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.

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