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Thinking ahead for Europe

Time for some shock (absorption):

Reinsurance of national unemployment insurance should be a Commission priority

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There is now widespread agreement that participation in a currency union suppresses or, at the very least, constrains standard national economic stabilisation channels. At European level there is currently very little automatic fiscal stabilisation, leading to insufficient capacity to deal with severe shocks.

Discussion of how to address that deficiency has now moved from analysis to prescription. Already two years ago, the Commission's "Blueprint for a Deep and Genuine Economic and Monetary Union" proposed that there should be an EMU-wide fiscal capacity, acting notably as a supranational automatic stabiliser, in particular in case of asymmetric shocks. Similar sentiment was expressed in the same year in the so-called 'Four presidents' report' "Towards a genuine Economic and Monetary Union". The commitment was reaffirmed in 2013 in the Communication on the Social Dimension of EMU.

In all of these official pronouncements, no time horizon or only a very long time horizon is envisaged. As a result, while various options have been debated on an exploratory basis, no specific official proposals for the implementation of a fiscal capacity have been made. Different policy options are currently being studied and discussed (see Beblavý, Gros and Maselli, 2014). One proposal consists of a harmonised scheme for eurozone countries based on an insurance fund financed through a payroll tax (collected by national agencies) and spent on a minimum standard of unemployment benefits that applies in the same fashion to all eligible workers.

We also believe that the time to make such a proposal for an EU-level shock absorption mechanism has come. In our view, however, the instrument that best aligns varying political and economic objectives is a form of reinsurance of national systems of unemployment insurance. It could be a sort of 'tornado shelter' fund, which will be used only in case of severe recessions, in light of the fact that 'business as usual' downturns are already covered by existing policies. The primary motivation for the reinsurance proposal is that it can have

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a substantial stabilising effect, especially in case of large shocks, and, at the same time, be politically realistic in terms of contributions, costs and administrative burdens.

Recent studies by the IMF (2013a and 2013b) find that about 20% of shocks to state income in the US are offset by the federal fiscal system. Had the EMU being equipped with such a system, however, it would have been of limited value during the crisis. Offering a country whose output falls by 1% (relative to the eurozone average) a transfer of 0.2% of GDP would be of very limited utility. A country hit by a very large shock, say 5% of GDP (like Portugal or Ireland) would of course receive a larger transfer, but the problems would not be substantially different (a fall of income by 4% instead of 5%). By contrast, in a system of insurance with a deductible of say 1% of GDP, the country hit by a small shock would receive nothing. But most of the large shock – everything above the 1% deductible – could then be offset.

What the eurozone really needs is not a system that offsets all shocks by some small fraction, but a system that protects against shocks that are rare, but potentially catastrophic. The many minor cyclical shocks that do not impair the functioning of financial markets can then be dealt with via borrowing at the national level, and all countries are (more or less) well equipped with labour market cushions.

The European Stability Mechanism – the eurozone's rescue mechanism – does not provide the needed insurance function because it only provides loans, which have to be repaid with interest, rather than a transfer when a shock materialises.

One way to create an insurance mechanism with a deductible would be to create a system of reinsurance for national unemployment insurance systems, under which the national systems would pay regular premiums to a central eurozone fund. This fund would then support the national system in countries where the unemployment rate has increased suddenly above a certain threshold. This is the type of absorption capacity that the Presidents of the EU should be considering – not merely copying the way the US federal fiscal system appears to offset a small proportion of all shocks.

From a political point of view, a shock absorption mechanism would be an important demonstration of European solidarity but one that did not entail permanent transfers. This could mark an important shift of the political discourse from redistribution to how to make Europe work better for all its citizens. Moreover, the reinsurance of national unemployment insurance systems could serve as pilot project for other policies that might need a form of supranational reinsurance in the future.

References

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