundell and Swoboda (University of Chicago, 1969). The need for such a mechanism in the euro area was emphasized 25 years ago by Delors (1989). See J. Delors, "Regional Implications of Economic and Monetary Integration," in Report on Economic and Monetary Union in the European Community ed. Committee for the Study of Economic and Monetary Union (Luxembourg: Office for Official Publications of the EC, 1989). A detailed overview of this issue was provided by J. Hagen and C. Wyplosz, "EMU's Decentralized System of Fiscal Policy," European Economy, Economic Papers 306 (European Commission, 2008).

5 M.D. Bordo, A. Markiewicz, and L. Jonung, "A fiscal union for the euro: Some lessons from history," NBER Working Paper, no. 17380 (2011).

6 Expressed statistically, the country-specific shocks should be independently and identically distributed and have an expected value of zero.

7 P. Engler and S. Voigts, "A Transfer Mechanism for a Monetary Union" (2012) (unpublished manuscript).

8 The demand shock is modeled as a transient increase in consumer demand over its long-term level. The results of a productivity shock are also available, see P. Engler and S. Voigts.

4 introduces a compensation payment system between the two countries (see box).

The model demonstrates that in a monetary union economic shocks are much more effectively absorbed and business cycles are much more synchronized when the countries have introduced a cyclical transfer system compared to the scenario in which the countries operate a purely national fiscal policy. The transfer payments would, at least in the model, stabilize the economy almost as well as if the country were still pursuing a national monetary policy. A similar effect would be achieved if the countries forming a monetary union were closely integrated in real economic terms.[9] The aim should therefore be to increase integration, especially among the euro area countries. However, since the measures needed to achieve this take a long time to come into effect, a high degree of integration has to be regarded more as a long-term goal. Until then, economic compensation payments could be an important element in stabilizing the EMU.

This kind of cyclical transfer system could therefore partially replace the missing stabilization functions of national monetary policy. This would be particularly relevant in times when national fiscal policies are unable to provide further economic stimuli due to high public debt coupled with high interest premiums on government bonds.

Structuring a Compensatory Payment Mechanism

There are already transfer payments between member states in the EU financed from the EU budget. At one percent of GDP, the EU budget is relatively small, however,[10] and the current transfer payment structure between the EU member states focuses not so much on balancing out economic fluctuations but primarily on compensating for long-term income disparities.[11] Nevertheless, along with the Common Agricultural Policy, regional policy is one of the EU's major expenditures. Around 35 percent of the total budget is invested in different structural funds which are used to support regions and countries with weaker economies. This means that some member states are always net contributors to the EU budget, while others are net recipients.

The transfers discussed here, not intended to serve to equalize income levels but rather to insure against asymmetric shocks and economic fluctuations, must fulfill the following characteristics:

a. Payments should be transferred quickly and on time: excessive delays in payments could lead to transfers failing to serve their stabilizing and synchronizing purposes and may then have a destabilizing effect on business cycles.
b. The payment mechanism should be governed by rules: the resultant automatism should increase the transparency of this compensatory tool and prevent arbitrary political decisions about transfer payments.
c. The compensatory mechanism should be oriented to cyclical fluctuations: over a longer period of time, member states will therefore be both donor and recipient countries.
d. The transfer mechanism should be accompanied by strong fiscal rules: such a system cannot and should not replace a sound economic and budgetary policy. Previous experience with debt crises in fiscal unions has shown that a credible no-bailout clause is crucial to the success of regional fiscal equalization systems within federal states.[12]
e. Participation in a compensation system should be subject to conditions such as structural reforms through economy policy.

Such a transfer mechanism could be implemented in different ways in the euro area. This could involve, for instance, direct fiscal transfer payments or indirect transfers by establishing a European social security and unemployment insurance system. In the first case, countries would pay some of their tax revenue, which is closely linked to the business cycle, such as revenue from VAT, into a joint European fund. These payments would then be redistributed to the individual member states in relation to per-capita potential growth. If a country's pro-

9 In contrast to predictions made by Krugman, it is assumed here that increased integration does not result in stronger idiosyncratic shocks arising from more specialization by individual countries, but only to increased cross-border trade, see P. Krugman, "Lessons from Massachusetts for EMU," in Adjustment and Growth in the European Monetary Union, eds. F. Torres and F. Giavazzi (London: CEPR, 1993). With the creation of a single market, the liberalization of capital and payment transactions, the free movement of people and of goods and services, the pre-requisites for EU economic integration are largely in place, but the current level of integration still has room for improvement. Although the percentage of imports from euro partner countries to GDP increased in most countries up to 2008, this figure was less than 15 percent in a number of countries.

10 In 2010, the federal budgets in the US and Germany were around 15 and 13 percent of GDP, respectively.

11 The EU member states and the European Parliament passed a resolution that a maximum of 1.23 percent of the Community's gross national income should be available to the EU. With a budget of around one percent, the EU's current multi-year financial framework for the period 2008–2013 remains below this threshhold. It is largely made up of shares in VAT collected by the member states, national contributions, based on GDP, and customs duties.

12 Bordo et al., "A fiscal union."

Box

Scenarios for the Effects of a Negative Demand Shock in a Two-Country Model

Scenario 1: Independent Fiscal and Monetary Policy with Flexible Exchange Rates[1]:
A negative demand shock causes domestic consumption and production to fall temporarily below their long-term levels, leading to deflationary pressure. As a result, the Central Bank lowers interest rates which, due to the system of flexible exchange rates assumed here, devalues its currency vis-à-vis its trading partners. Lower interest rates and devaluation dampen the economic downturn.

An appreciation of the local currency abroad has the overall effect of cooling its economy in the form of lower demand for export goods and lower import prices. The latter, on the one hand, depresses demand due to a substitution effect away from goods produced abroad while the deflationary pressure has a positive impact on demand, since this implies the Central Bank has scope to lower interest rates and thus stimulate aggregate demand. Upon a return to equilibrium, the domestic currency appreciates again, and so net exports fall and the increase in production slows. The opposite happens abroad.

Consequently, the business cycles of both countries are highly synchronized and only consumption develops differently in the two countries. The impacts of national monetary policy and the flexible exchange rate act as buffers against the effects of asymmetric shocks, on the one hand, and prevent a divergence of the national business cycles, on the other hand.

Scenario 2: Monetary Union without Compensatory Payment System
After a monetary union has been formed and the exchange rate fixed and each country has given up their independent monetary policies, the fall in domestic inflation induced by the demand shock only affects the average inflation rate of the EU to a small extent. Therefore, the cut in domestic interest rates subsequently implemented by the common Central Bank is lower than in Scenario 1. It is impossible to adjust the exchange rate. The negative effect of the shock on the domestic economy and consumption is more pronounced as a result. Abroad, however, consumption grows faster than it would with flexible exchange rates, and also production rises instead of falling. This is because there is no decrease in exports due to a nominal revaluation. Moreover, the common monetary policy within the monetary union means that only interest rates fall slightly compared to the flexible exchange rate abroad. Hence, real incomes increase due to rising employment.

1 For a more detailed description of the model used and the results, see P. Engler and S. Voigts: "A Transfer Mechanism for a Monetary Union" (2012) (unpublished manuscript).

duction in relation to potential production, i.e., its *output gap*, is lower than the average output gap in the euro area, the country is a net transfer recipient. If it is higher, then it is a net transfer contributor. The more synchronous the economic cycles of the individual member states are, the fewer transfer payments are made.[13]

The advantage of such a mechanism is that it supports a counter-cyclical fiscal policy in accordance with the Stability and Growth Pact. Countries experiencing an economic downturn and hence net recipients of compensatory payments can thereby increase their public spending without burdening their national budgets. While the effect of stimulating the economy purely through national fiscal policy is curtailed because consumers expect an increase in public spending in the present to be financed by tax increases or cuts in public spending in the future (Ricardian Equivalence),[14] such dampening effects would not occur if international a transfer mechanism could be used to stimulate economies.

One problem with this direct version of a fiscal transfer mechanism is, however, that figures for the output gap and potential production are normally very inaccurate and they are often revised over time. Transfer payments could therefore fail to serve their stabilizing

13 For a detailed description of such a mechanism, see von Hagen and Wyplosz, "EMU's Decentralized System."

14 However, empirical studies conclude that only some of the private sector take a long-term perspective. Many key players actually increase their spending after a tax cut.

As a result, business cycles and consumption in both countries become significantly more volatile and more asynchronous in the monetary union. A recession in one country cannot be weakened by an expansive monetary policy there and a depreciation in exchange rate, nor, conversely, can a boom be moderated.

Scenario 3: Monetary Union with Stronger Integration in Real Economic Terms

It is often argued that when a monetary union is formed, the asymmetry in the business cycle of the individual member states weakens due to increased integration in real economic terms.[2] If stronger integration in real economic terms is established in the present model by increasing the share of imported goods to consumption, the sub-regions of the monetary union are similarly affected by asymmetric shocks. A domestic demand shock is then evenly distributed to domestic and foreign goods, leading to more similar business cycles in both countries than if integration were weaker.

2 Frankel, Rose, "The Endogeneity of the Optimum Currency Area Criteria," The Economic Journal, 108 (449) (1998): 1009–1025; and Frankel, Rose, "An Estimate of the Effect of Common Currencies on Trade and Income," Quarterly Journal of Economics, 117 (2) (2002): 437–466. For an opposing position, see Krugman, "Lessons from Massachusetts."

Scenario 4: Monetary Union with Compensatory Payment System

Alternatively, both countries could introduce a compensatory payment system in order to produce similar economic results in the event of an asymmetric shock, as in the scenario with integration in real economic terms. In our model, this is represented by a payment from the country with relatively strong economic growth to the country with relatively weaker growth. The compensatory payments are intended to directly affect aggregate demand for goods. In the period following the shock-induced decline in demand, the domestic economy receives a payment,[3] which means there is a counter-cyclic increase in aggregate demand and the decline of consumption and production is tempered.

Abroad, on the other hand, expansion of the economy is curtailed by the compensatory payments. It is apparent that the decline in domestic demand and production is thus alleviated considerably and the foreign economic stimulus is slowed down and can even be reversed through a decline in production. This in turn leads to a dampening of volatility and a convergence of economic and consumption trends.

3 In the simulations, a transfer is modeled as a payment between private households . The model can, however, also be adjusted so that transfers are made between governments. Comparable simulation results can be achieved with both models.

and synchronizing purposes, or policy-makers might abuse the system.

One alternative would be the introduction of a European social and unemployment insurance scheme parallel to the national insurance systems. Assuming that unemployment is closely correlated to the economic situation of a country, a European insurance system of this kind would result in transfer payments between the member states of the monetary union, similar to a direct fiscal transfer system, only in this case it would not be governments that receive the transfers, but private households.[15]

15 See the contribution by Dullien and Fichtner in this DIW Economic Bulletin on the specific advantages and disadvantages of such a European unemployment insurance scheme.

Compared to a direct fiscal transfer system, a European social and unemployment insurance scheme would have the advantage that the factors determining the transfers are set quickly and more or less automatically. They would not have to be first calculated and negotiated, leaving less scope for arbitrary political decisions. Moreover, the effectiveness of an economic transfer mechanism as a tool for stabilizing business cycles depends on how fast aggregate demand is affected. Private households and governments could simply increase their savings rate when they receive net transfer payments. However, this is less probable in the event of a European unemployment and social security insurance scheme.

It should be emphasized that a compensatory payment mechanism in a monetary union cannot replace a sound economic and budgetary policy in the member states. Since the transfer system is not intended to redistribute the tax revenue or debt burden but to absorb asymmetric cyclical shocks, fiscal discipline and a sufficient level of international competitiveness continue to be of crucial importance for the stability of the euro area. Implementation of major labor market reforms or compliance with fiscal policy rules could be made a prerequisite for participation in the compensatory mechanism. As a result, a country's participation in the compensatory mechanism could be linked to the simultaneous inclusion of a debt brake in its constitution, or its adherence to the Stability and Growth Pact.

Conclusion and Policy Implications

In a monetary union without fully integrated markets, where both monetary and exchange rate policy are not available as stabilizing tools, a system of compensatory payments between the member states could play an important role in stabilizing and synchronizing economic fluctuations in the individual countries. To date, however, policy-makers have not been willing to surrender some of their fiscal sovereignty to allow a transfer mechanism to be introduced. In view of the current debate on the institutional restructuring of the EMU, the time now seems ripe to also consider introducing a fiscal compensatory system. The higher the compensatory payments are, the more reservations governments and the people will have about the introduction of such a mechanism. One challenge for the political debate is therefore to strike an optimal balance between stabilizing effect and the size of transfers.

Kerstin Bernoth is Deputy Head of the Department of Macroeconomics at DIW Berlin | kbernoth@diw.de

Philipp Engler is Junior Professor at the Freie Universität Berlin | Philipp.Engler@fu-berlin.de

JEL: E02, E32, E42, E61
Keywords: European Monetary Union, economic transfer mechanism, European unemployment insurance scheme

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),

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.

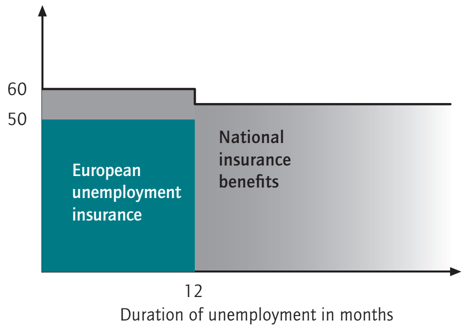
It would be left up to the individual countries to offer payments beyond this basic level of protection. The member states would then be able to top up the transfer payments—funded by national contributions or taxes—and/or extend the duration of transfer payments beyond the first year. In a similar fashion, 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.

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.

Sebastian Dullien is a Professor at the HTW Berlin | sebastian.dullien@htw-berlin.de

Ferdinand Fichtner is Head of Department of Forecasting and Economic Policy at DIW Berlin | ffichtner@diw.de

JEL: E32, E63, F41
Keywords: economic stabilization, European integration, unemployment insurance

Dr. Ferdinand Fichtner, Head of Department of Forecasting and Economic Policy at DIW Berlin

SIX QUESTIONS TO FERDINAND FICHTNER

»Harmonizing Europe's business cycles at no additional cost«

1. Mr. Fichtner, in order to reduce the cyclical differences among EU member states and inside the euro area, you are proposing transfer systems, such as a joint unemployment insurance scheme for the euro area. What is the idea behind it? The idea is to balance out disparities between countries in the euro area with an automated transfer system. We propose introducing a transfer system, for example, a European unemployment insurance scheme. This would lead to automatic financial flows between booming economies and countries in recession.

2. Would a European unemployment insurance scheme not lead to permanent transfers from the EU's rich countries to its countries in crisis? In our concept for a European unemployment insurance scheme, participants would only be eligible for a maximum of one year. Every unemployed person who had not yet returned to work after one year would be automatically excluded from this unemployment insurance. This would keep permanent transfers between countries to a minimum. But it cannot be fully excluded because there are countries where short-term unemployment is structurally higher, for instance, with seasonal work in the tourism industry. However, this could also be prevented by additional adjustments to our system.

3. Do you think the regulations governing the duration recipients are allowed to draw benefits should be synchronized throughout Europe? The unemployment insurance system we are proposing is only intended to provide basic coverage. If this level of coverage is not sufficient for national governments, they can establish additional coverage and thereby increase the benefit period or the amounts their citizens receive. There will, however, be certain uniform requirements which are not as high as they may first seem.

4. Do we need a European employment agency? No, a European employment agency would not be necessary because each country's social security systems will still be in use. This means that, in Germany, the Federal Employment Agency would continue to be responsible for contributions and payouts and for refinancing some of the European fund.

5. What additional expenses would be incurred by Europe's workers and employers? The total burden would remain the same, as long as the payments from this European unemployment insurance were still comparable with benefits paid by national unemployment insurance. And that would be the case with our concept.

6. Would a European unemployment insurance scheme not reduce incentives for governments to employ measures to consistently reduce unemployment? It is possible that a European unemployment insurance scheme of this kind would disincentivize national governments from trying to reduce unemployment because, ultimately, someone else is paying for it. But since we have restricted unemployment benefits to one year, in our view, there is no real disincentive because structural and long-term unemployment is the area where national governments have the biggest impact. There is not so much political scope for adjustments in short-term unemployment. Politicians generally use the reduction of unemployment for political gain. For example, employment programs appear to reduce short-term unemployment but do not really lead to any lasting changes to the labor market situation.

Interview by Erich Wittenberg.

A Skeptical View of Mechanisms for Business Cycle Harmonization in the Euro Area

by Karl Brenke

The European Monetary Union brought with it a standardization of monetary policy and a system of fixed exchange rates. This was accompanied by disincentive effects which, in turn, resulted in serious economic distortions. Proposals are currently being made—not only by DIW Berlin—as to how compensatory payment mechanisms could be used to better synchronize the economic development of the member states in the euro area in future. The present article discusses some of the problems of such transfer systems in detail and, on the whole, evaluates such mechanisms far more skeptically than the previous two articles in this issue.

Comprehensive compensatory payment systems are always associated with a risk of resource wastage. Furthermore, these systems can also have undesirable negative effects. The alternative to a compensatory payment system, some form of common European unemployment insurance, is not a workable solution since national benefits already act as automatic stabilizers. Such a move would ultimately only lead to a transfer of competences to the supranational level. This would be accompanied by a harmonization of national unemployment benefit systems and the deferral of control functions to a neutral European authority—and thus, more red tape. Moreover, the introduction of a common unemployment insurance scheme would, at least initially, result in a significant redistribution of resources, which could raise questions about distribution in the donor countries.

Although the crisis in the euro area is by no means over, and there appears to be no prospect of solving problems such as the excessive debt burdening in some countries or the widening gap in competitiveness, nonetheless, ideas are already being put forward as to how business cycles in the monetary union member states can be better harmonized in the future.[1] The following article discusses some of the problems these proposals present.

Comprehensive Fiscal Transfer System Not Expedient

Theoretically, a fiscal intervention mechanism inside the euro area could be a realistic instrument to compensate for or at least alleviate the distorting effects of a common monetary policy. Member states with comparably favorable business cycles would have to transfer financial resources to a common fund which would restrict the economic output of these countries. These funds would then act as a catalyst for production in countries that are lagging behind economically. It is essential that the direction and scale of the transfer can be rapidly adjusted in order to respond swiftly to economic changes in the individual member states of the monetary union. Given the scale of the task at hand, the necessary redistribution volume is likely to be enormous, at least in the interim.

A transfer system such as this would be very difficult to implement and, would ultimately not be workable in practice. The funds to be redistributed would have to flow and be used extremely quickly to achieve the desired effect. In order to avoid misuse of funds and resource wastage, good forward planning and some form of preliminary phase would be necessary—for example, in the award of public contracts. This would, in turn, be at the expense of required speed of action. Therefore, a situation might even arise where the economy has already re-

1 See the two previous articles in this issue of DIW Economic Bulletin.

covered by the time the measures come into effect and they would then have a procyclical effect.[2] Moreover, the transferred funds could also be used covertly by the public sector—for instance, by financing pending government projects under the pretext of economic stabilization.

Another challenge is to find a reliable instrument that indicates when and how much money is being transferred and also specifies the recipient and donor countries. It would be advisable to apply utilization of production potential in the individual member states as a guiding principle. However, available data on the output gap are unreliable and, therefore, unsuitable as a basis for important fiscal policy decisions. Although the European Commission and the OECD regularly publish estimates on the production gap, over time, these calculations are continually subject to sharp corrections.[3] The significant fluctuations between the regular revisions of, for example, the OECD estimates lead us to the conclusion that, because of these uncertainties, it would be better to avoid these calculations altogether.[4] This aside, the estimates deliver results that appear to be at odds with reality. Thus, it is surprising that, from 2006 to 2008, there was overcapacity in the German economy, and yet, at the same time, there was only a slight increase in wages during this period. Also, according to current OECD estimates, Greece would still have been receiving transfers from the common fund up until 2002, i.e., at a time where its consumer boom really accelerated.[5]

Although the transfer system outlined here is intended to mitigate cyclical divergences and the individual countries are supposed to alternate between being donors and recipients of the compensatory payments, the system could—in crisis periods such as the present time—result in unidirectional redistribution continuing over several years. Admittedly, in countries with prevailing weak economic growth, the production potential and thus also the estimated production gap would be reduced. However, this would only occur gradually. In this situation, harmonization of business cycles is no longer the issue.

2 Programs stimulating public construction in Germany were still, to a great extent, effective in 2011, i.e., at a time when the decline in production resulting from the global financial and economic crisis had long since been overcome, see F. Fichtner et al., "Verunsicherung und hohe Schulden bremsen Wachstum," Wochenbericht des DIW Berlin, no. 1 and 2 (2012).

3 I. Koske and N. Pain, "The Usefulness of Output Gaps for Policy Analysis," OECD Economics Department Working Papers, no. 621 (2008).

4 G. Horn and S. Tober, „Wie stark kann die deutsche Wirtschaft wachsen? Zu den Irrungen und Wirrungen der Potenzialberechnung," IMK-Report, no. 17 (2007).

5 OECD, Economic Outlook (Paris: 2012): 242.

European Unemployment Insurance: An Alternative Solution?

Proposals for the introduction of some form of European unemployment insurance program are less far-reaching. The fund would be created as basic protection: Only unemployed individuals who have made uninterrupted payments would be able to claim benefits, and the entitlement period should be strictly limited to, for example, one year. Seasonal unemployment and unemployment that is of a more structural nature, which is presumably the case for long-term unemployment, should be excluded. Also for a European unemployment insurance scheme, the stated aim is the harmonization of business cycles between member states.

In practice, this type of unemployment insurance can only be partially effective. If a country is experiencing growing unemployment, by paying out financial assistance, this type of insurance acts as an automatic stabilizer ensuring that available income and, thus, consumption do not fall too dramatically. However, it cannot prevent the economy from overheating, for example, due to excessive consumption.

A strong argument against the introduction of a common European unemployment insurance scheme is that it is superfluous because insurance and benefit systems to assist the unemployed are already in place in every member state. At the national level, these systems absorb the ramifications of economic downturns and, therefore, contribute to the synchronization of business cycles in the euro area. Thus, the need for reform could only arise if there were inadequate financial resources for individual national insurance funds i.e., if, as a result of rising unemployment, contributions have to be increased or benefits cut. Appropriate provisions at the national level should be perfectly sufficient to prevent this. It is therefore negligent to reduce contribution rates when the economy is performing well, which has happened in the past, since this implies that favorable economic development can continue indefinitely.

Of course, developments such as those observed in certain southern European countries in the past few years goes beyond the scope of conventional financial planning. Here, the issue is not a sluggish economy but rather a structural crisis, which will take some time to overcome. In this situation, economic policy instruments can do little to help.

A European unemployment insurance program would also need to provide sufficient funding to extend across all business cycles. This would be essential, particularly at times of uniform economic development within the euro area and when there is a general economic downturn across the region. Creating an institution like this would only shift the financial responsibility from the national to the supranational level. In countries such as Germany where unemployment insurance costs are borne by the social partners (the unions and management combined), autonomy would, to a large degree, have to be relinquished.

As with all national social security systems, a European unemployment insurance scheme would also take the shape of a fund with regional equalization effects. Areas with a relatively high share of citizens eligible for benefits would receive more than they contribute to the insurance fund; regions with comparatively few benefit claimants would be net contributors. The start-up phase of this new European institution would inevitably involve redistribution of substantial sums of money at the expense of the contributors in countries with a below-average number of short-term unemployed and probably also a generally more favorable labor market. Any surpluses accumulated by the national insurance schemes could be used for the new common fund. Otherwise, these countries would have to increase their insurance contributions and therefore also wages. In donor countries, for example, with parity financing, employers should be prepared for higher wage costs and employees for larger wage cuts. In Germany, a similar situation arose as a consequence of reunification.

However, this situation would not affect all employees but rather—as is the case for Germany—only those subject to mandatory social security payments and their employers. In Germany, for instance, civil servants and those in marginal employment (jobs paying less than 400 euros per month and exempt from social security) are excluded. It would be problematic from a redistribution policy perspective and difficult to explain to the public if only certain groups had to pay for intra-European transfers.

It is impossible to estimate the volume of redistribution funds that the introduction of a European unemployment insurance program would involve. The number of potential claimants of European unemployment benefits cannot even be roughly estimated as available data provides barely any indication. For example, unemployment figures collected as part of the EU's standard statistical reporting system cannot be compared with the number of unemployed registered with national employment agencies and most certainly not with the number entitled to benefits.[6] Moreover, it is uncertain to what extent European national economies, and thus also labor market developments will diverge from one another in future.

Harmonization of National Systems Would Be Required

Before a European unemployment scheme could be introduced, a number of details would need to be clarified. Above all, it would have to be ensured that the proposed basic protection and access to the benefits it entails is harmonized across all European countries. Some items that would require clarification are, for example: What legal options do the unemployed have to earn additional income; how should those participating in labor market policy measures be dealt with; what should be done in the case of voluntary redundancy—are these individuals eligible for benefits and should they have to wait before receiving them? Who should pay into the insurance fund? For instance, in Germany and France, contributions are made by both the employee and the employer, whereas in Italy, only the employer makes the insurance payments. Furthermore, in Germany and Spain, the unemployed can claim benefits up until the age of 64, while in other countries, such as France, the limit is lower. In practice, the introduction of a European unemployment insurance scheme could result in the benefits level in some countries being raised. This particularly relates to the unemployment benefit eligibility period as, in some cases, this is less than a year. In Italy, the eligibility period is generally nine months.[7] In Spain, it is dependent on the number of days over which contributions were paid so, in order to claim unemployment be-

6 The difference between the jobless and the unemployed can be explained using the German example: the unemployed are those who are registered with the German Federal Labor Office, are looking for employment that is subject to mandatory social security, and are available for work. An unemployed person can work for up to 15 hours per week—for instance, in marginal employment. Those who, although looking for work, have not registered with an employment agency are not considered to be unemployed–because, for example, they are not entitled to benefits despite their unemployed status. Further, those participating in active labor market programs are also not classified as unemployed—for instance, those attending training or people employed in what are known as job-creation programs or one euro jobs (to help the long-term unemployed become accustomed to regular work again). According to the International Labour Organization (ILO) definition that is also used by Eurostat in the EU-wide labour force survey, the jobless are those who are in no form of employment and who are actively seeking any kind of work–even if for a few hours and irrespective of whether they want to be self-employed or employed by someone else. According to the ILO definition, people are also considered jobless if they are looking for a job but are not registered with an unemployment agency, or if they are participating in training courses. Students in school and further education can also be jobless. Unemployed people in any kind of employment, even if only for one hour a week, are not classified as jobless.

7 Additionally, there are special provisions for the unemployed who were previously employed in manufacturing or construction.

nefit for a year, an employee must have made insurance payments for a period of at least three years.

Thus, in many respects, it would be necessary to instill some kind of uniformity in the structure of the benefit systems in those countries participating in the common unemployment insurance project. Above all, misuse would have to be prevented, as it might be tempting to exploit the European unemployment insurance scheme to ease the burden on national pension or social security funds.[8] Very clear and less ambiguous guidelines and regulations are, therefore, required; an adequate set of rules can, however, only evolve after the system has been in place for some time and that, alone, will not be enough. Experience with other EU funds shows that significant investment is required to monitor whether the regulations are also being complied with and funds are being used for the proper purpose.[9] All of this inevitably results in more red tape.

Citing the US system as an example, proponents of a European unemployment insurance scheme suggest that, during periods of higher or rising unemployment, it should be possible to extend the maximum period of entitlement to unemployment benefit—either automatically or on recommendation of the European Commission.[10] Such a move would be logical from a socio-political perspective since it cannot be ruled out that, for example, in the southern European crisis countries, the number of short-term unemployed might fall, not because of an improvement in the economic situation but rather because more and more jobless are sliding into long-term unemployment. This would lead to a paradoxical situation where some countries would receive less financial assistance despite deteriorating prospects on the labor market. If the long-term unemployed were covered by the European unemployment insurance scheme, this would ultimately result in government tasks being financed since public authorities would be relieved of their duty to pay social benefits. The creation of a European unemployment insurance scheme could provide an opportunity to comprehensively harmonize and europeanize national social welfare systems.

8 One inglorious example was the Hartz IV benefits reform in Germany (bringing together unemployment benefits for the long-term unemployed and welfare benefits). When this was implemented, the local authorities declared numerous former welfare recipients as unemployed, although these individuals were not sufficiently fit for work, in order to save welfare expenditure.

9 See, inter alia, European Court of Auditors, "Annual Report on the Implementation of the Budget," Official Journal of the European Union, 2011/ C 326/01, (Luxembourg: 2011): 15 ff.

10 S. Dullien, "A European Unemployment Insurance as a Stabilization Device – Selected Issues." Paper prepared for brainstorming workshop on July 2, 2012 at DG EMPL.

Conclusion

A comprehensive fiscal mechanism for synchronizing national business cycles within the European currency union would not be workable in practice. Furthermore, as with all interventions, considerable side effects would be likely; the risk of misallocations and resource wastage would be particularly high. Furthermore, government measures might not have an anticyclical, but rather, to a certain extent, a procyclical effect.

A European unemployment insurance scheme, which has also been proposed as a mechanism for harmonizing business cycles among EU member states is, however, superfluous in this context if national unemployment insurance systems are fully operational. If these systems work effectively, they act as automatic stabilizers and already have the desired effect. Such a mechanism would ultimately only lead to a transfer of competences to the supranational level. This would be accompanied by harmonization of national unemployment benefit systems and the deferral of control functions to a neutral European authority—and thus, more red tape. The harmonization of benefit claims could lead to a higher level of social assistance in some countries, thus making the system more costly. Certain countries would have to make more funds available and, in the donor countries, distribution problems could arise.

In essence, all proposals concerning the implementation of a more or less automatically functioning compensatory payment mechanism are geared towards restricting national governments, since it is generally believed that, for various reasons—motivated by opportunism, for instance—politicians tend to make mistakes.

Instead of attempting to reduce governmental influence, politicians should instead be held responsible so that they are in a position to counteract undesirable economic developments. Governments have already been capable of this in the past. The excessive spending policy and lack of reform to the tax collection system, for example, were political failings of the Greek government. In Spain, for instance, the government contributed to the creation of a housing bubble by developing new building plots. Instead, it would have been wiser for the state to increase taxes on real estate transactions which would have been more likely to have a dampening effect.

Wage policies have also failed. In Germany, as in other central European countries, the scope for distribution was not exploited by employers to implement corresponding wage increases. In other countries, however, wages outran productivity. The result was a divergence of competitiveness between the individual national economies.

If lessons had been learned from previous mistakes, a special equalization mechanism to harmonize business cycles in the euro area would be completely unnecessary. A policy that is focused on the needs of a currency union would be more than adequate, and there would be no need for even more technocracy.

Karl Brenke is a Research Associate at DIW Berlin | kbrenke@diw.de

JEL: E62, J88
Keywords: harmonization of business cycles, unemployment insurance