A Common European Unemployment Insurance – A Much Debated Route toward European Fiscal Union

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The crisis has reignited a debate on deeper fiscal integration in the euro area. The goal is to improve the capability of the currency union to cope with asymmetric shocks. One instrument in this context is the implementation of a European unemployment insurance (EUI) scheme aiming at automatic stabilization of income and aggregate output in countries affected by adverse macroeconomic shocks and rising unemployment. Recently, a number of proposals and estimates of the economic effects of such a scheme have been published. The empirical analyses indicate a non-negligible stabilization effect of an EUI. However, an EUI is likely to face several problems originating, among other things, from structural differences in labor markets and potential moral hazard by Member States. An EUI therefore does not appear to be the most appropriate approach to increasing common risk sharing.

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While the financial crisis had originated in the United States, it acquired a truly European nature in 2010, when observers started to question the survival of the euro, blaming, inter alia, shortcomings in the design of European Economic and Monetary Union (EMU) for the crisis. This experience led to a renewed debate on deeper fiscal integration so that the euro area could cope better with asymmetric demand shocks. Toward the end of 2012, the "four presidents' report" (Van Rompuy, 2012) and the "blueprint for a deep and genuine Economic and Monetary Union" (European Commission, 2012a) proposed to introduce a "fiscal capacity" at the central level of the monetary union, provided that this does not lead to permanent unidirectional transfers between Member States and that moral hazard of Member States is ruled out.

One instrument for heading toward a fiscal union is the implementation of a European unemployment insurance (EUI) aimed at automatic stabilization of income and aggregate output in countries affected by adverse macroeconomic shocks and rising unemployment. Recent publications on an EUI comprise proposals and estimates of the economic effects of such a scheme. We provide an overview of this literature and assess the ongoing discussion.

The article is structured as follows: Section 1 summarizes the main points of the debate on closer fiscal integration in the euro area. In section 2, we discuss some aspects of centralized risk sharing. In section 3, we characterize current national unemployment insurance (UI) systems in euro area Member States to gain a better grasp on proposals for an EUI. In section 4, we review design aspects of an EUI and discuss its likely stabilization properties. Section 5 sheds light on the question whether the requirements set out for introducing a fiscal capacity are likely to be fulfilled. Section 6 summarizes and concludes.

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1 A Fiscal Union for the Euro Area – The Renewed Official Debate

1.1 European Monetary Union – An "Unfinished" Project

Before the start of European monetary union, many economists had argued that the currency union would not survive unless it was complemented by a fiscal or even by a political union.[2] The need for some type of (joint) macroeconomic stabilization or – in today's terminology – a risk-sharing mechanism within the monetary union had also been voiced repeatedly in influential EU reports.[3]

Optimum currency area theory states that country-specific shocks to aggregate demand would – due to sticky domestic prices and limited labor mobility across euro area countries – translate into lengthy and painful internal devaluation, which the common monetary policy cannot address (De Grauwe, 2012). In contrast, euro area-wide automatic fiscal stabilizers would allow re-establishing equilibrium, while limiting the necessary reduction in domestic prices and wages in a country affected by adverse asymmetric demand shocks. A shared fiscal policy would above all benefit a currency union with relatively weak cross-country labor mobility, limited wage and price flexibility, differing labor market institutions and different degrees of trade openness – patterns which are characteristic for the euro area.

In the euro area, the precrisis norm for budgetary behavior was to let automatic stabilizers operate freely, with discretionary policy being the exception rather than the rule. Policy makers in the euro area countries agreed to coordinate national fiscal policies through the Stability and Growth Pact. This set of rules was meant to provide national fiscal policies with enough room for letting the automatic stabilizers do their work as well as for taking necessary discretionary measures in case of periods of slow or negative growth. However, when the crisis hit, it became clear that fiscal positions in many euro area countries allowed very little leeway for discretionary anticyclical measures. Moreover, in particular the sovereign debt crisis showed that the scope of national fiscal policies to act countercyclically will disappear if credit markets freeze up. No longer able to borrow, countries fail to smooth aggregate income and consumption. Hence, the incomplete design of the European monetary union was once again criticized (O'Rourke and Taylor, 2012; Krugman, 2013; De Grauwe, 2013).

1.2 A "Fiscal Capacity" for the Euro Area – A First Step Toward a Fiscal Union

The official debate on a fiscal union[4] for the euro area[5] started at the June 2012 European Council, when the presidents of the European Council, the Commission, the Eurogroup and the ECB were

[2] *See European Commission (2013a) for references to this older discussion.*

[3] *The MacDougall Report (Commission of the European Committees, 1977), the Delors Report (European Community, 1989) and the "One Market One Money" Report (Commission of the European Communities, 1990). For instance, one of the conclusions of the MacDougall Report was that public finance in economic unions plays a major role in cushioning short-term and cyclical fluctuations.*

[4] *The term "fiscal union" is used to mean very different things. We use it to refer to the creation of a significant tax and transfer system at the central level of monetary union capable of cushioning asymmetric shocks.*

[5] *We do not discuss fiscal risk sharing at the level of the EU as a whole because the issue of fiscal risk sharing is only critical in a currency union where national monetary and/or exchange rate policy instruments are no longer available.*

commissioned with coming up with a specific road map "towards a genuine Economic and Monetary Union." The final report of the four presidents (Van Rompuy, 2012) proposed "a timeframe and a stage-based process towards the completion of Economic and Monetary Union." The first stage was ensuring fiscal sustainability (e.g. the "six-pack" and "two-pack" legislations) and breaking the link between banks and sovereigns (above all, by establishing the Single Supervisory Mechanism (SSM) and the European Stability Mechanism (ESM)). Stage two includes the completion of the integrated financial framework and "setting up a mechanism for stronger coordination, convergence and enforcement of structural policies." The final, post-2014 third stage suggests "improving the resilience of EMU through the creation of a shock-absorption function at the central level" by establishing a "well-defined and limited fiscal capacity."

With regard to putting the concept of a fiscal capacity into practice, the four presidents' report suggests two broad options: the first is following a "macroeconomic approach," under which contributions and disbursements would be based on fluctuations in cyclical revenue and expenditure items, or on measures of aggregate economic activity. The alternative would be a "microeconomic approach," under which transfer payments would depend on a "specific public function sensitive to the business cycle, such as unemployment insurance." The fiscal capacity would then work as a complement or partial substitute to national UI systems. The report suggests that transfers could be limited to cyclical unemployment by covering only short-term unemployment. It states principles of a fiscal capacity, but does not define a specific plan in more detail.

In parallel to the four presidents' report, the European Commission submitted "A blueprint for a deep and genuine Economic and Monetary Union – launching a European debate" (European Commission, 2012a). This report likewise proposes a three-stage process, starting with the establishment of a "convergence and competitiveness instrument" within the EU budget to support rebalancing, adjustment and growth. In the second stage, a proper fiscal capacity for EMU should be established to support the implementation of the policy choices resulting from deeper policy coordination, in particular in the field of taxation and employment. The long-run solution would be to establish "an autonomous euro area budget" (European Commission, 2012a, p. 12). The European Commission, too, considers both a "macro" and a "micro" approach; like the four presidents' report, it does not propose a detailed scheme for a fiscal capacity, either.

Moreover, the issue was also addressed in an IMF staff discussion note (see Allard et al., 2013). The authors suggest several instruments for the further development of EMU, such as: (1) a "rainy-day fund,"[6] which would accumulate contributions from Member States and redistribute them to specific countries when they are hit by an idiosyncratic shock; (2) an EUI accompanied by efforts to enhance and harmonize labor market arrangements across euro area countries; and (3) a fully-fledged euro area budget with centralized provision of public goods, such as infrastructure, which could be used as a countercyclical tool.

[6] *This instrument is also discussed by the European Commission (2012a and 2013a).*

1.3 Guiding Principles for a Common Risk-Sharing Mechanism in the Euro Area

Both the four presidents' report and the blueprint by the European Commission clearly stress that a common fiscal risk-sharing instrument can only be implemented if it satisfies specific requirements, formulated as guiding principles in the four presidents' report: It should not undermine incentives for sound economic policy, and it should limit moral hazard and foster structural reforms. The fiscal capacity should not lead to unidirectional and permanent transfers between countries, nor should it be conceived as an income equalization instrument. Moreover, it should not result in an increase in expenditure or taxation levels.

In a similar vein, the Commission blueprint calls for a mechanism specifically designed to address short-term asymmetric cyclical developments, in order to avoid permanent transfers and to support structural reforms. Finally, such a mechanism needs to be subject to strict political conditionality to avoid moral hazard.

2 Is Centralized Public Risk Sharing Always Desirable?

In this section, we discuss two aspects that could affect the assessment of the usefulness of an EUI. First, we attempt to identify circumstances under which centralized automatic stabilizers are superior to Member States' automatic stabilizers. Second, we consider potential private alternatives to public risk sharing. At this point, it is appropriate to issue a caveat as it is far from obvious that fiscal stabilization at the central level of monetary union is always desirable. When a member country of a currency union is hit by an asymmetric shock, public insurance at the central level may indeed cushion such a shock. However, automatic stabilizers are no panacea – in the case of a supply shock and/or a permanent shock, they tend to delay necessary adjustment processes.

2.1 Centralized versus National Automatic Fiscal Stabilization

A partial centralization of automatic fiscal stabilization might be desirable because of coordination failures. In a currency union of small open and heavily interdependent economies, the individual member states do not provide enough automatic stabilization because their fiscal multipliers at the country level are small due to high marginal propensities to import. Thus, member states do not take the external stabilization effect into account (see Oates, 1999).

Furthermore, centralized fiscal shock absorption is preferable when individual countries face credit constraints. The crisis revealed that the scope of national fiscal policies to act countercyclically may become very restricted or may even disappear completely if credit markets freeze up. Consequently, such countries can no longer borrow and hence no longer smooth aggregate income and consumption. Similarly, a fiscal capacity could prevent countries which are restricted in making deficits by EU regulations, such as the Stability and Growth Pact, from being forced to undertake procyclical measures (see also von Hagen and Wyplosz, 2008).[7] However, the effect of an EUI hinges

[7] *Although the EU Economic Governance Reform 2011 increased the flexibility of the Stability and Growth Pact insofar that a "waiver" from any (procyclical) fiscal adjustment is provided in the event of an extremely severe crisis (see European Commission, 2013c), for less severe circumstances the von Hagen/Wyplosz argument is still valid. See also De Grauwe (2013).*

also on how Member States use the funds that are freed up by an EUI (e.g. Enderlein et al., 2014).

2.2 Private Alternatives to Fiscal Risk Sharing

There are two key market-based means to smooth country-level consumption and stabilize demand within a currency union: private insurance via international capital markets and cross-border saving and borrowing.[8] The insurance tool of choice in international capital markets is portfolio diversification. Yet, as stated by Allard et al. (2013), cross-border ownership of assets within the euro area remains more limited than in the U.S.A. or across the federal states in Germany. This behavior might have become even more pronounced with the recent crisis.

In Europe, however, private risk sharing is not only low, but also exhibits inherent problems. For example, Furceri and Zdzienicka (2013) estimate that the share of unsmoothed shocks is particularly high in recessionary periods (76% in 2008–2010), i.e. when it would, in fact, be badly needed. International credit markets appear reluctant and are quite unwilling to grant cross-country loans particularly in severe downturns.[9] Moreover, according to Fahri and Werning (2012), even with perfect financial markets, economic agents tend to underinsure as they do not take into account the aggregate demand externalities inherent in their choices. This argument is similar to the one of underprovision of automatic stabilization by individual states in currency unions.

3 National Unemployment Insurance Systems in the Euro Area

Some knowledge of existing UI systems is indispensable for the evaluation of any EUI proposals. In particular, the stabilization impact of an EUI depends crucially on its interaction with national UI schemes. The main characteristics of national UI systems are compiled by several institutions, for example by the OECD and the Swedish Institute for Social Research in its Social Policy Indicator Database (SPIN).[10]

3.1 Main Characteristics of National UI Systems in the Euro Area

National UI systems in the euro area are complex and heterogeneous. There are differences along three dimensions: (1) the unemployment replacement rate, (2) unemployment benefit duration and (3) eligibility. The unemployment replacement rate is indicated in the literature mostly as a percentage of previous net earnings (net replacement rate – NRR). Because of earnings thresholds and supplements to benefits (e.g. when the unemployed person has children), NRRs depend on previous pay and the family situation of the unemployed. The NRRs as published by the OECD for the euro area countries are shown in the left panel of chart 1. The numbers refer to a single unemployed person whose wage equals the average wage in

[8] *Allard et al. (2013), Asdrubali et al. (1996) as well as Sørensen and Yosha (1998) estimate that, in the U.S.A., about 80% of income shocks are smoothed out, with the largest smoothing impact coming from capital markets (45%), followed by credit markets (about 20%). Risk sharing via private and public mechanisms in EMU is roughly half as effective, as only about 40% of income shocks are smoothed.*

[9] *In this respect, banking union aims at further financial integration, the reduction of financial fragmentation as well as the alleviation of the bank-sovereign debt nexus.*

[10] *Other sources are the Mutual Information System on Social Protection and Social Security (MISSOC) by the European Commission and "Social Security Programs Throughout the World" published by the U.S. Social Security Administration.*

the respective economy. It is patently evident from this chart that replacement rates vary substantially, namely from 37% in Greece to 87% in Belgium.

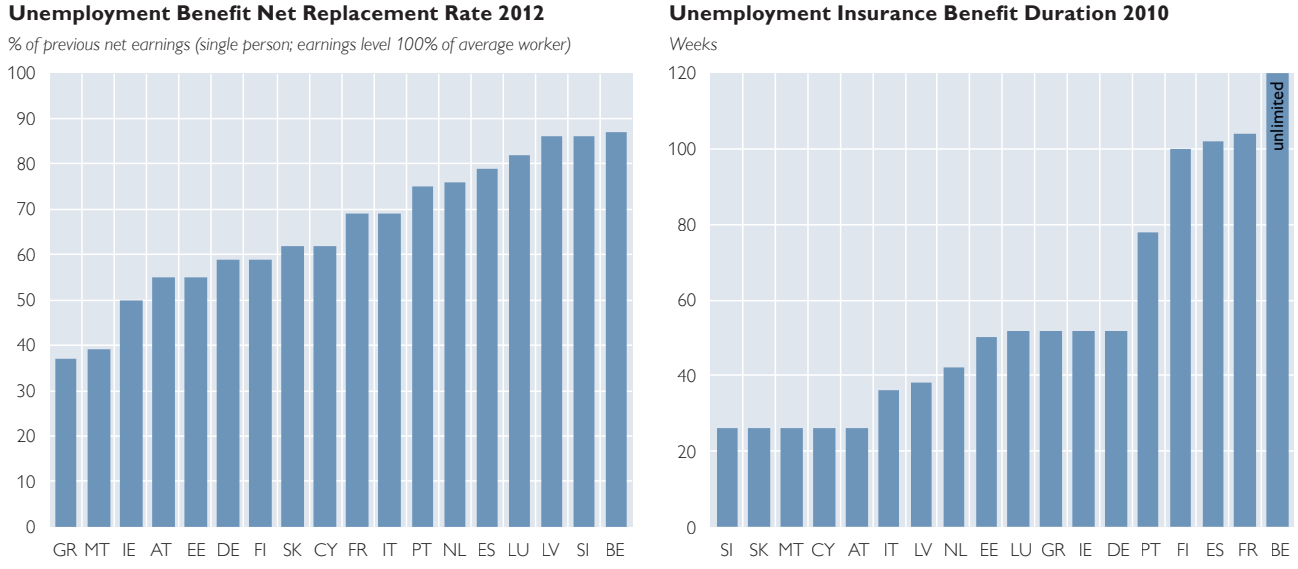
Unemployment benefit duration, likewise, varies greatly across the euro area countries, ranging from 26 weeks in a number of them, including Austria, to indefinite (Belgium). The right panel of chart 1 shows benefit duration as provided by the SPIN database for the year 2010. Benefit duration is often extended for specific vulnerable groups (e.g. young or elderly unemployed), and unemployed persons may requalify for unemployment benefit when they attend vocational training. Also, looking only at benefit duration could be misleading for countries that provide unemployment assistance payments (or social assistance)[11] for unemployed persons not entitled to unemployment benefits or whose benefits have expired. In contrast to UI benefits, unemployment assistance payments are means tested in most countries (i.e. family income and assets are taken into account).

The third dimension of UI systems, individual eligibility, typically depends on a qualifying period (i.e. the minimum number of weeks an unemployed person must have worked) within a certain reference period. Most countries have a qualifying period of 52 weeks; Slovakia has the longest such period (156 weeks), and France the shortest (17 weeks).[12]

It follows from such eligibility criteria that not all unemployed persons are covered by UI. Coverage, which is defined as the number of insured persons relative to the total labor force, may be low if some groups are excluded from the UI system altogether. For

Chart 1

Unemployment Benefit Replacement Rate and Benefit Duration in Euro Area Countries



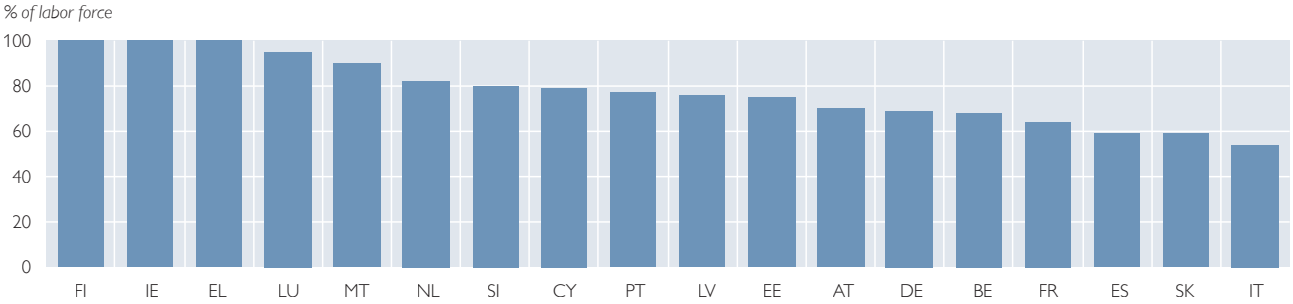
Source: OECD; Social Policy Indicator Database (SPIN).

[11] *See Esser et al. (2013) for different systems of unemployment assistance or social assistance that is available to unemployed persons whose benefits have expired. Italy appears to be the only country where there is no such income support.*

[12] *In Austria, the reference period is two years; the qualifying period is 52 weeks.*

Chart 2

Unemployment Insurance Coverage Rates (2010)



Source: Social Policy Indicator Database (SPIN).

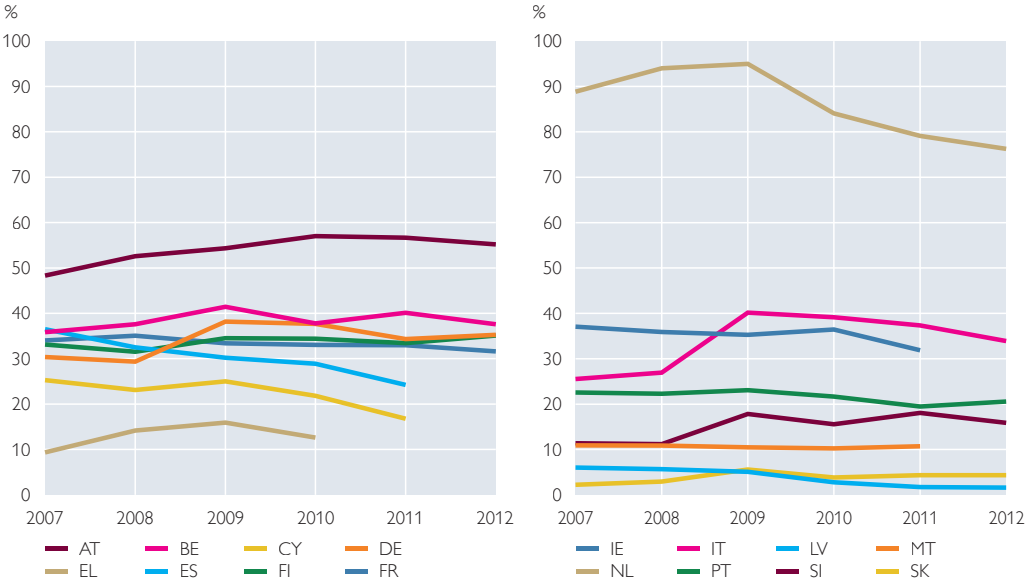
example, in many countries, self-employed persons are not included in the UI system. Chart 2 shows UI coverage rates for the euro area countries. Whereas coverage is 100% in Finland, Ireland and Greece, it is less than 60% in Spain, Slovakia and Italy.

A further important aspect of UI systems are job search (and job take-up) conditions that the unemployed persons have to fulfill in order to receive benefits (see Stovicek and Turrini, 2012).

To give an idea of the overall income support provided by national UI systems, chart 3 presents the ratio of unemployment benefits per unemployed person (Eurostat/ILO definition)[13] relative to average wages and salaries per em-

Chart 3

Unemployment Benefits per Unemployed Relative to Wages and Salaries per Employee



Source: Eurostat, authors' calculations.

[13] *This definition of unemployment does not necessarily correspond to the entitlement to unemployment benefits (see section 5.3).*

ployee. This chart once again reveals huge differences[14] among the euro area countries: With the exception of the Netherlands and Austria, the ratio is 40% or less throughout the euro area. It is very low in Greece (13%) and below 10% in Latvia and Slovakia. In most countries, the levels of the depicted ratio remained relatively stable during the observation period, with the exception of some crisis-ridden countries like Spain, where this ratio decreased over time.

4 Design of an EUI and Its Potential Stabilization Effect

Let us now turn to the design options for an EUI with regard to benefits, financing and eligibility. We also present some simulation results found in the literature to give an idea of the potential stabilizing effect of an EUI. The simulation methods used and the time periods underlying the estimates are very different, however. Thus, the estimates offered are hardly comparable.

Given the large number of pertinent contributions published over the last few years,[15] we have to restrict ourselves to a select few. We include Dullien (2013), as this author is probably the best-known advocate of an EUI. We consider contributions from an official European institution, i.e. the European Commission (2013a), and by Dullien et al. (2014) – the latter was commissioned by the Austrian Federal Ministry of Labour, Social Affairs and Consumer Protection. Attention is also given to Dolls et al. (2014) and Jara and Sutherland (2013) since they deliver – like Dullien et al. (2014) – a thorough impact assessment based on micro-simulation models rather than the crude mechanical simulations offered by Dullien (2013).

4.1 Designing an EUI – An Overview of the Discussion

A EUI scheme may interact with the national UI systems in different ways. Most proposals envisage a basic UI at the European level that substitutes the national UI for a certain period of time (e.g. one year) and can be topped up by national benefits. An EUI could aim at stabilization across countries, i.e. at alleviating cross-country business cycle differences. Stabilizing the euro area business cycle, i.e. intertemporal stabilization, might be an additional objective. Intertemporal stabilization implies that the EUI would be allowed to run surpluses and deficits in order to be effective in the case of common shocks. Accordingly, one would have to decide on the horizon over which the system has to be balanced and on how to balance it. In contrast, a system that merely aims at cross-country stabilization would have to distribute contributions contemporaneously as benefits. This complicates implementation as contribution rates or benefits would have to be adjusted regularly. Most of the discussion and also the simulation results discussed below are based on the assumption that an EUI will allow for intertemporal stabilization. Dullien

[14] *See Boeri and van Ours (2014) for a different approach to providing an overall measure of income support provided by unemployment benefit systems. According to their measure, Austria has the highest fraction of income stabilization among the countries surveyed (44.8%). The ratios are lowest in Portugal, Spain, Italy and Greece (15.3%, 14.9%, 5.8% and 2.4%, respectively). Boeri and van Ours argue strongly against simplistic comparisons of UI systems by using only benefit replacement rates and benefit duration, which has been quite common in the literature.*

[15] *For an overview, see European Commission (2013a) and Claeys et al. (2014a), which also review different types of schemes (e.g. catastrophic insurance) which we do not take into account.*

(2013) notes that this is – at least in the present economic situation where the effectiveness of monetary policy for business cycle stabilization is limited – the preferred approach.

Concerning the replacement rate, the proposals at hand assume that benefits depend on previous monthly wages and mostly amount to about half of that income. Maximum benefit duration is, as a rule, one year or less (see also section 5.1). Most studies assume that an EUI is financed by social contributions levied on labor income. The European Commission (2013a) departs from other papers in this respect by suggesting the system be financed not only by social contributions but also by a different tax base in order to shift part of the burden from labor income to other sources.[16] A specific contribution rate is not indicated. In Dullien (2013, 2014) and Dolls et al. (2014), the level of contributions is set in a way that the common EUI is balanced over the respective observation period. See table 1 for an overview of the specific proposals for the replacement rate, benefit duration and financing.

4.2 Assessment of the Economic Effects of an EUI[17]

Dullien et al. (2014) examine various schemes that differ in generosity: the most restrictive scheme provides unemployment benefits corresponding to 30% of the previous monthly net wage for a period of 6 months; in the most generous scheme, 70% of the previous income is paid out over 12 months. In the simulations, annual contributions and benefits amount on average to about EUR 40 billion in the most generous scheme. High net benefits (as a share of GDP) accrue to Spain, Greece, and France. Dullien et al. (2014) note that the net benefits to Spain and Greece are to a substantial extent a result of the crisis. These countries would have seen the highest transfers in 2012, namely in the amount of 0.9% and 1.0% of GDP, respectively. France, by contrast, permanently receives net benefits.

Dullien et al. (2014) measure macroeconomic stabilization as the impact of the EUI system on GDP growth rates and present results for selected countries. For the euro area as a whole, an EUI would have led to some stabilization during the crisis, with an increase in the euro area growth rate – relative to the baseline – of up to 0.13 percentage points in 2009. Stabilization is more pronounced in Spain, a country that was above average affected by the crisis. In the most generous model, GDP growth in Spain would have been higher in all years from 2007 to 2012 (except 2010) compared with the baseline. In 2009, in particular, the growth rate would have stood at –3.1% instead of –3.8%. For Austria, such an EUI would have mostly had a negative (but small) impact on growth.

Dolls et al. (2014) show that an EUI without national top-ups would have stabilized income in all Member States in 2009. On average, 42.5% of the shock on gross household income would have been absorbed by an EUI. In other years, the stabilizing effect would have been more modest, however. Over the whole period, countries with the worst

[16] *In this regard, the impact of taxation on the level of contributions and benefits and thus on stabilization should also be taken into account (see e.g. Box 5 in European Commission, 2013a). Currently, the financing of unemployment insurance differs from country to country: in most cases UI is financed by payroll taxes as paid by employers and workers (see Esser et al., 2013).*

[17] *In addition, Claeys et al. (2014b) offer the possibility of calculating online the effects of an EUI for different parameters.*

Table 1

Overview of EUI Proposals and Effects

		Benefit replacement rate (%)	Contribution rate (%)	Period under investigation	Maximum benefit duration (months)	Average annual payouts/ contributions (EUR billion)	Income stabilization	GDP stabilization
Dullien (2013)		50% of the insured earnings	depending on the assumptions on STU: 0.65% / 1.66% payroll tax	1995–2011	12	50	n. a.	0.2% (GR, 2001/02) to 55.8% (AT 2001/02)[1] measured as percentage of the deterioration in the output gap prevented by an EUI. The author shows only numbers for selected countries and periods.
Dullien et al. (2014). The authors analyze six schemes but focus on the two schemes presented in the table.	70/12 variant	70% of previous net earnings	1.33% of previous gross earnings	1999–2012	12	41	no specific numbers provided	0.13 percentage points (2009) to –0.12 percentage points (2010)[1] impact on euro area growth rate.
	30/6 variant	30% of previous net earnings	0.39% of previous gross earnings	1999–2012	6	12	no specific numbers provided	0.05 percentage points (2009, 2012) to –0.08 percentage points (2010)[1] impact on euro area growth rate.
European Commission (2013a). "Most proposed option" in table 11		40%–50% of previous earnings	financing mix proposed	n. a.	12	n. a.	n. a.	n. a.
Dolls et al. (2014)		50% of previous gross earnings	1.98% payroll tax	2008–2013	12	60	income stabilization coefficient 42.5% (2009)[1] for the euro area; precrisis calculations in Dolls et al. (2012) for the stabilization impact of national UI suggest a stabilization coefficient for unemployment shocks of national UI systems in the euro area of 20.2%.	n. a.
Jara and Sutherland (2013)	flat rate variant	33% of average national earnings	n. a.	n. a.	9 (months 4 to 12)	n. a.	19 percentage points (LV)[1] of additional income stabilization (coefficient of income stabilization).	n. a.
	proportional variant	50% of previous gross earnings	n. a.	n. a.	9 (months 4 to 12)	n. a.	24 percentage points (GR, LV, AT)[1] of additional income stabilization (coefficient of income stabilization).	n. a.

Source: Authors' compilation.

[1] Years/countries with most pronounced impact.

labor market outcomes would have received the most support – as intended by an EUI. Dolls et al. (2014) compare EUI-induced income stabilization with the stabilization offered by national UI schemes (see also Dolls et al., 2012). They conclude that the differences would be most pronounced in Estonia, Greece, Italy and Slovenia, and still above average also in Ireland and Spain. All of these countries have precrisis unemployment schemes in place that absorb only a fraction of unemployment shocks. Since the eligibility rules of the national unemployment systems are stricter than those of the EUI, low coverage ensues.

Jara and Sutherland (2013) consider the effect of an EUI that supplements national systems on disposable household income in selected euro area Member States (Germany, Estonia, Greece, Spain, France, Italy, Latvia, Austria, Portugal and Finland). They do not focus on a specific time period and assume that everybody has the same probability of becoming unemployed. The results of Jara and Sutherland (2013) show that an EUI would have positive effects on income stabilization but the impact on individual countries would be quite heterogeneous. The largest additional (i.e. relative to national UI systems) stabilization impact is observed for Greece, Latvia and Austria (23 to 24 percentage points in each case) under the proportional EUI scheme (i.e. benefits depend on previous income). The authors attribute these results mainly to differences in the design of national UI systems and in labor force characteristics (mainly the proportion of self-employed persons as they are not covered in many national UI schemes). The result for Austria is attributed to benefit ceilings in the national UI as well as to the fact that the earnings base is measured net of taxes and contributions (Jara and Sutherland, 2013, p. 24).

To summarize, the simulations show that an EUI may have a non-negligible effect. However, the impact depends on the precise design of the scheme and its interaction with national unemployment schemes. In particular, differences in the generosity of the European and the respective national unemployment scheme affect the country-specific impact of an EUI.

5 Are the Requirements for an EUI Likely To Be Fulfilled?

Let us recall, from section 1, the guiding principles of a fiscal capacity. First, the fiscal capacity should not lead to unidirectional and permanent transfers between countries. Second, it should limit moral hazard of Member States and it should not impede structural reforms. In the following section, we deal with these questions and briefly discuss some practical aspects of the implementation of an EUI.

5.1 Structural Differences between Labor Markets Make Unilateral Permanent Transfers Likely

The empirical papers reviewed suggest that, when we take a look at the period from the introduction of the euro until the more recent past, "core countries" like Germany, the Netherlands and Austria would have paid more into the scheme than they would have received in transfers. Countries in the southern rim, such as Spain, Portugal, Italy and Greece, that experience high unemployment rates, by contrast, are net recipients. This result is primarily due to the specific course of events and the deep structural crises in these countries on the periphery and need not be an argument against EUI *per se*. In contrast, here we discuss factors that are independent of the size of macroeconomic

shocks and which might suggest that there are winners and losers from such a scheme because of structural factors. Such factors are related to structural differences in the levels of unemployment and in the reaction of labor markets to aggregate shocks.

Given the significant differences in the unemployment rates of the euro area countries and the fact that the differences are at least partly due to different structural unemployment rates,[18] an EUI scheme covering total unemployment appears not to be politically feasible because the potential gains tend to be unevenly distributed (see also Keuschnigg, 2012). To avoid this obvious difficulty, the four presidents' report (Van Rompuy, 2012) and subsequent proposals suggest that an EUI should cover only cyclical unemployment, which, for practical reasons, could be approximated by short-term unemployment (STU, usually defined as the labor force share of the unemployed with unemployment duration of up to 12 months). STU has the advantage in this context that it is readily observable from unemployment statistics. Thus, there would be no need to estimate the cyclical position of an economy as it is required for "macroeconomic approaches" to stabilization. These estimates are sometimes controversial and lack robustness over time (European Commission, 2013a). However, the conceptual advantage of an EUI over stabilizers that are based on econometric estimates may be questioned.[19]

Even if an EUI is restricted to cyclical or short-term unemployment, there is another aspect of unemployment in which countries differ: euro area labor markets show heterogeneous reactions to aggregate shocks of a given size. The relationship between the deviation of the unemployment rate from its long-run equilibrium and the deviation of real output from its equilibrium value is known as Okun's law. In a recent review, Ball et al. (2013) find that the Okun coefficient varies substantially across countries. Table 2 contains their results for a number of euro area countries.

The absolute value of the coefficient for 1980–2011 is by far the highest in Spain (–0.85); it even seems to have risen in absolute terms since the mid-1990s. This is probably attributable to reforms in the 1980s which made it easier for firms to employ leased staff (who are also much easier to lay off

Table 2

Estimates of the Okun Coefficient (1980–2011; annual data)

	Whole period	Until 1995	As of 1996
Austria	–0.14	–0.13	–0.14
Belgium	–0.51	–0.63	–0.31
Finland	–0.50	–0.61	–0.30
France	–0.37	–0.40	–0.34
Germany	–0.37	–0.43	–0.27
Ireland	–0.41	–0.46	–0.38
Italy	–0.25	–0.14	–0.36
Netherlands	–0.51	–0.71	–0.34
Portugal	–0.27	–0.22	–0.46
Spain	–0.85	–0.79	–0.92

Source: Ball et al. (2013).

[18] *There is a wide consensus that cross-country differences in unemployment rates are strongly driven by differences in structural unemployment rates (European Central Bank, 2012; European Commission, 2013b). However, the extent to which unemployment is structural or cyclical is subject to an intensive debate (see Arpaia et al., 2014, and Diamond, 2013).*

[19] *It is not obvious that STU is indeed a good proxy for cyclical unemployment: In quarterly data (from the first quarter of 1999 to the first quarter of 2014) for the whole euro area (EA-18), the correlation coefficient between the short-term unemployment rate and the cyclical component of the unemployment rate (obtained with an HP filter, parameter λ=1600) is merely 0.41.*

when demand goes down).[20] At an Okun coefficient of a mere –0.14, which seems to have been quite stable over time, Austria, on the other hand, is shown to record the weakest unemployment reaction to output fluctuations. The reaction of unemployment to macroeconomic shocks depends on many structural factors. They include the degree of employment protection, labor relations (e.g. the system of collective bargaining) and the readiness of firms to shield workers against demand disturbances (the role of "implicit contracts" and the extent to which employment adjustment occurs through the intensive rather than on the extensive margin, i.e. through the adjustment of working time rather than headcount employment) but also the role of active labor market policies (ALMP), to which we will turn below. Box 1 provides further evidence on structural differences between labor markets.

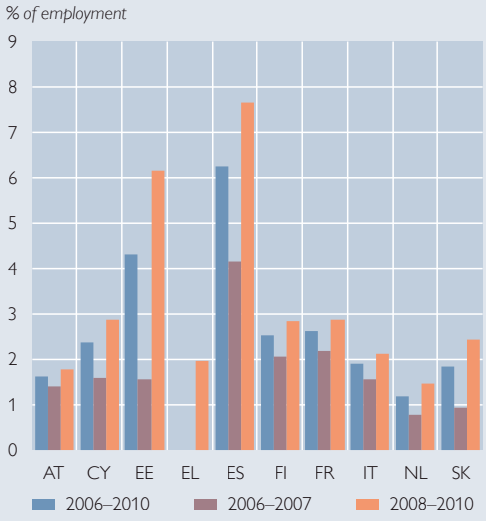
Box 1

Structural Differences between Labor Markets: Evidence from Flow Data

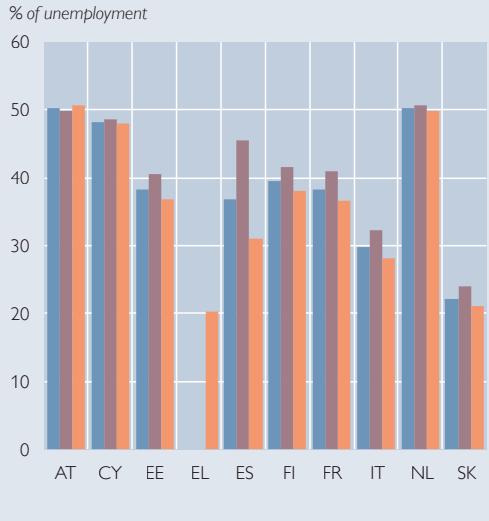
By definition, the equilibrium unemployment rate (provided that the labor force is constant) is given by $u^* = (s/(s+f))$ where s is the separation rate (flows from employment to unemployment) and f is the job-finding rate (flows from unemployment to employment). Equilibrium unemployment is thus determined by both s and f, which depend on structural characteristics of labor markets. s is influenced by the degree of employment protection, the degree of labor hoarding and the extent to which labor is adjusted on the intensive or extensive margin, respectively, while f might depend on the generosity of unemployment benefits, the strictness of job search requirements or the role of active labor market policies.

Annual Labor Market Transition Rates in Euro Area Countries

From Employment into Unemployment



From Unemployment to Employment



Source: European Commission (2012b); for Austria: authors' calculations.

Note: The transition rate for a particular year (t) is the share of transitions from year (t) to year (t+1).

[20] *Spain has been a country with high employment protection for permanent contracts, but it also had the highest share of leased workers before the crisis (28% of the total workforce). It can thus be regarded as a country with a high degree of "dualism" in its labor market (Boeri, 2011).*

The chart above shows annual labor market transition rates for ten euro area countries[1] from 2006 to 2010, as presented in a survey published by the European Commission (2012b). We calculated the values for Austria ourselves, drawing on Austrian Labour Force Survey (LFS) data. The left panel of the chart displays employment to unemployment transitions and the right panel shows unemployment to employment flows.

Different patterns emerge (see European Commission, 2012b) which suggest structural differences in labor market reactions[2]: One group of countries posts relatively high transition rates from unemployment to employment and moderate inflows into unemployment (Austria, the Netherlands, Finland, and to a certain extent also France and Cyprus) both before and during the crisis. Another group of countries, e.g. Italy, records low overall labor market dynamics before and during the crisis (low flows out of unemployment into employment, but also in the opposite direction). Finally, there are countries with generally high dynamics and a significant deterioration in both rates (such as Spain) or countries with generally low dynamics (like Greece).

[1] *Results for Greece are available for 2008–2010 only.*

[2] *More evidence on labor market flows and cross-country differences is provided in two reports by the European Central Bank (2012 and 2014).*

Given the way labor markets are currently structured, unidirectional permanent transfers are likely to result from an EUI. To address this issue, it is often suggested (e.g. by the European Commission, 2013a, and Andor, 2014) that contribution parameters of an EUI scheme be regularly adjusted to bring the system closer to ex ante balance over the medium term.[21] An alternative are "clawbacks," which would neutralize net transfers ex post. Such mechanisms would resolve the problem of permanent transfers but make an EUI scheme more complex and reduce its stabilization impact.

5.2 Potential Moral Hazard Problems

Moral hazard problems are intrinsic to any form of insurance. In case of an EUI, moral hazard could potentially arise for a number of aspects. One is the extent to which structural factors that are under the control of the government influence the level of unemployment. Under an EUI scheme, governments might be less willing to pursue policies which reduce unemployment risks if such policies go along with considerable political costs. Claeys et al. (2014a) observe that there is a tradeoff between the stabilization properties of an EUI and design features aimed at limiting moral hazard. For example, stabilization would be larger if income support were very long lasting. But this would presumably lead to moral hazard at the level of the individual countries. Thus, it is essential that the income support provided by an EUI is only temporary and rather short term (see also Dolls et al., 2014). Moral hazard can also be avoided if there is ex ante or ex post adjustment of UI parameters but the presence of such adjustments limits the stabilization effects of an EUI.

A more relevant problem with an EUI could be that such a scheme provides adverse incentives to absorb shocks at the intensive margin of

[21] *A similar mechanism is present in the U.S. system. The European Commission (2013a) recommends establishing Member State accounts. As in the U.S. unemployment system, these accounts would have to be balanced over a specified time period (e.g. by – automatically – adjusting contribution rates).*

employment rather than at the extensive margin because some of the costs of such employment adjustment would be borne by national governments (ALMP measures like expenses for short-time work benefits), whereas unemployment benefits are financed by the common pool (Dolls et al., 2014). This constitutes an argument for a greater harmonization of national labor market policies.

5.3 Is there a Need for More Harmonization of National UI Systems?

EUI proponents regularly stress that an EUI could easily complement the diverse national UI systems and that there is no need to harmonize these systems (e.g. Dullien, 2014). An EUI would replace national UI temporarily. However, in national systems, there are clear provisions as regards UI contributions and eligibility to benefits. The harmonized data of the European Labour Force Survey (EU-LFS) that Dullien (2014) refers to are not relevant for an EUI: Unemployment in the EU-LFS is merely weakly related to unemployment benefit eligibility,[22] and being classified as "employed" in the EU-LFS does not necessarily mean that such persons have to contribute to unemployment insurance. For an EUI, common standards concerning eligibility would have to be established and monitored because otherwise countries could claim higher than justified unemployment benefits or they could try to reduce the contributions to the common UI scheme (see Enderlein et al., 2014).

Further aspects are the relationship between unemployment benefits and job search requirements on the one hand and the relationship between unemployment benefits and ALMP measures (such as educational training) on the other. They imply great variance among countries because there are very diverse ways to organize public employment and training schemes for the unemployed.

Thus, it seems quite obvious that eligibility criteria and regulations concerning UI contributions should be harmonized across countries at least for the time span EUI is granted to individuals. The European Commission (2013a) suggests introducing common eligibility standards (for a qualifying period, a reference period, and the types of labor contract covered).[23] Moreover, an EUI and national schemes should likewise be harmonized with a view to avoiding difficulties when an unemployed person's eligibility to EUI benefits expires. Such a harmonization of national social systems would be an ambitious task.

6 Summary and Conclusions

The recent financial and economic crisis has revealed that more central risk sharing – e.g. in the form of a EUI – might be beneficial for the euro area. Several proposals for the design of an EUI have been discussed widely, and empirical analyses indicate that such a scheme would have a non-negligible

[22] *Many of those classified as "unemployed" are not recipients of unemployment benefits because they are not eligible. Indeed, this fraction of the unemployed also differs widely among EU Member States (see Dullien, 2013). Moreover, some recipients of unemployment benefits are not classified as unemployed (e.g. because they had worked a few hours in the reference week of the survey).*

[23] *According to Dolls et al. (2014) as well as Jara and Sutherland (2013), all new unemployed, including former self-employed persons, should be eligible given a certain period of previous contributions. Dullien et al. (2014), on the other hand, propose that EUI eligibility should be connected to eligibility for national unemployment benefits. As eligibility varies substantially, this would put countries with tight eligibility criteria at a disadvantage.*

stabilization effect, in particular in countries where the income stabilization provided by national UI systems is low. Moreover, an EUI is believed to be especially helpful for Member States that have lost access to capital markets or that are restricted from borrowing for other reasons.

Nevertheless, any practical implementation of an EUI is likely to suffer from shortcomings for various reasons: Structural differences in labor markets (i.e. different reactions of unemployment to shocks and different magnitudes of labor market flows) imply that costs and unemployment benefits tend to be distributed unevenly. Additionally, moral hazard by Member States cannot be ruled out. Apart from that, there are numerous practical difficulties associated with the implementation of an EUI. Finally, the costs and benefits of an EUI should be compared with those of other instruments to establish a fiscal capacity.

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