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Unemployment Insurance in America: A model for Europe?

Karolien Lenaerts, Félix Paquier & Suzanne Simonetta

Summary

After the crisis, the longstanding debate on a European unemployment benefits scheme (EUBS) was revived as part of a much larger debate on the need for a supranational automatic stabilisation function for Europe. The American unemployment insurance (UI) system, given its two-tier structure, has often been regarded as a model for a potential EUBS. Previous research has examined the lessons to be learned from the US UI. This paper builds on this literature but goes one step further as it carefully assesses whether the lessons from the US system could actually be implemented in a European context. Indeed, while there are important parallels between the US and the EU in some areas, significant differences in others may complicate implementation or even render it impossible. In this paper, the aim, therefore, is to identify the aspects of the US system to draw inspiration from – in light of the EU’s institutional and political realities – and explain how they inform a potential EUBS. This exercise concentrates on the design and implementation of a potential EUBS. The paper highlights that a two-tier system helps to better attain the goals of unemployment insurance, as demonstrated by the American experience. It also shows the advantages of being pragmatic and taking an incentives-based approach. Other issues, such as solidarity and redistribution, seem more difficult to tackle in Europe than in the American context and would require further examination. Finally, discretionary measures should be considered with caution.

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1. Introduction

The European Union has been in troubled waters for a decade. With the global crisis starting in 2008, the subsequent eurozone debt crisis, the rapid growth of Euroscepticism and then Brexit, 2017 not only marks the 60th anniversary of the Treaty of Rome but also an important moment to reflect on the future of the European project.

One topic that has received a lot of attention is the further development of EMU, as the crisis demonstrated shortcomings in the EMU's institutional architecture (Andor, 2016). This has re-launched the debate about a supranational automatic stabiliser for Europe. In this regard, one option under consideration is a common European unemployment benefits scheme (EUBS), inspired by the American UI system (Alcidi and Thirion, 2017). Yet while the discussion on a European UI has mostly focused on the stabilisation capacities of the scheme, its potential social impacts should not be overlooked. The idea that "Europe is not social enough" (to quote Jean-Claude Juncker)¹ has gained traction, and an EUBS could also be a way to partly fill that gap.

The American unemployment insurance (UI) is a two-tier system, with two levels of government – the 53 'states' (the 50 American states plus the District of Columbia, Puerto Rico, and the U.S. Virgin Islands) and the federal government – that interact and complement each other in the provision of UI. Many of the existing EUBS proposals aim to establish a similar two-tier structure: i.e. a UI system involving the different member states as well as a European, supra-state, dimension.

To avoid confusion, in this paper we refer to the lower level of government (in terms of geographical coverage) – composed of the 53 American states and the 28 EU member states – as 'state'. The higher level of government – i.e. the federal government in the US or any potential supra-state entity involved in the provision of UI in Europe – is referred to as the 'supra-state'. This paper does not address the general question of the rationale behind unemployment insurance. Instead, we focus on the goals, value-added and main challenges of *involving the supra-state level of government in the establishment or funding of UI, rather than having UI determined only by the states independently.*

While Europe and the United States differ significantly with respect to their economies, social issues, political preferences, history and culture, there are important parallels that make the

¹ Jean-Claude Juncker, State of the Union address, 14 September 2016.

American UI system an interesting model for a potential EUBS. Having said this, the fact that the American UI system functions in a way that reflects national realities and responds to its specific challenges means that it cannot simply be copied to the European context.

With this paper, we aim to contribute to the debate by identifying lessons that can be learned from the American UI system and assessing their applicability for Europe. Our work is based on extensive review of the literature, with a specific focus on recent work on a European unemployment benefit scheme and studies that compare such a potential EUBS with the US system. Some of the latter work highlights the lessons that can be learned from the American system, but few of these studies challenge these lessons or consider whether they can actually be applied, which is the key aspect.

We start by identifying similarities in the issues that both systems face and in the goals they pursue. We further assess the differences in how these goals and issues are expressed in the US and in Europe. Europe can learn from the longstanding US experience on how to manage a two-tiered UI system, which also means that unexpected challenges and shortcomings experienced in the US provide valuable lessons for Europe.

The remainder of this paper is organised as follows. Section 2 presents the current American federal-state system, describes the European context and different options that can be envisioned for an EUBS. Section 3 synthesises the goals and value-added of the involvement of the supra-state level in UI. The following two sections deal with important issues that any two-tier UI system faces: the issue of solidarity and redistribution between states (section 4) and the trade-off between flexibility and harmonisation regarding how the system works in each state (section 5). Section 6 is about a more specific issue that comes up when supra-state involvement is used to offset large economic shocks: should temporary programs be activated automatically or be discretionary? The final section of the paper sets out the conclusions and policy recommendations.

2. The American and European unemployment insurance systems and options for a common European unemployment benefits scheme

2.1 The American unemployment insurance system

The US unemployment insurance system is a *'federal-state'* system that was introduced in 1935 with the Social Security Act. The UI system is an important part of the US social security program, directly paying out benefits to eligible unemployed workers. To be eligible for UI benefits, individuals have to be out of work, through no fault of their own, demonstrate workforce attachment, and be able and available for work (US DOL, 2016). As the US UI scheme is rather complex, we focus here on the core features, which are examined in more depth in the remaining parts of the paper. For a comprehensive overview of the UI system, we refer to US DOL (2016).

Under the US UI system, each state finances its own unemployment insurance through payroll taxes paid by employers. Important features related to the unemployment benefits, including

the weekly benefit amount, the duration of benefits and most of the eligibility requirements for benefit receipt, are determined at the state level in an independent way. This has resulted in substantial differences between the states. In addition to the state taxes, employers pay a federal unemployment tax on wages paid to employees. The full federal tax rate is high, but in states in conformity with a series of federal requirements employers receive up to a 90% credit against the federal unemployment tax. The federal government also provides states with grants to administer their UI programs if the states conform to a set of additional requirements. Federal requirements include experience rating (the rate of state unemployment taxes assigned to a given employer must be higher for employers who created more unemployment) and a prohibition on using unemployment trust funds for anything other than unemployment benefit payments. In other words, the federal level (the Department of Labor) puts forward guidelines and standards that states must follow (as a condition of tax credit and grant receipt), while leaving the implementation and design of the scheme to the state (Alcidi and Thirion, 2017). In practice, all 53 states comply with federal requirements and receive the tax credit.

Besides this regular UI, the US system is also equipped with temporary federal programs such as the Emergency Unemployment Compensation (EUC)² and the permanent Extended Benefits (EB) program, which extend the duration of benefits in case of economic downturn. EB is generally available in a given state if the total unemployment rate exceeds trigger levels in that state (and under permanent law are partially financed at the federal level and partially financed at the state level).³ EUC and similar federal programs are launched in a discretionary way in all states. These programs are fully financed by the federal government. The federal government does not pay unemployment benefits directly to unemployed individuals: states receive money from the federal government to finance the temporary federal programs and are responsible for their administration.

Revenue from federal tax is earmarked for three main uses. First, it is used to finance the administrative costs of UI. Second, federal tax revenue is used to finance temporary federal programs (such as the EUC and EB). Third, it is used to provide loans to states that run out of money to finance their UI benefits.⁴ Note, however, that some states opted to issue bonds during the Great Recession rather than borrow from the federal government to avoid the likelihood that employers would have to pay higher contributions.

² Earlier programs similar to EUC had different names. More details on these programs can be found on: https://www.oui.doleta.gov/unemploy/spec_ext_ben_table.asp.

³ In the original design, Extended Benefits programs in a given state are financed both by the state (50%) and the federal government (the other 50%). However, during the Great Recession, 100% federal funding was provided. Note that the mandatory trigger for EB is based on the insured rather than the total unemployment rate, but this is not very responsive. States have used the optional total unemployment rate trigger instead.

⁴ These loans may offer better rates to states than normal financial markets because under certain circumstances, interest is only charged on loans that are not repaid by the end of the fiscal year in which they were obtained and because interest rates may be lower than what is available from the financial markets.

2.2 Unemployment insurance in Europe: current situation and the potential for a common EUBS

In the European Union, UI is only provided at the state level; there is no supra-state entity involved. Unemployment insurance schemes exist in one way or another in all EU countries and were created in most countries in the years following WWII.⁵ There are large differences in the design and implementation of UI provision among EU member states (Esser et al., 2013; Beblavý and Maselli, 2014b; Beblavý et al., 2015). One striking example is the duration of benefits, which range from less than six months in some countries (e.g. Hungary) to very long durations in others (e.g. in Belgium, unemployment benefits have an unlimited duration) (European Commission, 2013). Esser et al. (2013) present a taxonomy of unemployment insurance schemes, distinguishing between five models that can be identified in Europe: targeted, voluntary state subsidised, state corporatist, compulsory basic security and compulsory income security.

The idea of involving the supra-state level in the provision of UI in Europe has much been debated in recent years. In fact, there are many different possibilities. First, the involvement of a supra-state or European level can be limited to guidelines that states must or are incentivised to follow. However, research conducted so far considers a much more ambitious European UI in which there would be a supra-state dimension to benefit financing. Many schemes have already been investigated, with different financial transfer options. The main distinction is whether these schemes were *genuine* or *equivalent* schemes (Beblavý and Lenaerts, 2017).⁶ Beblavý and Lenaerts (2017) consider as genuine EUBS the schemes that would pay unemployment benefits directly to unemployed individuals (i.e. a direct transfer from the supra-state level to the individual, though in practice it would run through the existing state-level infrastructure) and would be funded through contributions from employers and employees. An equivalent EUBS, by contrast, is one in which financial transfers for an EUBS would occur between the state and a supra-state entity. We do not focus on one specific form of EUBS but consider the idea of involving the supra-state level in an EUBS, be it genuine or equivalent. Moreover, the American UI is neither a purely genuine nor a purely equivalent scheme according to the criteria used in the work of Beblavý and Lenaerts (2017). Rather, it combines elements of both types of schemes.

⁵ Germany, for example, had UI before the US (introduced in 1927). In most EU countries, however, UI was introduced only after WWII. In France, for instance, it was only established in 1958.

⁶ Beblavý and Lenaerts (2017) consider in the 'equivalent' category only those schemes that are only activated when the rate of short-term unemployment exceeds a trigger threshold level, so that the transfers occur only when they are most needed. Conversely, they consider in the 'genuine' category only schemes with no trigger, i.e. always activated. Nevertheless, these are not the only options that exist. Other studies have imagined equivalent schemes with no trigger, or genuine schemes with triggers. The issue of how to decide when the system should be activated is discussed more in depth in Section 6.

3. What are the goals and value-added of a supra-state unemployment benefit scheme?

Public unemployment insurance has various goals, such as avoiding the shortcomings of private UI, improving job matching in the economy, providing macroeconomic stabilisation and redistributing income among individuals (see Box 1 for more details). The subject we focus on in this paper is the extent to which those goals are achievable without supra-state intervention in a two-tier UI system. To what extent, in a union or federation of states like the US or EMU – which is also a single market and a currency union – does the involvement of the higher level of government in the provision of UI allow better attainment of its objectives? In addition to the general goals of public UI, a supra-state UI may have additional goals that a state UI does not have. For example, an EUBS may aim to reinforce the European Union through better social protection, which could make the advantages of the EU more tangible for European citizens.

Box 1. The general goals of public unemployment insurance

The academic literature on the provision of UI by public authorities has identified various objectives and rationales. From the perspective of neoclassical economic theory, it may be argued that a public UI addresses the shortcomings of a private UI, which would face market failures (adverse selection in particular) and positive externalities. It may also be argued that UI relaxes job seekers' budget constraints and allows them to better choose their jobs, thereby improving job matching in the economy. From a macroeconomic perspective, the usefulness of UI is to stabilise the economy by automatically dampening fluctuations in GDP: when a country is hit by an economic shock, the increase in unemployment automatically triggers an increase in public expenditure for unemployment benefits that has a positive impact⁷ on GDP.

Those economic goals are not the only rationales for UI. Other goals, which are just as fundamental, are assisting jobless workers through income support and ensuring a certain level of redistribution among individuals. The latter argument is one of the possible results of philosophical reflections on justice and fairness in a society, such as John Rawls' theory of the "veil of ignorance" (Rawls, 1971.)⁸

3.1 Addressing coordination issues in a single market: interstate competition and spillover effects

A primary reason for the intervention of the supra-state dimension in the provision of UI, in any two-tier political architecture, is *interstate competition* regarding labour costs and social protection. The underlying theoretical reasoning is the following: with the implementation of a single market that includes several states or countries, free movement of goods, capital,

⁷ One additional euro of public expenses in unemployment benefits may even induce an increase of GDP that is greater than one euro, thanks to the multiplier effect. In the Keynesian theory, the multiplier effect is because the additional euro of public expenses creates one additional euro of income, which in turn is spent (at least partly) on consumption and thus creates additional income.

⁸ Of course, another question is the desirable level of redistribution among individuals in a society. That is a tricky question, which we do not address in this paper.

services, and people makes it appealing for states to lower their labour costs to attract firms from the other states.

That is precisely why supra-state involvement was necessary in the US when UI was created. Until the Social Security Act (SSA) of 1935, during the depths of the Great Depression, no state had a social insurance program for jobless workers. While the need for such a program was acute and several states considered legislation to authorise the creation of UI, no programs were implemented prior to the federal enactment, because the issue of interstate competition could not be overcome. It can also be understood as an example of the classic ‘prisoners’ dilemma’: without certainty about what the others would do, each party makes a suboptimal choice that mitigates their risk should the other parties fail to make the socially optimal choice. In this case, the overriding concern was that if a state creates a UI program and assesses taxes on employers to fund the program but the neighbouring states do not, employers would leave the state with the higher tax burden. The SSA elegantly solved that problem by eliminating the basic competitive disadvantage. It established a federal unemployment tax that employers in all states have to pay. However, if a state has a UI program that meets certain requirements, employers in that state receive up to a 90% credit against the federal unemployment tax. Even taking state unemployment taxes into account, it would be possible for employers to have higher total unemployment tax payments in states that do not have UI programs.⁹ As a result, even though the SSA did not technically require the states to create UI programs, all of them did. Strong incentives are what helped overcome interstate competition and enabled states to create UI programs.

In the EU, the competition among member states regarding labour costs and social protection is often referred to as ‘social dumping’, which can be defined as “downward pressure on social conditions due to competition from countries with lower social conditions” (Sapir, 2015). In the current political and economic climate in the EU, social dumping is a much debated issue (for instance, the European Parliament adopted a resolution about social dumping in the European Union in September 2016).¹⁰ Learning from the historical experience that led to enactment of the SSA in the US, an EUBS could contribute to the fight against social dumping in Europe, through a certain degree of harmonisation of national systems. That harmonisation could be

⁹ Under the Federal Unemployment Tax Act (FUTA), two credits are available to employers in states with laws that meet all requirements. The ‘normal’ credit is for the amount of state unemployment taxes the employer paid. The ‘additional’ credit is for the difference between the normal credit and the amount the employer would have paid had it been assigned a 5.4% tax rate. The maximum total tax credit is 5.4 percentage points. Both credits are needed to ensure that experience rating of state unemployment taxes has the desired effect. (Without the additional credit, employers with ‘good’ experience would pay higher FUTA taxes than employers with ‘bad’ experience. Thus, the total unemployment tax bill — both federal and state — for both sets of employers could be comparable.) Regarding interstate competition, if a state does not have a UI program, employers in the state would have to pay the full 6.0% FUTA. If a state has a UI program that meets the requirements of FUTA, the federal tax rate would be 0.6%. If the employer had ‘good’ experience, its state unemployment tax rate could be quite low. If it were 1.0%, its total unemployment tax would be 1.6%. Thus, employers in a state with a UI program could pay lower unemployment taxes than employers in a state without a UI program.

¹⁰ See: <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+REPORT+A8-2016-0255+0+DOC+XML+V0//EN>

achieved either through a genuine system that would replace (at least partly) or supplement existing national systems, or through an equivalent system with minimum standards for national schemes. It should be noted that although social dumping is frequently mentioned in the political debate, there does not seem to be strong empirical evidence of its existence in Europe. For example, some researchers pointed out that the differences in labour taxes do not seem to provide a sufficient incentive for business relocation, especially from the 'old' to the 'new' member states (Maslauskaitė, 2013).

In addition to interstate competition, a lack of coordination between states can lead to a suboptimal level of social protection, which is what economists call 'spillover' effects (Beblavý and Lenaerts, 2017). Spillover effects are likely to occur in a single market without coordination of social protection, like Europe. Due to the high level of economic integration in Europe, a shock in one country also has negative impacts on neighbouring countries. Similarly, a fiscal policy – such as unemployment benefits – that stabilises the economy in one country also has positive impacts on neighbouring countries. These effects are externalities that may lead countries to underestimate the gains of their fiscal policy and may result in suboptimal levels of social protection. A common stabiliser would be helpful to overcome these issues.

The American example is an important one for the EU case, although one has to keep in mind that the starting point and institutional context are very different. While in the US the state UI schemes had not been developed prior to commencement of supra-state involvement, the opposite applies to the European context. Furthermore, the substantial divergences in the UI systems that exist in the EU today reflect national preferences and institutional differences that may be very difficult to align. At the same time, these substantial divergences are precisely what necessitate improved coordination.

3.2 Relaxing budget constraints to improve macroeconomic stabilisation

Most studies conceptualise a potential European UI as typically involving financial transfers between the states and a supra-state entity (either through state-level, or individual and/or employer-level contributions and payment); that is under the assumption that such a UI would not be limited to a set of guidelines on how states may set the parameters of their UI. Those transfers correspond to a supra-state insurance that pools risks at a broader than state level. As economic cycles vary among states, they may offset each other. Thus, the increase in unemployment benefits in a state experiencing a shock might be partially financed through transfers from the states that are not hit by that shock. The cost of financing unemployment benefits in states where UI is addressed at a supra-state level is likely to be lower than in states that would borrow on their own on financial markets to cover all costs for unemployment benefits. Supra-state involvement in UI thus relaxes the impact of budget constraints on UI and raises their potential stabilisation impact: the impact of public unemployment benefit expenditures on GDP is larger if those public expenditures do not need to be fully offset by tax increases or by incurring more debt (Bayoumi and Masson, 1998; Enderlein et al., 2013). Moreover, in the event of severe crisis in a given state, reduced budgetary constraints minimise the necessity or likelihood of unemployment benefits being cut.

The mitigated budgetary impact made possible by federal involvement in UI is especially important in currency unions like EMU or the US (Enderlein et al., 2013). One reason is that a state has fewer options to lessen the risk of default when it enters a currency union, because it has to issue its debt in the common currency, which means that it cannot use monetary policy to alleviate the impact of increased debt. States in a currency union may not have sufficient access to capital markets during recessions if doubts arise about the viability of their debt. This may undermine their capacity to finance UI. The second reason is that the absence of monetary policy at the state level removes the most important device to absorb temporary macroeconomic shocks. Currency unions can rely on the common monetary policy to deal with symmetric shocks affecting the currency area as a whole, but the absorption of asymmetric shocks impacting only some states of the union becomes much more difficult.

Yet, asymmetric economic shocks are precisely what the European Union has been facing in recent years (Enderlein et al., 2013). While it has been argued that labour mobility and/or wage elasticity are mechanisms besides monetary policy that could provide necessary adjustments, strong wage rigidities in many euro area countries (Allard et al., 2013) and low labour mobility in Europe (Alcidi et al., 2016) have prevented these mechanisms from providing efficient stabilisation. Moreover, in the years following the 2008 economic crisis, European countries were unable to achieve efficient stabilisation through fiscal policy on their own, mostly because of high debt, the EU's fiscal rules, and financial market constraints (Beblavý and Maselli, 2014b; Alcidi and Thirion, 2016; Poghosyan, 2016). One of the most important goals of an EUBS would therefore be to provide fiscal stabilisation and fill this gap.¹¹

In the US some supra-state aspects of the UI system have been efficient in providing macroeconomic stabilisation. As mentioned above, in the US the federal government makes benefits more generous in a variety of ways in the event of major economic downturn. The permanent EB program, which is partially federally funded, becomes available in states whose unemployment rates exceed certain levels. The federal government also created the Emergency Unemployment Compensation (EUC) program, extending the duration of benefits, and in the American Reinvestment and Recovery Act (ARRA), among other things, increased all UI weekly benefit amounts by \$25. These programs were fully financed by the federal level. Vroman (2010) estimated the macroeconomic stabilisation impact of unemployment benefits in the US during the Great Recession and found that, on top of the regular UI program, the emergency extensions of benefits also played an important stabilising role. The emergency programs could be a valuable source of inspiration when designing an EUBS.

Another interesting characteristic of the American system is the possibility for states to borrow from a federal account – often at a lower price than those of normal financial markets – to finance their UI if reserves are exhausted. This is a typical example of how federal involvement

¹¹ Another question is: why are unemployment benefits better than other fiscal policy tools? There are three arguments to support the position that an EUBS is the ideal tool (Beblavý et al., 2015). First, it is quintessentially counter-cyclical. Second, because households that lose a source of income need to sustain their consumption levels, UI has a strong multiplier effect. Finally, it is activated automatically in a crisis.

may relax budget constraints and create more financial leeway. Some 36 states borrowed from the US Treasury between 2009 and 2013 (O’Leary and Barnow, 2016). In Europe, some countries (France and Croatia, for example) decreased the generosity of their UI during the crisis (European Commission, 2011), which would perhaps have been avoided with financial support from the EU. However, in the US, those federal loans did not prevent a few states from scaling down the generosity of their UI after the crisis (O’Leary and Barnow, 2016). Nonetheless, it may have been worse without federal involvement, and may also be evidence of the need for an even greater federal role in the US.

3.3 Improving social protection and redistribution

Another potential consequence of supra-state involvement in UI is achieving a higher level of social protection and redistribution of income among individuals. For instance, thanks to the relaxation of budget constraints, supra-state involvement in UI in the US made it possible to maintain more generous unemployment benefits during the 2008 economic crisis than the benefits that would have been disbursed without supra-state intervention. As a result, several authors suggest that the emergency enhancements of benefits during the crisis prevented an increase in poverty in the US (Sherman, 2011; Gabe and Whittaker, 2012).

In Europe, improved social protection could make the advantages of the EU more tangible for its citizens, and thus increase trust in the institutions. This would be an important potential consequence of an EUBS, as many recent events – such as the 2016 vote in favour of Brexit – have underlined the increasingly widespread feeling of distrust towards the EU. As Eurobarometer (2014) shows, since the 2008 economic and financial crisis, the feeling among EU citizens that their country’s membership is a good thing has generally decreased. The decline is the largest in some of the countries that were most affected by the crisis, such as Greece and Spain. Given their very high levels of unemployment, it seems likely that these countries, in particular, would have benefited from an EUBS. According to the same study, people regard unemployment as the main issue facing their country (Eurobarometer, 2014). Moreover, when asked what would strengthen the feeling of EU citizenship, the response with the highest support was “*A European social welfare system harmonised between the member states*” (over 40% of respondents). The European Commission has acknowledged the need for a more social Europe and recently launched the “*European Pillar of Social Rights*”. An EUBS would be an important step toward a more social Europe.

4. Solidarity – does sharing the advantages of union mean sharing its burdens?

Financial transfers between the supra-state entity and the states mean that there can be losers – i.e. states for which transfers to the supra-state entity exceed transfers received from the supra-state entity – and winners – i.e. states for which transfers to the supra-state entity are smaller than those obtained from the supra-state entity. Especially in the short run, a supra-state role in UI entails some level of *solidarity*, in the form of redistribution among states. In the long run, the involvement of the supra-state level can include tools that prevent redistribution by requiring ‘winners’ to pay back, as we will discuss further in this section.

In Europe, the implementation of such a form of redistribution, even if only in the short run, would face challenges. One challenge is the acceptance by European citizens of the principle of solidarity, according to which citizens of a given state may have to finance part of the unemployment benefits provided to citizens of another state. Acceptance of this principle would represent a huge step forward towards a greater role for the EU. It appears to be anything but a formality, given the current context. According to Eurobarometer (2014), about 40% of Europe's citizens do not feel that they are European citizens.

The fact that this question is even being asked demonstrates how fundamentally different Europe and the US are in this regard. While the 'red state'/'blue state' divide is quite significant in the US, public consciousness and political rhetoric regarding UI in the US do not really acknowledge interstate transfers as a major concern (although an understanding of the potential 'winners' and 'losers' is imperative when designing a proposal that requires congressional action.) The dialogue about UI spending in the US focuses more on other aspects, not specifically related to the supra-state dimension (e.g., the impact on job creation, disincentives to seek work, benefit adequacy, and so on). It may be that Americans' sense of common identity, history, language and culture is such that questions about interstate transfers of unemployment benefit spending do not generally get asked.

The fact that interstate transfers are not a major concern in the US may also be due, in part, to the way the transfers occur. States do not directly make payments to the federal government to support unemployment benefits. Employers pay taxes to the federal government. State unemployment tax revenue is used for state benefit payments. Federal unemployment tax revenue is used for several purposes, including state costs to administer their UI programs, loans to states that run out of money to pay benefits, the federal share of the permanent extended benefits program, and any special temporary federal unemployment programs. When the federal unemployment reserves became depleted during the Great Recession, general revenue, which comes from a variety of sources, was used (such as federal income taxes and other revenue whose use is not limited to a specific purpose). Although some of the funds had to be paid back, a significant portion of federal unemployment spending did not. Recognising the urgency of making additional unemployment benefits available, these other federal funds were dedicated to this purpose. For these reasons, while the net transfers from employers in one state to unemployed workers in another state in terms of the federal unemployment spending could theoretically be calculated, the overall perception is that the transfer was going from the federal government to the states. When there were concerns about the level of federal spending during the Great Recession, they were generally about whether the economic conditions warranted additional action rather than about whether some states were contributing more to cover the cost of unemployment benefits than other states.

Fostering development of a European identity to make solidarity among EU states more acceptable, as it is in the US, may seem to be too ambitious a goal. However, the way the interstate financial transfers occur in the US could perhaps be taken as inspiration to foster acceptance of a potential EUBS. For instance, to limit the temptation to calculate the net transfers from one country to another, perhaps a European payroll tax on top of national taxes

would be more acceptable than a system in which contributions would be a certain percentage of GDP collected directly from the member states (as proposed in the equivalent variants described in Beblavý and Lenaerts, 2017). Likewise, benefits paid directly to unemployed people by a supra-state entity may be better than transfers to the state's budget (even if those transfers are earmarked to the payment of benefits). Moreover, making solidarity and redistribution among states more acceptable in Europe may require rethinking how the 'winners' and 'losers' are determined to take a broader, more comprehensive approach when considering a UI scheme. Direct spending on unemployment benefits in a state is, of course, a necessary component of this calculation. However, there are other considerations that, while harder to quantify, are meaningful. Monetary union created winners and losers. So did free movement of labour. One might expect that, when taking a more expansive approach to making this determination, interstate transfers for unemployment benefits may not appear to be as inequitable as they presently do to some individuals. Furthermore, EU citizens do not seem to be against solidarity. According to Eurobarometer (2014), when asked "Will EU countries have to work more closely together as a consequence of the crisis?" more than 80% of EU citizens said yes.

As an EUBS necessarily implies redistribution in the short run to be efficient, one solution that has been put forward to make it more acceptable is to include in the EUBS system provisions that prevent redistribution *in the long run*, such as *experience rating at the state level*, or *claw-back* (Beblavý and Lenaerts, 2017). Experience rating at the state level is a mechanism that ties a given state's contribution to the supranational fund to the state's likelihood of using it. Claw-back would tie a given state's contribution to the supra-state fund to the state's balance vis-à-vis the supra-state fund. On the one hand, such mechanisms would avoid the theoretical possibility of an EUBS giving rise to permanent winners and losers. They would also be helpful tools to address *institutional moral hazard*, which is another challenge raised by redistribution across member states (Beblavý et al., 2015; Vandenbroucke and Luigjes, 2016). The government of a recipient country may decide not to implement unpopular or costly policies if it knows that this will be compensated by an increased financial support from the federation. On the other hand, those mechanisms may limit the power of an EUBS to relax states' budget constraints, stabilise the economy and improve redistribution.

The way the American system deals with the issue of moral hazard suggests that there is a variety of possible responses. First, interestingly enough, exceptional measures like Emergency Unemployment Compensation or Extended Benefits programs, as well as the enhancement of benefits within the American Reinvestment and Recovery Act, were implemented with no provision – like an experience rating or claw-back – aimed at preventing institutional moral hazard¹². In general, despite some notable elements of interstate solidarity, for instance through EUC-like or EB programs, institutional moral hazard does not seem to be high on

¹² Individual moral hazard is more of a concern in the U.S. For this reason, the Middle Class Tax Relief and Job Creation Act of 2012, among other things, modified the Emergency Unemployment Compensation program to require that everyone receiving these benefits receive a reemployment and eligibility assessment, which verified the individual's work search efforts and provided assistance with finding a job.

today's political agenda in the US (Vandenbroucke and Luigjes, 2016). From this observation one could derive the conclusion that moral hazard should not necessarily be considered as a big issue in the design of a future EUBS either. At the same time, mechanisms other than state-level experience rating or claw-back limit the possibility of institutional moral hazard in the US, and may also be appropriate for Europe. First, some limitations of redistribution among states in the long run also exist in the American system. When a state borrows from the federal unemployment account to finance its UI in the case of exhaustion of its reserves, the loan has to be repaid, and interest is charged on loans that remain outstanding for a specified period of time (Beblavý et al., 2015b). Moreover, experience rating does exist in the American system, though at the firm level: employers' state taxes vary in any given year based on their experience with unemployment.¹³ (This is required under federal law as a condition for employers in a state to qualify for federal unemployment tax credits.) For this reason, employers who lay off more workers pay higher state unemployment taxes than employers who lay off fewer workers, in general. Note that in the US, experience rating systems vary in their effectiveness for different reasons, but the general rule is still accurate.

Furthermore, institutional hazard may also be mitigated through supra-state monitoring of the unemployment programs implemented by states. In the US, there are several performance oversight programs¹⁴ in which the federal government reviews state actions for a sample of unemployment claims to ensure that their policies and operations are consistent with both federal and state law. While states had made searching for work a condition of ongoing eligibility for benefits many years ago, federal law was amended in 2012 to make this a national requirement as a condition of administrative grant receipt. Thus, when state operations are reviewed, an essential component is determining whether the state made proper eligibility decisions based on the work search requirements in state and federal law. In this case, if it is found that an individual did not engage in the requisite work search activities to maintain their eligibility for benefits, the state must adjudicate the issue and, if supported by the facts of the case, determine that the benefits were improperly paid and commence efforts to recover these amounts.

Finally, the way the Extended Benefit (EB) program is financed in the American system can also be a model for Europe in mitigating moral hazard. EB lengthens potential durations by 50% of the entitled duration of regular UI benefits when the unemployment rate exceeds a threshold in a given state, and provides a 50-50 sharing of benefit payment costs between federal and state governments. Financing an equivalent EUBS in a similar way would be an option to prevent moral hazard. For example, the rule could be that for each euro received by a given

¹³ Tax rates also vary from year to year based on the reserves in states' account in the Unemployment Trust Fund.

¹⁴ For example, in the Benefit Accuracy Measurement program a sample of weekly unemployment claims is selected and auditors verify every aspect of the individual's eligibility for benefits — this includes determining whether the proper amount was paid to the individual and whether the individual searched for work. In addition, the Benefit Timeliness and Quality program focuses primarily on state activity when adjudicating eligibility issues that arise on an unemployment claim. No matter what type of eligibility issue, states must meet a set of procedural requirements including making a reasonable attempt to obtain necessary information from all appropriate parties and explaining well in the written determination the rationale for their conclusion.

state from the supra-state entity, it would have to increase its UI spending by two euros. During the Great Recession, the EB program in the US was entirely financed by the federal government under a temporary change in the law; however, its original design can be enlightening for Europe.

5. Flexibility: how far should states determine how unemployment insurance works?

The current national unemployment benefit schemes in Europe are highly heterogeneous in terms of eligibility requirements, replacement rates, reference wages and duration of the unemployment benefits (Esser et al., 2013; Beblavý and Maselli, 2014b; Beblavý et al., 2015). Thus, when it comes to the design of a potential EUBS, one key question is whether it should entail a convergence of current national schemes or allow a certain level of heterogeneity. On the one hand, a certain level of homogeneity may seem necessary, in particular to prevent interstate competition, social dumping, or spillover effects (see section 3). On the other hand, the different choices made by different states about various features of UI may reflect (strongly) diverging political preferences (Beblavý et al., 2015). In addition, state flexibility enables innovation and is an opportunity to experiment with new ideas on a smaller scale. From a more pragmatic perspective, a homogeneous scheme may prove very difficult to achieve. Homogenisation through a genuine scheme would require substantial legal reforms at national level as well as substantial administrative effort (Beblavý et al., 2015; Coucheir et al., 2016). These hurdles would be less problematic if mere minimum standards were imposed on member states' UI. However, imposing requirements about eligibility, reference wages, the replacement rate or duration of unemployment benefits may be rejected by European citizens, who could resist such attempts to limit their national sovereignty in favour of the EU.

In the US, there is significant variation among states in terms of the weekly benefit amount, the duration of benefits and the eligibility requirements for UI benefit receipt. This heterogeneity represented a pragmatic necessity more than a policy preference when the system was created. In the 1930s, the federal government had a much more limited role than it does now. For this reason, the US Supreme Court decided that several of President Franklin Delano Roosevelt's New Deal initiatives were unconstitutional because they attempted to expand the scope of federal action. Concerns over constitutional challenges strongly influenced the design of the UI program. It is for this reason that the US UI system is premised on strong incentives — tax credits for employers and grants to administer the program for states. From a legal perspective, states are not required to operate a UI program, which is why the Supreme Court ruled that it was constitutional.¹⁵ Federal law thus only establishes some broad requirements to ensure that states are operating genuine UI programs, while states retain substantial authority to establish their preferred program parameters. Even the temporary federal

¹⁵ The case is known as *Steward Machine Company v. Davis* (301 U.S.548 (1937)).

unemployment programs (EUC and EB) are technically voluntary.¹⁶ States sign agreements with the US Department of Labor indicating that they will administer these programs on behalf of the federal government as specified in operating instructions and the federal government reimburses the state for benefit and administrative costs. States have always chosen to make these benefits available to their unemployed workers, although they retain the right to opt out at any time.

Nevertheless, some features of the American states' UI schemes are harmonised, as a way to deal with principal-agent problems: i.e. in that way ensuring that the supra-state entity gets the states to behave in accordance with its wishes (O'Leary and Barnow, 2016). In the US, three options are used to deal with those principal-agent problems: mere guidelines, incentives and compulsory rules. Regarding *guidelines*, one example is that in the 1980s and 1990s, the US Department of Labor and federal advisory commissions set guidelines to states about the level of the weekly benefit amount and the duration of benefits. Until the Great Recession, these guidelines were largely followed (O'Leary and Barnow, 2016). In terms of *incentives*, as mentioned earlier, employers receive up to a 90% credit against the federal unemployment tax in states with UI programs in conformity with certain requirements, such as a minimum level for the state's payroll tax rate and applying a firm-level experience rate to state unemployment taxes. In practice, all states conform to these requirements. Finally, harmonisation can also be attained through *compulsory requirements* that states are obliged follow. For example, it is compulsory for employers in all states to pay federal unemployment taxes.

Overall, the main lesson that Europe can learn here is perhaps that pragmatic concerns may carry more weight than policy concerns when determining the extent to which flexibility should be maintained under any European unemployment benefit scheme. While opinions will certainly vary about what would be best for workers and for the economy of each member state, what is most important is achieving an outcome that is better overall than what is presently available to avoid the problems experienced in the past.

6. How should the system manage big shocks? Rules vs. discretion

As was already indicated above, the temporary federal programs that provide more UI benefits to long-term unemployed workers are among the key characteristics of the American UI system. With these programs, the US federal government has recognised that during recessions workers need additional assistance and that states should not bear the full costs.¹⁷ This aspect of the American system is an instructive example for Europe. Some authors have, indeed,

¹⁶ For instance, during the Great Recession, if a state did not want to enter into an agreement to pay EUC or the \$25 weekly benefit supplement on behalf of the federal government it did not have to. Nevertheless, all states did. For Extended Benefits, however: the existence of Extended Benefits in states' laws is one of the requirements to obtain tax credits; moreover, states can amend their EB laws regarding a variety of parameters.

¹⁷ Note that some states also have their own solely state-financed programs to extend the duration of benefits during periods of high unemployment for individuals in approved training programs who have exhausted benefits or for other reasons. The California Training Benefits (CBT) scheme is one example. Others can be found here: <https://ows.doleta.gov/unemploy/pdf/uilawcompar/2016/special.pdf>.

argued that what Europe really needs is not a UI system that offsets all shocks by some small fraction, but a system that protects against shocks that are rare, but potentially catastrophic (Beblavý and Maselli, 2014). One question is how to decide when such temporary programs should be activated in a given state. Two main options have been put forward. The first – which we can call *rule* – is to set a criterion, typically when the rate of unemployment exceeds a certain threshold, that would trigger the system automatically. The second one – which we can call *discretion* – is to decide on a case-by-case basis without any *ex ante* rule.

Most American temporary programs are enacted in a discretionary way, in response to economic downturns. However, there are several major challenges to taking this approach. First, there is always a significant delay. It takes time for there to be sufficient awareness that economic conditions warrant additional action, and time to develop the program parameters. It also takes time for Congress to pass a bill and the president to sign it into law. And that is not the end of the challenge. It also takes time to prepare to administer a new program. When it is a discretionary program, the requirements are not known in advance. It takes time for operational guidance to be written and time to train staff, modify computer systems, and do everything else that is necessary to implement a new program. The Great Recession began in November 2007, but the Emergency Unemployment Compensation (EUC) program was not enacted until June 30, 2008. Even after the program was up and running, these challenges continued because EUC was modified and extended several times –sometimes retroactively (see Nicholson and Needels (2011) for an evaluation of the program). With greater complexity, there are more operational issues, more public confusion and, inevitably, errors that must be corrected. Another challenge with discretionary programs is that they often are not sufficiently targeted to the states that are most impacted by the recession because some of these benefits have always been available in all states regardless of their unemployment rate. This is really a political issue: to win votes, there generally needs to be ‘something for everyone’ (i.e. something for every state). There was a similar rationale when determining the unemployment rates that would make certain tiers of EUC benefits available.

The example of the Extended Benefits program further illustrates these points. EB was intended to establish a mechanism to automatically provide additional weeks of benefits when unemployment rates are high and rising. EB ‘triggers’ on when state unemployment rates exceed specified levels. In general, these benefit costs are shared equally between the state and the federal government.¹⁸ Experience with the program, however, has demonstrated that the triggers need to be reconsidered since the program either does not activate or activates much later than it should during a recession. (During the Great Recession, EB did not become available until early 2009 in many states.) It is for this reason that there has been interest in reforming the EB program so that it will function more effectively during the next recession and avoid the necessity of another ad hoc emergency program.

The US experience clearly points out that discretionary programs might not be the ideal solution. This is probably also true for Europe: the multi-level governance structure,

¹⁸ This was true in the original design. During the Great Recession, 100% federal funding was provided.

institutional differences and the necessity to apply a subsidiarity principle make the decision-making process potentially even slower than in the US (Beblavý and Maselli, 2014b). While discretionary elements may be politically more acceptable than a non-discretionary system, their potential downside also needs to be taken into consideration. Especially for big shocks, with severe economic and social effects, it is important to develop a UI mechanism that is highly responsive.

7. Conclusions

In recent years, there has been a revived interest in the idea of introducing a common European UI system. This debate was refuelled after the economic crisis starting in 2008 but already dates back to the 1970s. When it comes to the design of a potential EUBS, many have looked to the American case for inspiration: the two-tier US system has a longstanding, successful history and may therefore shed light on the key factors to take into consideration, including the strengths and pitfalls of the system. There has been a growing body of literature that draws lessons from the US system for a potential European UI, but only few studies have assessed whether these lessons are actually applicable to the European context. With this paper, we aimed to fill this gap.

Supra-state involvement in UI might help to achieve some of the goals of UI, especially in a free market and currency union, because it addresses coordination issues. This was particularly evident when UI was created in the United States: there, a two-tier system had to be implemented to overcome interstate competition. Even though interstate competition may not be as important issue in Europe, an EUBS could help to deal with other coordination issues, including spillover effects. Supra-state involvement further increases the stabilisation power of UI by pooling risks at a wider than state level, which relaxes state budget constraints. This is especially necessary in a currency union, and the experience of recent years has demonstrated that it is needed in EMU, in particular. The American example shows that supra-state intervention has indeed provided efficient macroeconomic stabilisation during the Great Depression. Not only does the additional financial leeway provided by supra-state involvement improve macroeconomic stabilisation, it also contributes to other goals such as redistribution of income among individuals.

The acceptance of the principle of solidarity (i.e. redistribution between states) may be one of the big hurdles a European level UI has to overcome. It is interesting to note that it is not considered as a big issue in the US. This is likely due to a weaker sense of European identity among European citizens, compared to the highly developed American identity in the US. But it could also be due to the way financial transfers occur between states in the American UI system, which should perhaps serve as an example for Europe. The American case also suggests that net transfers between states within the UI system are not the only factor to consider when determining which states win and which states lose. Other gains and losses that stem from the integration into the EU or EMU should also be taken into account. The issue of solidarity is also related to the risk of institutional moral hazard. The American example shows that there is a variety of possible tools to prevent institutional moral hazard. Those many different tools

should be considered in the design of a potential EUBS; the current proposals may have focused on too few tools to address institutional moral hazard.

When it comes to the trade-off between harmonisation and flexibility for states' UI system, the main conclusion is that even though a certain level of harmonisation would be desirable for an EUBS there are also arguments, both theoretical and more practical, to support flexibility. In the US, for example, pragmatic concerns have been the main driver determining how the UI system was set up. They also have led to substantial flexibility. At the same time, as in any principal-agent problem, the American example shows that a range of tools, including guidelines, incentives, or compulsory parameters, are available to arrive at a certain degree of harmonisation. This dual approach, i.e. pragmatism and combining several different tools, can inspire Europe to strike a balance between harmonisation and flexibility.

We conclude by highlighting the role of the temporary federal programs launched by the US federal government at times of economic crisis, which have been a source of inspiration to the European context. A broad consensus has been reached that the EU, and especially EMU, needs additional stabilisation mechanisms to absorb big shocks – rather than a mechanism that absorbs small shocks as well. While the American temporary programs are typically launched or activated on the basis of discretionary decisions, this approach results in severe delays and requires political consensus. As a result, automatically launched temporary programs appear to be a better choice for an EUBS.

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