Macroeconomic stabilisation of the Eurozone: is a European unemployment insurance scheme the answer?

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Although there is a broad consensus that the deepening of economic and monetary union in Europe (EMU) should include new fiscal instruments able to play a role in macroeconomic stabilisation, agreement on the design and scope of mechanisms to achieve this has been elusive. Several recent political initiatives have sought to pave the way for the introduction of a new mechanism, but they have struggled to gain traction.

A European Unemployment Insurance Scheme (EUI) has regularly been among the options canvassed. Its aim would be to provide an instrument linked to divergence of the unemployment rate from an agreed benchmark, with two main aims. The first is macroeconomic stabilisation and the second is the social goal of acting directly to mitigate the adverse social consequences of a cyclical downturn. These two aims also constitute a form of risk sharing, with all the political economy complications this engenders. This paper examines whether and how EUI could work.

The case for European Unemployment Insurance

There is a long history to the idea of EUI, although it is primarily its prospective function as a stabilisation instrument that has been the rationale for it. Thus, in a major European Commission study entitled The Economics of Community Public Finance, published in 1993, a chapter by Italianer and Vanheukelen was devoted to explaining a stabilisation scheme linked to variations in the unemployment rate. They argued that a relatively modest fund could play an effective role in EMU, but their resort to the unemployment rate was because it was a quickly available indicator of cyclical fluctuations, rather than because of an overt social objective.

Latterly, EUI has been advocated by, among several academics, Sebastien Dullien, who asserts that it “would provide a rather sensible and straightforward way to improve economic governance of EMU”, and draws parallels with the US where federal level insurance has a crucial role in supporting state-level policies. While Dullien mentions the importance of maintaining the flow of resources to the individual, he also highlights the need to avoid reducing incentives to seek work. EUI was also the subject of a major study undertaken by researchers at the Centre for European Policy Studies (CEPS). Their background work identified proposals for a large number of variants on EUI, of which 18 were studied in depth. While stabilisation is again the primary rationale, they explicitly relate EUI to social objectives, principally the extension of coverage of unemployment benefits and the wider social dimension of European integration.

The idea was further promoted by Laszlo Andor, during his tenure as European Commissioner for Employment, Social Affairs and Inclusion up to 2014, and has since featured in several recent sets of proposals for reform of economic and monetary union. For example, the Reflection Paper published


2 https://www.ceps.eu/content/feasibility-and-added-value-european-unemployment-benefit-scheme
in May 2017³ proposed EUI as one of two viable options for stabilisation – the other was a fund to protect investment rates; it also mentioned a so-called ‘rainy day fund’, but with less enthusiasm.

Former Italian Finance Minister Pier Carlo Padoan put forward an outline for a scheme in 2015⁴ in which he maps out some of the relevant choices. He notes the existence of a plausible legal basis in article 136 or 175 of the Treaty, both of which relate to enhancing economic policy coordination. He is explicit that the rationale has to include modernisation of the social model and facilitating adjustment, but also stresses that even net contributors potentially gain from the improved macroeconomic stability provided by a suitable stabilisation mechanism. He speculates, further about whether a well-conceived EUI could encourage reform, rather than (as the often expressed moral hazard argument has it) deterring it. The obvious implication is that a balance has to be struck in the design.

Potential forms of stabilisation instruments

What any fiscal stabilisation mechanism can realistically provide will depend on its scale, the mandate given to it and terms on which it can be accessed, and the incentives for using it in preference to other means of dealing with an economic shock.

Clearly, if an instrument has only a modest financial capacity, it will be incapable of acting to counter a ‘symmetric’ shock affecting all (or most) countries participating in the scheme, but may have value for an ‘asymmetric’ shock only affecting one or two participants. In practice, too, a modest scheme may be suitable for small countries, but ill-suited to larger ones. Concerns about whether even the substantial credit line of the European Stability Mechanism (ESM) would suffice to deal with one of the larger Eurozone members exemplify the latter point. The 2015 package for Greece, an economy accounting for under 2% of Eurozone GDP, provided for loans of up to €86 billion, representing 17% of the ESM’s notional €500 billion capacity and close to 40% of Greek GDP in 2015. Even if it is accepted that the Greek case is exceptional, the entire firepower of the ESM is equivalent to only about a quarter of the GDP of France or Italy.

The mandate for a stabilisation instrument is tricky for a number of reasons, not least because in the Eurozone context, there is necessarily a cross-border dimension to any support: in emotive terms, one country’s tax-payers are being called on to bail-out another’s. Net contributors to the system typically want to limit their risk of not being repaid and to insist on strict rules for accessing it. This translates, inter alia, into questions of the duration of the support, the terms on which it is offered and limits on the explicit or implicit fiscal transfer involved. Very favourable loan terms, for example, provide the recipient government with a net gain compared with prevailing market rates for the borrowing they would otherwise have to undertake. According to the ESM web-site, the Greek public finances in 2017 were better off by as much as 6.7% of GDP because of the low interest rates payable on ESM loans.

Then there is how to limit the support to prevent it becoming a permanent system of transfers (a distributive aim which is not necessarily compatible with the stabilisation objective). The rationale

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for a stabilisation policy is to counter a temporary shock, but while this involves a fiscal transfer in the short-term, it becomes something different if it endures. A true stabilisation instrument should work in both directions, including by transferring from poorer to richer participants if the conditions were met. Moreover, political economy considerations will loom larger if some countries are seen to be persistent takers while others only give.

Lack of convergence of real business cycles can be an additional justification for a top-down stabilisation instrument, but there is also a danger of confusion in objectives. Net transfers could improve the synchronisation of business cycles across counties, rendering the conduct of monetary policy easier. However, a concern is whether a net inward transfer would reduce the incentives for a country to adopt policies to improve its resilience against shocks. This is a well-known phenomenon in insurance markets, although there can be a counter-argument that insurance allowing economic agents to take measured risks is often advantageous.

A recent study by Gerrit Koester and David Sondermann\(^5\) of the European Central Bank examined the stabilising effect of a range of instruments, including an EUI, posing a number of key questions. A first is whether any new mechanism would be new capacity or just a diversion of existing national stabilisers – the latter would have, at best, limited impact. They dwell on how the probability of receiving support from the fund is understood, because of the link with moral hazard: in essence, if there is an equal probability over time of all participants drawing from the Fund it will be more politically acceptable. However, their analyses of different plausible variants suggest most would lead to permanent transfers and thus be vulnerable to moral hazard objections. Similar concerns are expressed in a paper by researchers on the ADEMU project\(^6\).

A further point noted by Koester and Sondermann is that fiscal multipliers may be higher in countries facing an asymmetric downturn than in those in a more buoyant phase of the economic cycle. As a result, a net transfer from the latter to the former would boost aggregate GDP. To the extent that short-term unemployment is a good proxy for such variability in national economic cycles and the level of unemployment benefit expenditure adjusts automatically to cyclical fluctuations, it makes sense to anchor a stabilisation system on unemployment rates.

**Heterogeneity in labour market conditions and institutions**

Differences in how national labour markets function will affect the manner in which any mechanism linked to unemployment functions. EU Member States all have distinctive provisions for supporting the unemployed, with some offering relatively generous replacement incomes, while others have more limited schemes, with tougher eligibility criteria. They also differ markedly on the extent to which they embody active labour market policies aimed at raising employability. Such differences make it trickier to gauge what level of unemployment signals a cyclical shock and its magnitude.

One of the legacies of the years of crisis has been a pronounced divergence in unemployment rates. As figure 1 shows, the range in the Eurozone prior to 2008 (average of the years 2005-7) was

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\(^6\) [https://repositori.upf.edu/bitstream/handle/10230/27718/Ademu-WP-048-2016%20An%20Unemployment%20Insurance%20Scheme%20for%20the%20Euro%20Area.pdf?sequence=1](https://repositori.upf.edu/bitstream/handle/10230/27718/Ademu-WP-048-2016%20An%20Unemployment%20Insurance%20Scheme%20for%20the%20Euro%20Area.pdf?sequence=1)
between 4.2% in Denmark and 13.8% in Poland and Slovakia. Figures for the most recent quarter show the substantial widening of the range – from 2.3% in the Czech Republic to 18.8% in Greece – as well as some striking developments. Thus France and Germany had the same rates going into the crisis years in 2008, but with the latter now close to full employment (3.4% in Q3 2018), the comparison is highly unflattering for France (9.0% in the same quarter). Greece was exceptionally badly affected, but the negative developments in other southern member states are also noteworthy: unemployment rates are in double figures in Spain and Italy, as well as Greece, and nearly all the rise in European unemployment has been in the South. By contrast, rates in other central and eastern Europe, are mainly clustered around the 5% mark and have declined substantially, as in Germany.

A different tack is taken by other ADEMU researchers: the authors identify labour market reforms – including a less generous unemployment benefit – as a potentially more effective way of lowering the high unemployment rates affecting some countries. They nevertheless believe a European level scheme could facilitate labour market reform and thus be “an important cohesive EU institution”.

**Figure 1 Unemployment rates pre and post crisis (%, ranked by change over the period)**

![Unemployment rates graph](source: Eurostat)

Note - latest figure is Q2 2018 for the UK and Greece

**Political considerations**

Fiscal policy tends to be politically sensitive, implying that care will be needed in ensuring that any new stabilisation instrument is appropriately legitimated. Such sensitivities also characterise benefits at the heart of national welfare states, with distinct national norms and preferences evident in how they are designed and implemented. It follows that any unemployment insurance scheme with cross-border incidence will have to accommodate these distinctive expectations.

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The tone of two political declarations in 2018 is instructive. Support for a new stabilisation instrument was articulated in the *Madrid declaration* in which the Spanish and French governments emphasised its potential role in stabilisation and highlighted the need to “complement national fiscal stabilizers in countries hit by a large economic shock, avoiding an excessive adjustment burden on national budgets and the associated social costs”. While the language is cautious, it clearly advocates cross-border transfers.

By contrast, the *Meseberg declaration* from the French (again) and the Germans is more circumspect. “We will examine the issue of a European Unemployment Stabilization Fund, for the case of severe economic crises, without transfers. France and Germany will set up a working group with a view to making concrete proposals by the European Council of December 2018. Strategic decisions on the Eurozone budget will be taken by the Eurozone countries.”

Despite this raising of expectations that decisions would be made, the December 2018 European Council confined itself to calling for further work by the Eurogroup on an instrument for competitiveness and convergence. While this does not rule out an EUI for stabilisation purposes, it illustrates the continuing ambivalence of the Eurozone’s leaders about what sort of instrument to adopt. Behind this is an interpretation of what would be accepted by tax-payers, especially in those countries most likely to be net contributors to any putative scheme.

However, a study by researchers at the University of Amsterdam, based on a cross-country survey of public opinion, suggests citizens may be more receptive to an EUI than is implied by the hesitation of politicians. While a relatively small minority of respondents expressed strong opposition, there was broad support for a scheme provided it meets certain design requirements. Citizens favour generous schemes if they include provision of training and require claimants to be subject to conditions, such as accepting job offers. Support is weaker in North-West Europe than in the South or Centre-East, perhaps reflecting predictable national preferences. In an interesting finding, which belies the positions of their respective governments, French respondents were less supportive than Germans, suggesting a need to delve more deeply into how these preferences are formed.

Intriguingly, the study does not find citizens opposed to a scheme likely to entail cross-border fiscal transfers, although citizens prefer decentralized rather than supranational mechanisms. The findings also suggest less enthusiasm in countries where unemployment is low. The inference drawn by the Amsterdam research team is that this points to a reinsurance model for national schemes, not one substituting for them. However, some of their findings – in what is a methodologically complex approach – do need to be interpreted with caution because of uneven support across categories of countries.

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10 [http://aissr.uva.nl/content/news/2018/12/eurs.html](http://aissr.uva.nl/content/news/2018/12/eurs.html)
**Possible forms of an EUI: issues to confront**

The profusion of recent work on an EUI identifies a number of ways it might be implemented, taking into account a range of issues to be resolved. There is clearly support both for having a strengthened stabilisation capacity in the EU and, despite some reservations, for an EUI to be one of the favoured options. Several critical issues nevertheless have to be confronted for it to come to fruition, some technical, some much more political. The technical dimension has been extensively covered in the rich range of analyses, such as those by CEPS, the ECB and the contributors to the ADEMU project.\(^\text{11}\)

Several aspects of the design of an EUI have to be considered. Eligibility is crucial both in determining what the scheme is to cover and its political acceptability. A first question is whether it should be only for Eurozone members, presumably on a mandatory basis, or (as with banking union, one of the more successful governance developments in response to the euro crisis) be open on a voluntary basis to others. Confining it to the Eurozone would be the most coherent answer, because a stabilisation mechanism can be understood as part of the governance of the euro and, with increased attention being paid to the social consequences of EMU, consistent with current reform ideas. From this perspective the political as well as financial acceptability of support is likely to be more emphatic than what might be predominantly a solidarity argument for other EU members.

The trickiest issues will be around how to determine when payments from the scheme are triggered. The wide variations in national unemployment rates partly reflect structural differences in labour market structures. The persistently high rate of unemployment in Spain, for example, is affected by regional disparities and other rigidities affecting the ability of the labour market to match unemployed with vacancies. Because of such rigidities, the rate of unemployment consistent with macroeconomic equilibrium is higher than elsewhere.

This notion of the NAIRU (non-accelerating inflation rate of unemployment) has its critics, who argue that it can be misleading. A refinement canvassed by several contributors to the debate could be to focus on short-term unemployment, on the grounds that it is more directly affected by cyclical fluctuation, whereas long-term unemployment stems from labour market rigidities. But the boundary between short-term and long-term is fluid, and labour market institutional features such as the speed with which benefits are paid or the public employment service can assist someone who loses a job will alter the level of short-term unemployment.

Nevertheless, for any EUI system to work, some sort of threshold is needed, and may mean a relatively crude formula balancing the level of unemployment of different durations and the change from an agreed benchmark. Viable examples are provided by, among others, the CEPS and ECB researchers cited above. It could also be achieved by using other sorts of indicators of the economic cycle. For example, the ‘output gap’ is an alternative, but is beset by its own methodological difficulties, both in conceptual terms and in the econometric techniques used to estimate it.

The scale of support needed to make a genuine impact and what is politically acceptable to countries fearful of being persistent net contributors may be incompatible. In a simple variant, EUI could be no more than a cash payment to unemployed individuals, essentially a passive transfer. However, when labour market policy has become much more orientated towards active policies aimed at a quick return to employment, this would be a retrograde approach. An option could be to

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11 Op cit.
limit the role of an EUI to larger, but rarer, interventions, leaving smaller-scale stabilisation to the national arena. This would also have the attraction of simplifying agreements on thresholds. As Daniel Gros has argued, there is little to be gained from a system that ‘offsets all shocks by some small fraction ... [because they can] ... be dealt with via borrowing at the national level’.

This leads on to the matter of whether an EUI should be a substitute for national systems, a complement or a form of reinsurance only called when the ability of the national system to cope is compromised. Under a logic of top-down stabilisation, it would make sense to pool resources into a common fund, thereby emulating what happens in most nation-states where unemployment insurance is a central competence and acts automatically to stabilise regions subject to asymmetric shocks. But at European level, such an approach would face such strong political objections that it is implausible without decisive – and even less plausible – steps towards political union.

There will be politically sensitive questions about how any EUI should be administered. These might be thought of as of second-order importance provided the economics of an EUI are well-conceived, but experience suggests the institutional arrangements matter. Inter-governmental deals are somewhat easier to organise (witness how the ESM was established) than full incorporation into the EU legal order, but a logical approach would be to assign responsibility to the European Commission. Various practical issues will also need to be settled. Automaticity may be desirable in triggering payments, but can create resentment on the part of net contributors. Such resentment can be attenuated by the imposition of conditionality, but as the push-back by the Italian government against budget rules shows, conditions can also foster resentment. There is, too, a potential drawback of stigmatisation: being bailed-out is perceived as a form of failure by governments and this sense will be exacerbated by tough conditions on receipt of the support.

Unemployment benefit payments vary hugely over time and across countries. According to OECD harmonised data, using a definition of ‘expenditure on cash benefits for people to compensate for unemployment’ (it includes redundancy and early retirement payments), the highest public cost over the last three decades were in the early 1990s in Finland and Spain: around 4.5% of GDP. At the other end of the scale, payments have been 0.1% of GDP or lower in several countries, such as Denmark where the approach of active labour market policies means virtually no ‘passive’ unemployment benefit is paid. In 2015, the range among Eurozone members of the OECD was from just under 3% of GDP in Belgium and 2% in Spain to barely 0.2% of GDP in Lithuania and 0.5% of GDP in Greece. The corresponding figure for the US was 0.2% of GDP.12

It follows from these data that even in the highly unlikely event that the EU level took over a significant proportion of the costs, the aggregate scope for using unemployment benefits for stabilisation purposes would be limited. The politically much more plausible option of the EU fund topping-up national systems – reinsurance – will require a number of choices to be made. A good overview of some of the key parameters of an EUI is provided by Koester and Sondermann.13

Drawing on a range of prior studies they note the following:

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12 Eurostat data, using a broader definition of unemployment benefit, put the outlays for the EU as a whole at 1.4% of GDP in 2014, but this figure is not directly comparable with the US figure from the OECD.

13 Op cit
The focus should be on changes in short-term unemployment fluctuations, on the grounds that they best capture cyclical fluctuations.

An EUI should have common replacement rate – with most proposals suggest around 40-60% of earnings. Although Koester and Sondermann explain why this makes sense from a perspective of fairness to claimants, they do not mention the possible unfairness from a cross-border perspective. If there are big differences in median wage (and price) levels.

EUI should be fiscally neutral in the medium term, but able to borrow in the short-term

The literature discusses very varied triggers, including deviations from median values among participating countries, taking account of estimated equilibrium unemployment rates (NAIRU concepts) and others.

Transfer should be limited to 1% of recipient country GDP.

While in direct schemes, money flows straight to the unemployed resulting in a boost to spending power of consumers, a reinsurance scheme is more complex because the transfer would be to government agencies. This raises question of whether there should be an obligation to spend (tantamount to the additionality principle in cohesion policy).

The degree to which the recipient country, (but clearly not the individual claimant) has to refund the amount drawn also has ramifications. Claw-backs can limit the stabilisation properties.

Taking account of labour market rigidities is a particular challenge.

The aggregate stabilisation effect is very limited in the Eurozone as a whole, according to Koester and Sondermann because some members are most often net contributors and some net recipients. A small net growth stimulus nevertheless arises because of differential multipliers that mean a greater boost to demand in recipient countries than in the loss in contributor ones. However, the stabilisation impact is not necessarily anti-cyclical for some participating countries when there is a common shock, if those less affected by the shock are, in effect, penalised by having to make net contributions to the EUI, thereby amplifying their own shocks.

Conclusions

A common stabilisation mechanism would undoubtedly add to the range of policy instruments for the euro, but should not be regarded as a panacea because the effectiveness of such an instrument is likely to be limited, depending on the nature of the shock it is intended to alleviate. From a purely stabilisation perspective, what matters is the speed with which an instrument provides its counter-cyclical impact and how well it targets the area subject to a shock. An EU level instrument on any plausible scale is unlikely to be powerful enough to make a realistic difference to a symmetric shock, such as during the 2008-9 financial crisis. The alternative of coordinated action is more realistic.

But if the primary purpose is to deal with shocks confined to one or two member states, a new instrument would have the potential to make a difference. There is manifestly support for some form of Eurozone fiscal stabilisation mechanism and, specifically, for one based on unemployment insurance. For this reason, an EUI would be a good option, because its underlying premise would be to receive inflows from buoyant economies and to pay out to those in difficulty. There could be challenges as well about consequences for the unemployed, including whether there should be restrictions on which individuals are eligible. But such questions are not much discussed.
However, there is much less of a consensus on the scale, design and implementation of such a mechanism, implying it will struggle to make progress. This conjunction is something of a paradox because it means an acknowledged gap in economic governance is not easily going to be filled. But the technical challenges of designing a scheme are manageable; instead, the lack of enough political will is the principal obstacle. Political realism suggests the best way to implement it would be some form of reinsurance model in which the EU/Eurozone level only intervenes once the national system has exhausted its capacity. This implies a mechanism focused on larger, asymmetric shocks, not minor cyclical fluctuations. It also means setting the eligibility threshold at a high level, with the corollary that the mechanism would intervene relatively rarely, making it a backstop.

How, then, could the apparent deadlock be broken? Political declarations (such as those of Madrid and Meseberg, discussed above) have their place in setting the agenda, and preparatory work by the likes of the Eurogroup Working Group is both necessary and valuable in refining the options. But for EUI to make real progress, it will need political decisions and more strenuous efforts to align the incentives for opposing camps.

The Vatican’s “conclave” methodology may be the answer, at least metaphorically: lock the finance ministers in a room until they can agree on the broad outline of a viable scheme...