A European Unemployment Insurance Scheme

Necessary? Desirable? Optimal?

Grégory Claeys, Research Fellow, Bruegel

Zsolt Darvas, Senior Fellow, Bruegel

Guntram Wolff, Director, Bruegel

July, 2014

Key messages

- **New debate on a European unemployment insurance as a stabilisation tool**
- **Prior political consent to fiscal risk sharing needed**
- **Ambitious project with implications for**
  - labour market institutions, activation policies etc.
  - Moral hazard (early retirement policies, health insurances (?))
  - and public finances
- **While more European stabilization mechanisms desirable, other mechanisms may be easier**
  - EUI not easy to build therefore rather for next crisis
  - Investment fund and better use of EU budget may be more practicable
- **Could be a powerful signal of a further „federalisation“ of Europe and solidarity if political consensus**
- **Could be a strong mechanism to fundamentally reform labour markets**

Why a European unemployment scheme?

Main possible reasons advanced:

1. Stabilisation: it could help stabilising output fluctuations
2. Solidarity: deepening the solidarity between EU peoples is an objective of the EU, as laid down in the EU Treaty
3. Convergence of labour market institutions: the large heterogeneity could hinder the efficient function of the single market. A European unemployment scheme may promote labour market harmonisation

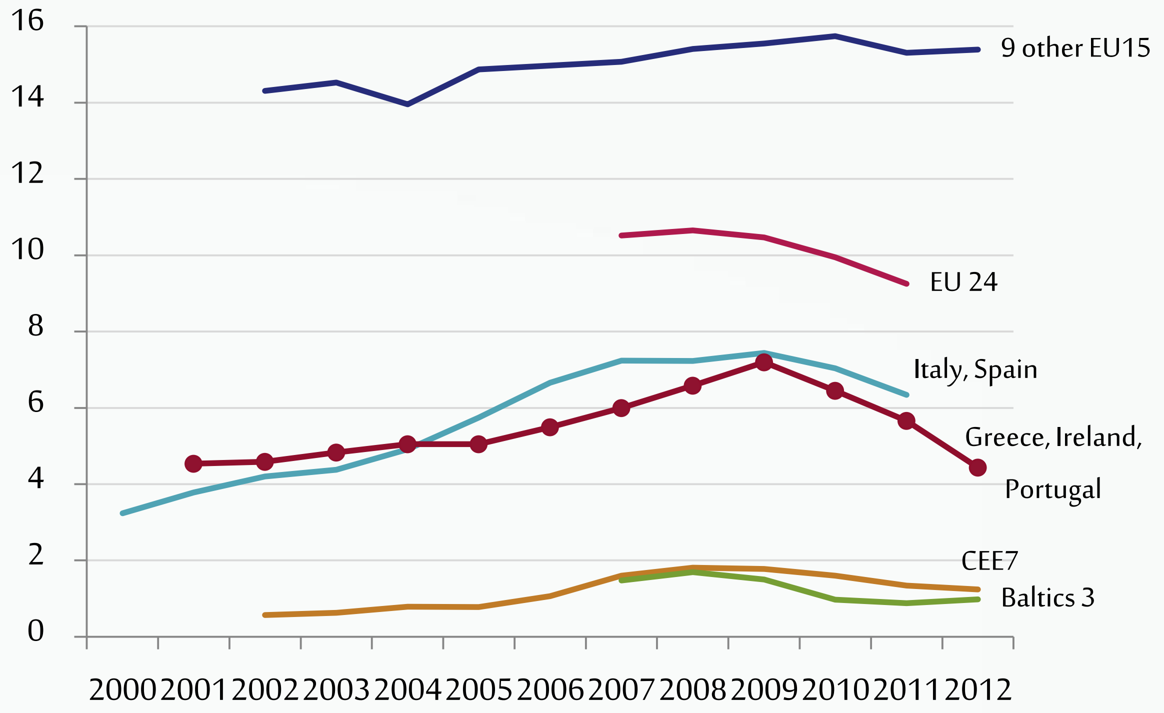
→ How important are these reasons and what are the counterarguments and pitfalls?

Stabilisation: Is the current framework sufficient?

- **EU fiscal framework: constructed on the principle of de-centralized fiscal policy.**
  - The idea of the Maastricht treaty was to have budgets under control in good times to give fiscal space in bad times to let automatic stabilizers work at the national level
  - EU budget: limited (1% of GDP) and not designed for cyclical stabilization
- **In the crisis, approach broadly worked but two problems arose:**
  - Insufficient stabilization at euro-area level in second phase of crisis
  - Some countries reached their fiscal limits more quickly than anticipated, also due to private sector problems → As a result, automatic stabilizers did not operate freely in countries with the sharpest fiscal adjustment
- **Other stabilization mechanisms such as labour mobility and cross-country financial integration underdeveloped compared to "optimal" monetary union**

Stabilisation: a role for a European Unemployment Insurance Scheme?

Unemployment benefit payments per number of unemployed, *EUR thousands per year*



Two main reasons for the reduced benefit/person:

- **More long term unemployment (who receive less or no benefit)**
- **Reduced benefit/person for short term unemployed**

Note: Unemployment benefit payments per number of unemployed, € thousands per year

Source: Darvas and Wolff (2014) based on Eurostat.

Stabilisation: a role for a European Unemployment Insurance Scheme?

- **Size of macroeconomic stabilization coming from unemployment schemes is variable**
- **In USA, the stabilization effect by federal-state system of unemployment insurance on regional shocks is rather small:**
  - Asdrubali et al. (1996) find only limited role, whereas Chimerine et al. (1999) show a more significant one.
- **Important elements to consider:**
  - Size of stabilization effect depends on parameters of the programme (coverage rate, replacement rate, duration, etc.) and the multiplier effect.
  - Unemployment insurance of a limited size (1% of GDP)
- **Simulations of different European Unemployment Insurance schemes proposed in the literature show potential annual transfers to countries in deep recession of around 1%-2% of GDP (e.g. Dolls et al. 2014).**

Solidarity?

- **Treaty on the European Union:**
  - "Solidarity" is a value on which the Union is built and the Treaty aims "to deepen the solidarity between peoples" and "to promote economic, social and territorial cohesion, and solidarity among Member States" (Preamble and Articles 2 and 3)
- **Four Presidents report (2012):**
  - "Establishing a well-defined and limited fiscal capacity [in the euro area] to improve the absorption of country-specific economic shocks, through an insurance system set up at the central level."
- **Italian Presidency of the Council of the EU (2014):**
  - "Special attention will be paid to the issue of automatic stabilisation through discussions on the possible establishment of an EMU-wide unemployment benefit system as a tool for asymmetric shock absorption at central level"

→ Political consent would be needed on whether more solidarity is wanted and whether a EUI is the best way to do so.

Heterogeneity of labour market institutions

- **Great heterogeneity of labour market institutions**
  - Reflects long historical divergences
  - Some systems are less efficient than others
  - Some systems are better or worse adapted to the necessities of monetary union
- **Institutions interact with others (active labour market policies, early retirement?, corporate governance?)**
- **Mobility:** similar labour market institutions could foster labour mobility
- **Efficiency:** converging to an efficient model would be a major improvement
- **Single market:** similar labour market institutions could reduce the administrative costs of corporations and foster a more efficient allocation of capital

→ A European unemployment scheme could be conditioned on labour market harmonisation

Arguments against a European unemployment insurance

- **Other instruments could be more powerful for regional as well as aggregate stabilization and could be automatic**
  - Larger European investment facility
  - EU budget could be redesigned by eliminating inefficient items in favour of stabilization
- **While solidarity is mentioned in the Treaty, the Maastricht treaty was designed explicitly to avoid fiscal transfers in monetary union**
- **Heterogeneity in labour markets also reflects country preferences**

Potential difficulties in constructing a European Unemployment Insurance

- Difficulty of harmonizing labour market institutions (conceptually and technically)
- Moral hazard/free riding problem: Potential negative incentive effects on labour market reforms as well as pension and health care reforms.
- Treaty reform would be desirable to establish the right democratic legitimacy of such a scheme
- Due to the lack of possible state subsidies to the European Unemployment Scheme, contribution rates (paid by employees and/or employers) could be higher than today, which may cause resistance
- Current importance of social partners involvement at the national level would have to be shifted to the European level

Key choices for Europe

- **EU or euro area?**
  - Stabilization, solidarity and labour market harmonization issues apply to all EU countries
  - Yet, monetary union has specific stabilization requirements
- **Permanent transfers?**
  - If not, country specific contribution rates need to differ to ensure that there is no expected transfer between countries in the long run
  - System is technically complicated as assessment of "structural" unemployment needs to be made
- **Borrowing facility or not?**
  - To play a stabilization role in case of a euro area wide shock, borrowing facility would be needed
  - In a system without borrowing facility, if the fund is depleted, then either unemployment benefits have to be cut, or the participating countries have to subside the fund, which could mean transfers from a country with mild recession to a country with severe recession

Key choices for Europe

- **All-time or catastrophic insurance?**
  - All-time insurance: requires larger contributions to the common fund
  - Catastrophic insurance: if rules based → difficulties in defining the trigger and the sunset; if discretionary → what governance?
- **What duration?**
  - If only short-term: the stabilisation impact would be rather small
  - If longer term too: risks permanent transfers to structurally unemployed and could create incentives for black economy
- **What replacement rate?**
- **What interaction with social partners?**

Key choices for Europe

- **Should the harmonisation of labour market institutions be sought?**
  - If not, country-specific contribution rates should reflect the structural differences in labour market institutions (i.e. contribution rates should be higher in countries with less efficient labour markets) and even then moral hazard problems could arise
  - If yes, difficult to specify the desirable standards, but also a big opportunity for fundamental labour market reforms
- **Would a common scheme require a common administration?**
  - Without common administration, implementation is likely to be heterogeneous, creating serious moral hazard problems
  - Efficiency gains from a reformed administration could be high and labour market matching across Europe would be facilitated
  - Extremely ambitious reform
- **A scheme for now or for the future?**
  - Is it possible to create such a scheme fast enough to support those in need now?

Conclusions

- **A EUI could enhance macroeconomic stabilization, solidarity and labour market convergence**
- **It would be a huge step, perhaps bigger than creation of banking union** (long and demanding political negotiations, involving many stakeholders, such as social and labour ministers, finance ministers but also unions and employers' associations)
- **While stabilization function and deepening solidarity are relevant arguments, the most important question is about the convergence of labour markets.**
  - Stabilization effect of labour insurance could be small if badly designed
  - Stabilisation in catastrophic recessions could be achieved more simply by a sizeable European investment programme
  - Towards a much more efficient and integrated European labour market.
- **Could become a strong political signal that the euro area progresses on the way to a more complete monetary union.**

Thank you for your attention!

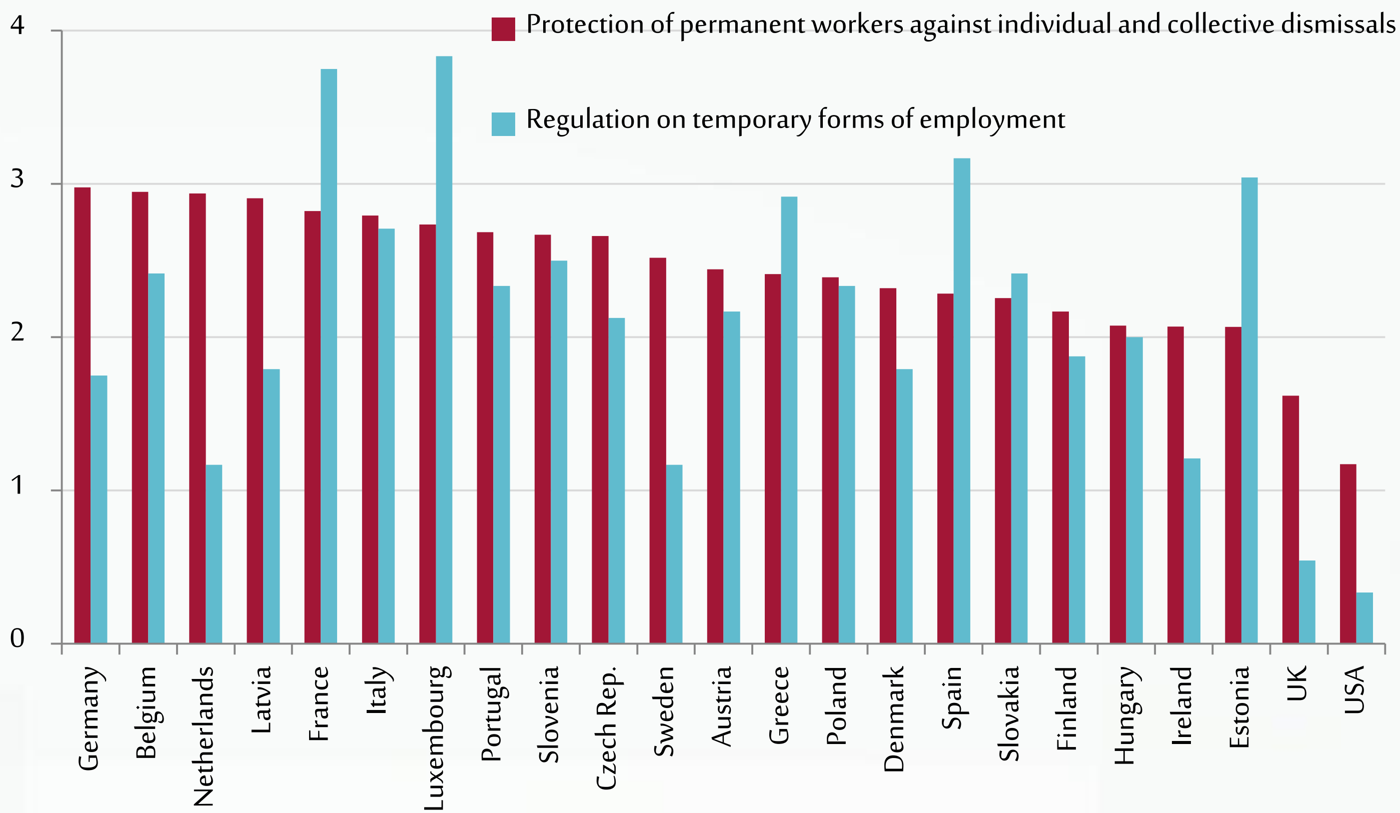
Grégory Claeys, gregory.claeys@bruegel.org

Zsolt Darvas, zsolt.darvas@bruegel.org

Guntram B. Wolff, guntram.wolff@bruegel.org

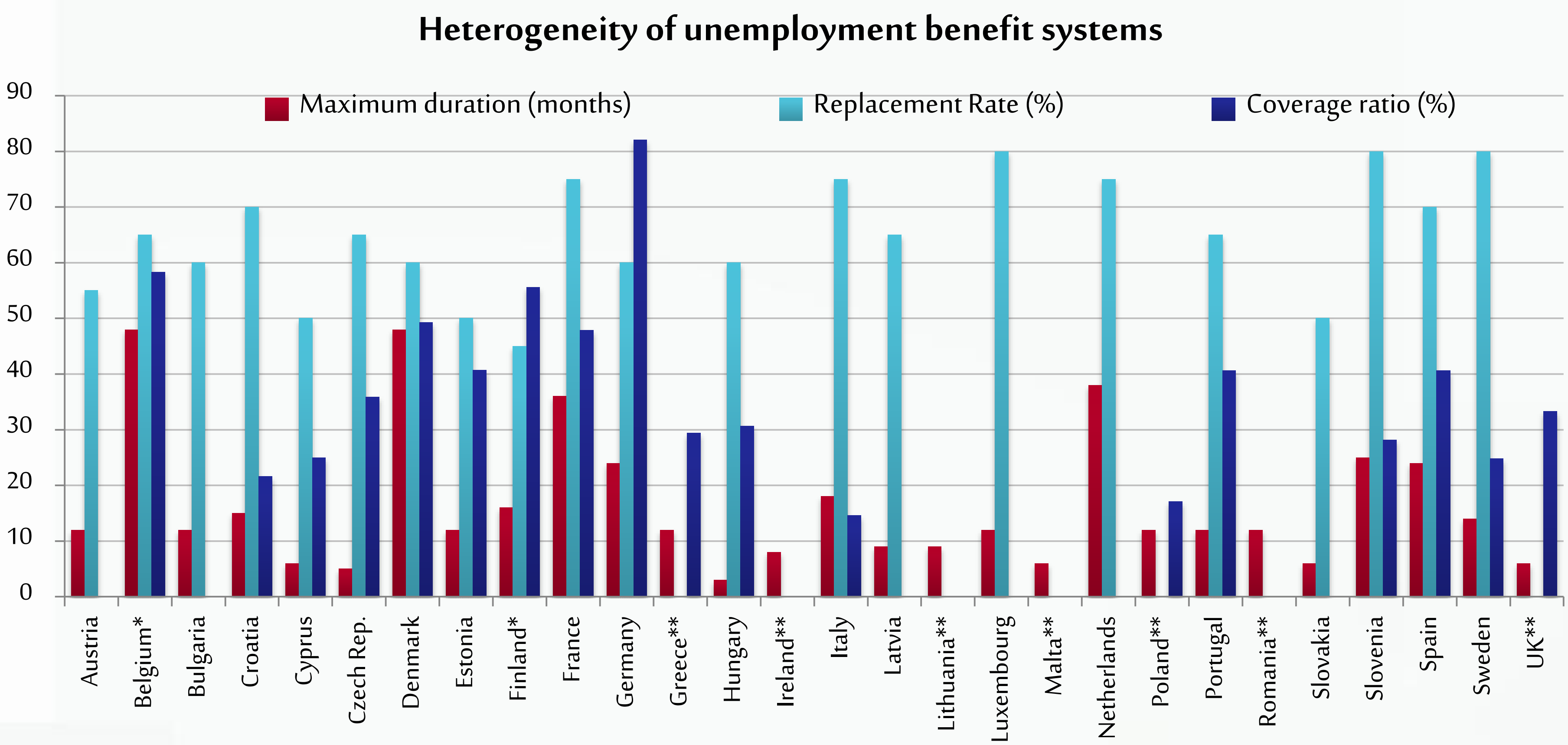
ANNEX: Heterogeneity of labour market institutions

Heterogeneity of labour market institutions



Source: OECD.

Heterogeneity of labour market institutions, cont'd



Source: European Commission and National Authorities.

Maximum Duration: The maximum duration of benefits an unemployment person could receive. Countries marked with * provide an indefinite unemployment stipend after other benefits have been exhausted.

Replacement rate: Represents initial percentage of wage provided by benefits. Many countries reduce the percentage over time. Countries marked with ** provide flat rates of insurance coverage.

Coverage ratio: number of unemployed receiving benefits over total unemployed

Proposals currently discussed

Two polar proposals:

- **Basic unemployment scheme:**
  - at all times, a European fund provides unemployment benefits to short-term unemployed
  - at a specified (lower than in most countries) wage replacement rate
  - which can be topped-up by national systems both in terms of the level of benefits and the duration
- **Catastrophic insurance**:
  - the European fund pays benefits only when the unemployment rate increases significantly

There are various design options in both cases

Inspiration from the US unemployment benefit schemes

- **Regular Unemployment Compensation Programme (provided by states):**
  - 26 weeks in most states
  - Funded by payroll taxes on employers (and on employees in a few states)
  - Federal fund with state compartments; if accumulated amount in the fund's compartment is not sufficient, then state can borrow from the federal fund, but must fully repay loans + interest within two years or the benefit from the federal fund will be decreased requiring
- **Emergency Unemployment Compensation (federal):**
  - Special extended benefits in states with high unemployment
  - additional weeks is determined by specific legislation
  - funded by the general revenues of the federal government; enacted by special legislation the state to fill the gap with a state tax
- **Extended Benefits Scheme (state and federal):**
  - Extends duration of benefits for 13-20 additional weeks if unemployment rate hits triggering rate in a given state (for those who have exhausted their regular and emergency unemployment compensation)
  - Typically funded 50/50 by state and federal, but 100% funded at federal level during the most recent recession.

Literature

Asdrubali, P., Sorensen, B.E. and Yosha, O. (1996) ‘Channels of Interstate Risk Sharing: United States 1963-1990’, The Quarterly Journal of Economics, Vol. 111(4), 1081-1110

Chimerine, L., Black, T. and Coffey, L. (1999), ‘Unemployment Insurance as an Automatic Stabilizer: Evidence of Effectiveness Over Three Decades,’ Unemployment Insurance Occasional Paper 99-8, (Washington, D.C.: U.S. Department of Labor, Employment and Training Administration)

Darvas and Wolff (2014), Europe‘s social problem and ist implications for ecomomic growth, Bruegel Policy Brief for informal ECOFIN

Dolls, M., Fuest, C, Neumann D., Peichl A. (2014) An Unemployment Insurance Scheme for the Euro Area: Evidence at the Micro Level