An Unemployment Re-Insurance Scheme for the Eurozone? Stabilizing and Redistributive Effects

Summary of the study

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Introduction

The debate on eurozone reforms has gained fresh momentum in 2018: The German and French governments put forward reform proposals for the euro area in the joint Meseberg declaration in June and agreed on a common eurozone budget in November. One building block under discussion is a fund to stabilize national unemployment insurance schemes. In October, the German Federal Ministry of Finance (BMF) outlined one such re-insurance scheme. The basic idea behind the BMF proposal is to grant loans to national unemployment insurance systems in times of severe economic crisis in order to avoid aggravating (i.e., "procyclical") cuts in payments (benefits) to the unemployed or increases in contributions while the crisis lasts. This would create a re-insurance system for national unemployment insurance schemes designed to strengthen their role as "automatic stabilizers" and making the eurozone more resilient in times of crisis.

Reform proposals are also being discussed in academia. Recently, a group of 14 prominent French and German economists put forward a set of reform proposals designed to strengthen both market discipline and risk sharing in the euro area (Bénassy-Quére et al. 2018). Under this proposal, the latter could be achieved by a stabilization fund financed by contributions from the member states that would offer aid in major crises. However, the proposal stipulates that these payments should take the form of temporary transfers and not, as in the BMF proposal, loans. Criticism of a fiscal capacity is voiced in the annual report of the German Council of Economic Experts (Sachverständigenrat 2018). This would lead to misguided incentives and a "transfer union through the back door". The annual report contains a minority vote by Isabel Schnabel, who would under certain conditions countenance an unemployment re-insurance scheme that is incentive-compatible. All council members emphasize that evaluation studies on the expected effects of such an instrument are required so as to be able to weigh more soundly the positive and negative consequences.

The study summarized here is the first analysis to evaluate an unemployment re-insurance scheme for the euro area as regards potential stabilizing and redistributive effects. The results show that such a scheme can stabilize economies in the euro area and could thus contribute to cushioning large labor market shocks. More specifically, this study runs a series of simulations to show that an unemployment re-insurance scheme would have had a counter-cyclical effect in all euro area countries during the simulation period and would not have led to permanent transfer payments. The novel feature of the study is that it separates the stabilization effects of the unemployment re-insurance scheme into two channels relevant to the current political debate: First, it indicates the potential for stabilization through payments between countries (so-called interregional stabilization). Stabilization through this channel arises because labor market fluctuations differ across countries, i.e., shocks are not completely "symmetric". Second, the study estimates the so-called intertemporal stabilization potential. This channel describes the stabilization that member states can achieve when taking out loans in times of crisis and repaying them in good times. Thus, this channel is indicative of the stabilization potential of loan-based re-insurance models as set out in the BMF proposal. The distinction between the two stabilization channels is crucial for assessing the possible value added of different reform options. Intertemporal stabilization can be achieved through national debt or through financial assistance programs of the European Stability Mechanism (ESM) in the case of loss of market access. By contrast, interregional stabilization only arises by pooling contribution payments within a common fund and disbursing transfers from it if a member state is hit by a large labor market shock.

Methodology

The study uses Eurostat household micro-data from the European Labour Force Survey (LFS) and from the EU Statistics on Income and Living Conditions (SILC) to analyze labor market developments and the resulting income fluctuations in the 19 current euro area member states over the period 2000-2016. The study runs simulations to calculate the stabilization and distribution effects of the stabilization fund (the re-insurance) on the assumption that it would have been introduced for the euro area in the year 2000.

The following limitations of the analysis must be taken into account when interpreting the results: The analysis assumes that in the counterfactual scenario (i.e., with the fund in place) labor markets would have evolved in the same way as actual labor markets in the euro area did. If the macroeconomic stabilization effect of the fund had led to more favorable labor market developments, the financial flows could have been lower than shown in the study. Conversely, if the fund had led to negative incentive effects in the member states and consequently to less favorable labor market developments, the financial flows would have been greater. A further simplifying assumption in the simulations is that the stabilization fund would have been available to all 19 current member states over the entire period under review. That is, the study assumes that all 19 consent to and qualify for the scheme.

The stabilization fund analyzed in this study is designed as a re-insurance scheme for domestic unemployment insurance systems. In the simulations, it is financed by contributions paid by the member states in times of declining unemployment, while payouts are only made in the event of major labor market shocks. In years with severe shocks, the risk is highest that national fiscal policy would be constrained and unable to provide sufficient stabilization. The empirical analysis stipulates two conditions to be met before any payouts from the re-insurance scheme are triggered. First, the unemployment rate in a member state must be above the average of previous years. Second, the unemployment rate must rise sharply within a single year. These two conditions ensure that the fund is only "activated" during major economic crises. The study considers two variants with threshold values for the required rate of change in the unemployment rate of one and two percentage points. The level of the payment to national schemes is determined by the additional expenditure on unemployment that an average unemployment insurance scheme would have to bear in the corresponding year. As with typical insurance systems, payments received do not have to be repaid in subsequent years. A re-insurance scheme of this kind would have a countercyclical effect during booms and downturns and would prevent large labor market shocks from leading to increases in contributions or cuts in domestic unemployment benefits.

Results

The simulations show that unemployment re-insurance would have cushioned major labor market shocks in the euro area and the associated loss of income for employees by an average of 15 to 25 percent since the introduction of the euro (see table below, column "Interregional"). In the crisis year 2009, the scheme would have granted eurozone countries an additional stabilization amounting to 14 billion euros. In particular, it would have stabilized the member states in which unemployment rose sharply during the financial crisis, e.g., Spain and Ireland. But also countries such as Finland, Austria and France would have been stabilized to a similar extent. The re-insurance scheme would have mitigated around 21 to 24 percent of the major labor market shocks in these countries. In the variant with a threshold value of one percentage point for the rise in the unemployment rate necessary for activation, some member states, including Germany, would also have received assistance in the early 2000s. This would have cushioned the income losses caused by rising unemployment in Germany in 2003 by 17 percent.

Average stabilization effects of a euro area stabilization fund, 2000 to 2016

	Interregional	Intertemporal	Total
AT	24	25	49
BE	0	0	0
CY	24	26	49
DE	17	18	35
EE	20	21	41
EL	16	18	34
ES	21	24	45
FI	24	26	50
FR	21	23	44
IE	21	22	43
IT	15	16	30
LT	21	23	44
LU	24	25	49
LV	23	25	47
MT	0	0	0
NL	20	22	42
PT	19	21	40
SI	20	21	40
SK	15	17	32
EA-19	18	20	38

Source: ifo Institute | Bertelsmann **Stiftung**

Explanation: The coefficients in the first column ("Interregional") show the share of income losses caused by major labor market shocks (increase in unemployment rate of at least one percentage point and unemployment rate higher than the average of the last seven years) that would have been cushioned by the simulated re-insurance scheme. The coefficients in the second column ("Intertemporal") show the proportion that an average unemployment insurance system in the eurozone would have cushioned through debt issuance. The coefficients in the third column show the total stabilization potential. The simulations are based on the assumption that the re-insurance scheme and domestic unemployment insurance schemes are revenue neutral over the simulation period 2000-2016.

The various stabilization effects delineated above would have been achieved by the interregional smoothing potential of the fund, which results from different labor market fluctuations in the member states. This effect is economically significant. By way of comparison: the intertemporal stabilization potential of an average *domestic* unemployment insurance system is about 16 to 26 percent in the period under consideration (see table above, column "Intertemporal"). It should be noted that intertemporal stabilization can also be achieved through existing channels such as issuing national debt in times of crisis (assuming member states have market access). This stabilization channel was, however, only available to a limited extent in some countries in the course of the financial crisis and its effects could also be rendered by the re-insurance scheme in these cases.

The study also shows that the average annual payments by member states into the re-insurance scheme would have been less than 0.1 percent of GDP throughout the simulation period (see graph below). Some countries would have been net contributors and others net recipients (marked blue or green in the graph), but no member state would have made or received permanent contributions. All member states would have paid contributions

into the re-insurance scheme in at least three years. In the re-insurance variant requiring an increase in the unemployment rate of at least one percentage point for payment, all member states except Belgium and Malta would have received payment from the scheme in at least one of the years under consideration.

Source: ifo Institute | BertelsmannStiftung
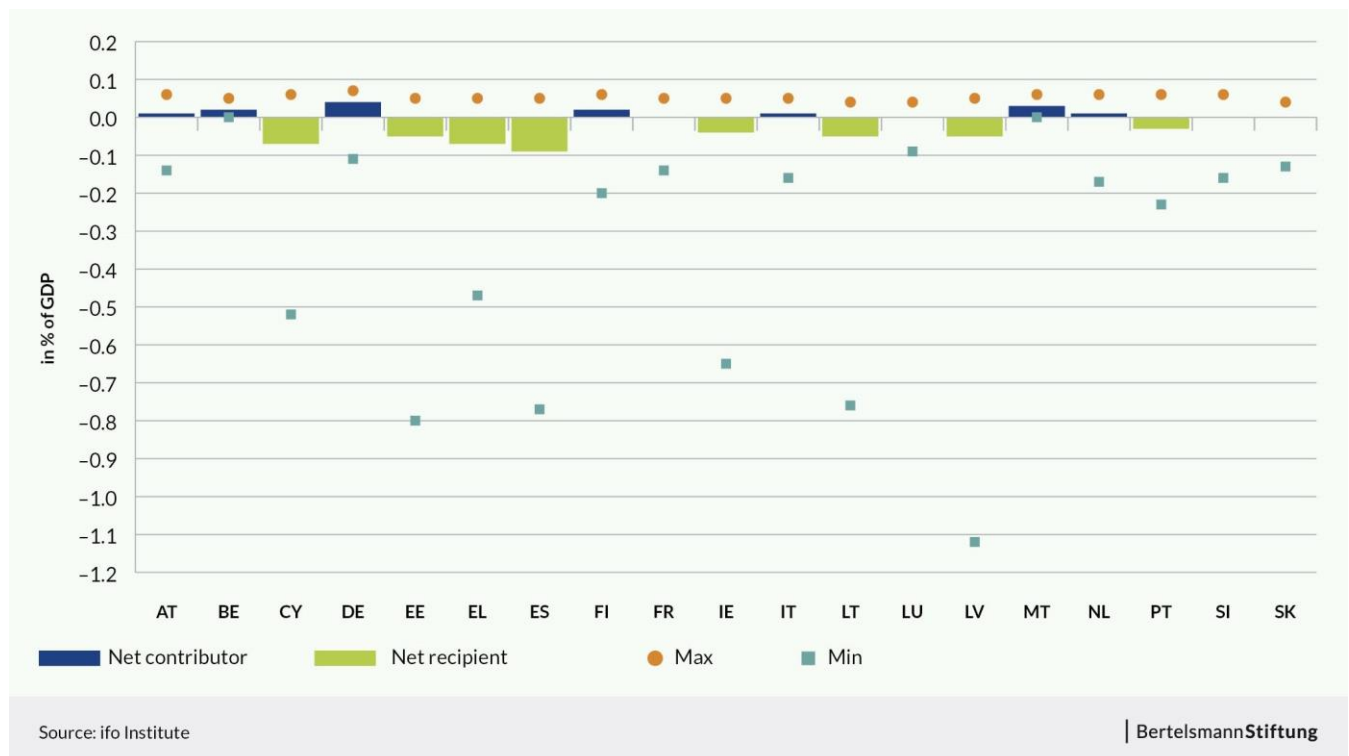
Explanation: The graph shows the simulated average annual net contributions of the EA-19 member states to the unemployment re-insurance scheme over the period 2000 to 2016, the maximum ("Max") and the minimum contribution ("Min"). Negative contributions are transfers, so "Min" refers to the maximum transfer from the scheme. Considered re-insurance variant in this figure stipulates that transfers are made if the unemployment rate rises by at least one percentage point and the unemployment rate is higher than the average of the previous seven years.

Conclusion

The study presents an ex-ante evaluation of an unemployment re-insurance scheme for the euro area. Thus, the paper contributes to the current euro area reform debate, but neither strongly advocates nor rejects the introduction of a re-insurance scheme. It does not establish whether or not the introduction of such a scheme is desirable in terms of overall welfare, but focuses on its stabilizing potential. The results suggest that a re-insurance scheme can achieve significant stabilization compared to domestic unemployment insurance systems or loan-based re-insurance models due to its interregional stabilization potential. The analysis of intertemporal stabilization also indicates that loan-based models can be effective. Overall, this study's re-insurance scheme could have dampened major labor market shocks in the Eurozone by around 15 to 25 percent since the introduction of the euro, thus almost doubling the stabilization that an "average" unemployment insurance system with no funding constraints would have achieved. The re-insurance scheme analyzed in this study would have been revenue neutral at euro area level over the period 2000 to 2016, but not for individual member states. According to the simulations, the average annual net payment is between -0.1 and 0.1 percent of GDP; notably, the re-insurance scheme would not have led to permanent transfers between the member states.

In the early years of the period under review, the scheme would have built up surpluses that would have been depleted during the financial and economic crisis. Nevertheless, implementing an effective debt limitation would be necessary to counteract political pressure to bailing out the re-insurance scheme. In addition, it is important to structure an unemployment re-insurance scheme in such a way that the risk of negative incentives is minimized as far as possible. Changes in economic behavior ("moral hazard") were not taken into account in the

simulations. As assumed in the simulations, the re-insurance system should only take effect in the event of major shocks and cushion only part of the losses incurred as a result of a given crisis. The scheme's availability could be linked to conditions, in particular compliance with European fiscal rules. Finally, the study stresses that unemployment re-insurance should be seen as one potential element of a larger and balanced reform package that contributes to enhanced market discipline, risk reduction and risk sharing.

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