bruegelpolicybrief

ISSUE 2014/06
SEPTEMBER 2014

BENEFITS AND DRAWBACKS OF EUROPEAN UNEMPLOYMENT INSURANCE

by Grégory Claeys
Research Fellow at Bruegel
gregory.claeys@bruegel.org

Zsolt Darvas
Senior Fellow at Bruegel
zsolt.darvas@bruegel.org

and Guntram B. Wolff
Director of Bruegel
guntram.wolff@bruegel.org

POLICY CHALLENGE

European Unemployment Insurance is one option for stabilising country-specific economic cycles thanks to risk sharing, but it would not substantively influence the area-wide fiscal stance. Moral hazard problems are significant but can be reduced by a less generous design and more harmonisation of labour markets. The former would, however, reduce the scheme's stabilisation effect. P The fo720 TDj0 st 1 Tf10 0 0 10 .24 .02 Tm.1372

national level. If administered at national level, the scheme would foresee payments between national administrations. Ideally, financial flows would go from countries with low unemployment to countries with high and increasing unemployment.

One often-proposed scheme (the 'all-time' variant) would cover a large percentage of the previous income of a person losing a job for the first 12 months of unemployment[5], replacing fully or partly the current national systems. The revenues would come – as in the national case – from contributions paid by employers and employees. Countries could supplement the EUI scheme if they wish to increase payments to the jobless above the EUI payouts. The EUI scheme might be allowed to borrow on markets to deal with a recession affecting all countries. Simple mechanical simulations suggest that such a scheme would lead to flows towards countries in heavy recession of 0.5 percent to 1.5 percent of their GDP[6]. The flows typically end after three years if country-specific contribution rates are adjusted upwards to prevent permanent transfers.

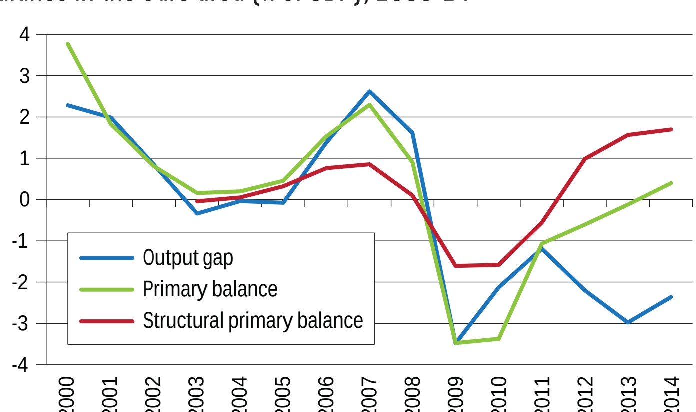
Another variant of the scheme (the 'catastrophic' variant) would provide support to countries in case of a negative shock large enough to have a major negative impact on public finances[7].

EUI AS AN INSTRUMENT OF FISCAL STABILISATION POLICY?

Insufficient macroeconomic stabilisation in the EU and the euro area in particular is often given as a reason why the EU should create an EUI scheme. The founders of Europe's monetary union allocated the role of fiscal stabilisation to national budgets without any European counterpart. With prudent fiscal policy in good times, it would be possible to let automatic stabilisers operate freely and to implement discretionary stimulus in crisis times, thereby dampening the impact of a recession. This strategy broadly worked in most EU countries during the recent crisis, but there were two problems, which will likely reappear in future downturns:

- Inadequate stabilisation at EU/euro-area level and the lack of a European instrument to influence the European fiscal stance. Member states implement the policy deemed appropriate for their own economies, subject to the constraints of the European fiscal governance framework. During 2011-13, the sum of national fiscal policies led to a European fiscal stance that was not optimal given the downturn in the business cycle. Figure 1 shows that, following the 2008-09 stimulus, fiscal consolidation followed in parallel with the narrowing of the output gap. However, after 2010 the output gap widened again in Europe while fiscal policy continued to consolidate. Therefore, the aggregate fiscal stance did not address the widening output gap and fiscal policy became pro-cyclical[8].
- Several countries ran out of fiscal space and were forced to implement pro-cyclical fiscal tightening in a deep economic crisis. This was especially critical in euro-area countries where changes to a country-specific exchange rate cannot help the adjustment. Though one can argue that the lack of fiscal space in some euro-area countries during the recent crisis was the consequence of inadequate pre-crisis policies, it was difficult to identify vul-

Figure 1: Output gap and general government primary budget balance in the euro area (% of GDP), 2000-14



Source: European Commission May 2014 forecast. Note: The primary budget balance does not include interest payments. The structural primary budget balance measures the underlying position of the primary budget balance by eliminating the impact of the economic cycle and one-time expenditure and revenue items. The output gap measures the difference between actual and potential GDP.

5. Andor, László (2014) 'Basic European unemployment insurance as an automatic fiscal stabiliser for an EMU 2.0', Speech/14/485, conference on 'Economic shock absorbers for the euro zone', Brussels, 20 June.

6. See Dullien, Sebastian (2013) 'A euro-area wide unemployment insurance as an automatic stabilizer: Who benefits and who pays?', Paper prepared for the European Commission (DG EMPL); Lellouch, Thomas and Arthur Sode (2014) 'An Unemployment Insurance Scheme for the Euro Area', *Trésor-Economics* 132, Direction Générale du Trésor; Claeys, Gregory, Simon Ganem, Pia Hüttl and Thomas Walsh (2014) 'Do it yourself: European unemployment insurance', Bruegel blog, forthcoming.

7. Insurance for large shocks based on budgetary transfers linked to the output gap is proposed by Wolff, Guntram B. (2012) 'A budget for Europe's Monetary Union', *Policy Contribution* 22/2012, Bruegel. A 'contingent' unemployment benefit scheme, which would be triggered only in case of

nerabilities when policies were adopted and the European surveillance framework also failed to foresee that a crisis might come and lead to fiscal constraints. Even countries that had low pre-crisis public debt levels and budgetary surpluses, such as Spain and Ireland, faced major fiscal constraints during the crisis.

It is unlikely that these two problems will be sufficiently resolved by the reformed EU economic and fiscal governance framework. While the EU's two-pack regulations[9] will enable the European Commission to assess the *ex-ante*

in social policies and significantly different views about how labour markets should be organised.

a substantial pan-European investment plan.

2 **Should the scheme be for the EU or euro area only?** While stabilisation, solidarity and labour market harmonisation issues apply to all EU countries, monetary union has specific stabilisation requirements given that its members can be affected by asymmetric shocks. One possibility would be to implement it at euro-area level and to give other EU countries the option to join, similarly to the banking union.

3 **Should labour-market institutions be harmonised and should the social dialogue be elevated to European level?** As the eligibility criteria for the EUI scheme would have to be decided at the European level, it would be preferable that social partners play a role in their definition. Without harmonisation of labour market institutions, structural differences in labour market institutions should result in different contribution rates (ie contribution rates should be higher in countries with less efficient labour markets) which would undermine the stabilisation properties of the scheme. Harmonisation would instead require agreement on desirable standards. One option would be to start the EUI with country-specific contribution rates which would be adjusted frequently (eg yearly) to eliminate long-lasting transfers between countries participating in the EUI. As participating countries progress with labour market harmonisation, contribution rates could be harmonised too.