

CEPS COMMENTARY



Thinking ahead for Europe

The case for a European unemployment benefit scheme

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We argue in this brief that the European economic governance system needs to be equipped with a supranational automatic stabiliser that would kick-in automatically in the event of an economic downturn, to avoid unduly burdening the national public finances. One option that should be seriously considered is the creation of an unemployment benefit system for the euro area.

The idea is far from new. The first proposal was put forward by the former Commissioner Robert Marjolin in 1975. In a seminal study on the future of the economic and monetary union, he argued:

Further progress requires the manifestation of a political will. This will is today uncertain and needs to show itself and to fortify itself by action. At a time when Europe finds itself confronted with redoubtable dangers, under the name of “inflation”, “massive balance of payments deficits” and “unemployment”, the only reasonable way for the member countries is to face together (...) these perils.¹

There are multiple arguments in favour of such a system. The first rationale derives from the realm of spill overs.² The more integrated national economies become, the less effective are the national instruments of economic policy, because a large part of the fiscal stimulus translates into an increase in imports. This results in an increasing gap in the balance of payments of the country. This argument also arises from the idea of fiscal policy as a common good among integrated economies: national governments may be reluctant to implement a fiscal policy of the optimal size (in terms of average expenditure as a percentage of GDP) because they will not be able to reap all the benefits, part of which will accrue to neighbouring economies. Hence, a common fiscal policy is needed to reach the optimal level of resources devoted to fiscal policy.³

Moreover, it is precisely during financial market dislocations that the spill-over effects are likely to be particularly strong. Recent experience has shown that very large shocks can impair the ability of a government to offset shocks to demand, exactly at a time when it is needed most. The Banking

¹ Marjolin et al. (1975).

² See Weyerstrass et al. (2006) and Caporale & Girardi (2013) for a comprehensive review.

³ Goodhart & Smith (1993); Majocchi & Rey (1993); Enderlein et al. (2013).

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Union and the Capital Markets Union are expected to make these shocks less likely, but the danger remains. This is also due to the fact that further financial integration can exacerbate contagion in case a crisis breaks out.⁴

Not surprisingly, even in the most decentralised federations, like Canada and the United States, the federal budget is in the range of 15 to 20% of GDP. In addition to defence and foreign relations, this budget is used to finance both welfare redistributive and macroeconomic countercyclical policies.⁵ By comparison, the EU's budget at 1% of GDP, represents breadcrumbs. As a result, a 1% drop in GDP in the US or Canada results in a decrease in household consumption of only 0.2%, compared to a 0.6% in the EU/EMU.⁶ Together with the European Stabilisation Mechanism (ESM), EU-level unemployment insurance could provide better stabilisation properties at relatively low cost.

Looking more specifically at European countries, researchers have calculated that the capacity of national unemployment benefits to stabilise income in the face of an unemployment shock is limited in many member states, including Italy and Greece. It is less than 10% in Greece, Slovenia, Estonia and Italy, and up to 25% in continental and Nordic countries.⁷ This is consistent with the above-mentioned risk of sub-optimal stabilisation due to high economic integration. There are two possible explanations for the underperformance of national insurance: either the subsidies benefit only a limited portion of unemployed workers, or these subsidies are not generous enough to avoid an excessive fall in consumption. The share of the labour force covered by some form of unemployment insurance can be anywhere in between 50 and 100% in Europe, and replacement rates over the previous salary are also very heterogeneous (ranging between 20% and 80% of the average gross wage).⁸

Another reason to shift some of the unemployment expenditure to the 'federal' level lies in market failures. Goodhart and Smith observed as early as 1993:

The case for government intervention usually rests on the existence of some market failure, or imperfection. In the case of intervention for the purpose of stabilization, the purported failure is that of (labour) markets to clear, whether by means of wage flexibility or by migration (though migration would not be an effective response to a common shock).⁹

They argue that labour markets in the EU appear relatively sluggish in adjustment: not only is the elasticity of wages to unemployment lower than in other advanced economies, but migration also occurs in smaller numbers between European countries compared to American states. Therefore, given European rigidities, "unless stabilised, adverse shocks are likely to impinge to some considerable extent on real variables, output and unemployment (rather than primarily on nominal variables)".¹⁰

And not much progress has been achieved on this ground since. The ECB argues at the very beginning of a working paper that "It has been well established that the wages of individual workers react little, especially downwards, to shocks that hit their employer".¹¹ Such rigidity is confirmed in both real and nominal terms. At the same time, the Great Recession proved that mobility also cannot be considered as an adjustment mechanism. Despite the prolonged duration

⁴ Cottarelli & Guerguil (2014).

⁵ Ibid.

⁶ Ibid.

⁷ Dolls et al. (2012).

⁸ Strauss et al. (2013).

⁹ Goodhart & Smith (1993, p. 421).

¹⁰ Ibid.

¹¹ Babecký et al. (2009)

of the crisis, the percentage of EU citizens willing to move to another country remains severely limited: 0.3% per year, or one and a half million people, which is equivalent to about one-tenth of the percentage observed in the United States.¹²

Apart from the purely economic arguments related to market failures and the spill-over effects of economic policies, the creation of a European unemployment benefit scheme also responds to the current political considerations. The support for the Eurosceptics has never been as high as reflected in last year's European Parliament elections. Moreover, when asked what they think are the two most important issues facing the EU, Europeans consistently rank the economic situation and unemployment in the top two places.¹³

The devil is more than ever before in the details. The creation of a supranational unemployment benefit scheme faces many challenges. A principal one, for example, is related to moral hazard: can the system minimise the temptation of member states to postpone reforms as a consequence of the knowledge that they will receive financial help from the EU level? Or where should the line be drawn on the stabilisation-redistribution axis? Would a supranational system require the harmonisation of the national systems? And finally: can this be done at all within the current legal framework?

Eighteen variants of such a scheme are currently under study by a team of researchers led by CEPS. These 18 variants can be grouped around two main typologies: genuine systems and equivalent systems. In the first group, the systems considered are those in which financial transfers from the supranational fund directly target unemployed individuals. Equivalent European unemployment benefit schemes are those in which financial transfers from the supranational fund occur only from and towards member states as a reinsurance mechanism between national insurance schemes. The difference between the two typologies is substantial. The idea behind a 'genuine' scheme is that it would cover a small portion of every shock, whereas in 'equivalent' schemes, the supranational fund could insure sovereigns more extensively but only in the event of major labour market turmoil.¹⁴ We are currently engaged in computing a micro and macroeconomic estimation of the stabilisation capacity of each scheme and will publish our findings in the course of the coming year.

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¹² See Barslund et al. (2015).

¹³ Eurobarometer. Question asked since 2011.

¹⁴ For further details please read: Beblavy, Gros, and Maselli (2015) and Beblavy and Maselli (2014).

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