A feasible shock absorber for the euro area

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1 A feasible scheme in the current EU framework

The sovereign debt crisis of 2011-13 has exposed the limits of a monetary union with fully decentralised fiscal policies. In the impossibility of managing country specific negative shocks through monetary policy and exchange rate fluctuations, national governments can only resort to counter-cyclical fiscal policy to stabilise the economy. In practice, we have seen that they may have little room to manoeuvre due to the interplay of the union fiscal rules and the limited access to capital markets whenever the fiscal position has deteriorated. A centralised fiscal tool could help to absorb idiosyncratic negative shocks.

This idea has long been present in the debate on the European unification, at least since the reports prepared by the expert commissions chaired by Marjolin and MacDougall in the 1970s, and by Delors a decade later. It has gained new momentum in the midst of the sovereign debt crisis with the suggestion from the so-called report of the Four Presidents to create "An EMU fiscal capacity with a limited asymmetric shock absorption function" a priority later confirmed by the Five Presidents' report in 2015. Critics fear that such a capacity could foster opportunistic behaviour and weaken the incentives to promote painful growth-enhancing reforms, but the thorniest issue is probably the cross-countries income redistribution that it could imply.

These fears might be excessive, at a closer scrutiny. Indeed, it is possible to design a centralised shock absorber that can offer non-negligible stabilisation of the business cycle, and yet be incentive compatible and limited in the extent of cross-country redistribution. In a recent paper[1] we envisage a device for risk-sharing across countries based on a hypothetical unemployment benefit (UB) for the euro

[1] Brandolini, A., Carta, F. and F. D'Amuri. 2014. A feasible unemployment-based shock absorber for the Euro Area, Bank of Italy Occasional paper 254.

area. This device, that we call Notional Euro-wide Unemployment Insurance (NEUI), consists of a supranational fund which finances the expenditure that each country experiencing an adverse shock would incur to pay the common unemployment benefit (UB) to its citizens. The NEUI is “notional” because it mimics an individual-level insurance scheme but operates via transfers at the macrolevel. With respect to a rainy-day fund, it is less subject to political discretion and is targeted to a specific shock clearly linked to the business cycle: entry into unemployment. To limit opportunistic behaviours, the hypothetical UB could be parameterised to benefits of limited duration and replacement rate and be activated only in case of large negative shocks. In accordance with the subsidiarity principle, national schemes would remain in place, based on rules set by national governments; but the NEUI subsidy would be explicitly acknowledged in order to make citizens cognisant of European solidarity.

Payments to the NEUI fund could be determined by a contribution rate that balances disbursements and receipts in the medium run, either for each country (full experience rating) or only for the euro area as a whole (partial or no experience rating). Varying the generosity of the system and the degree of experience rating would imply different levels of macroeconomic stabilisation and cross-country redistribution. In presence of experience rating we are not allowing any permanent redistribution of resources across countries, obviously limiting the extent of risk-sharing. In case of partial experience rating redistribution across countries is milder than in the absence of experience rating; however contribution rates are set to keep the supranational fund balanced on a given time period.

2 Analysis and results

Within the outlined boundaries, it is possible to design several schemes that differ for the eligibility criteria, the maximum duration and amount of the benefit, the trigger activating the program and the financing regime. In order to identify the preferable design, we need to estimate the stabilisation offered by each scheme. We assume that the NEUI fund is financed via a consumption tax increase, and that the freed resources are used by beneficiary countries to raise public investments. The impact on GDP can be calculated by applying the multipliers adopted by the European Commission in its forecasting exercises.

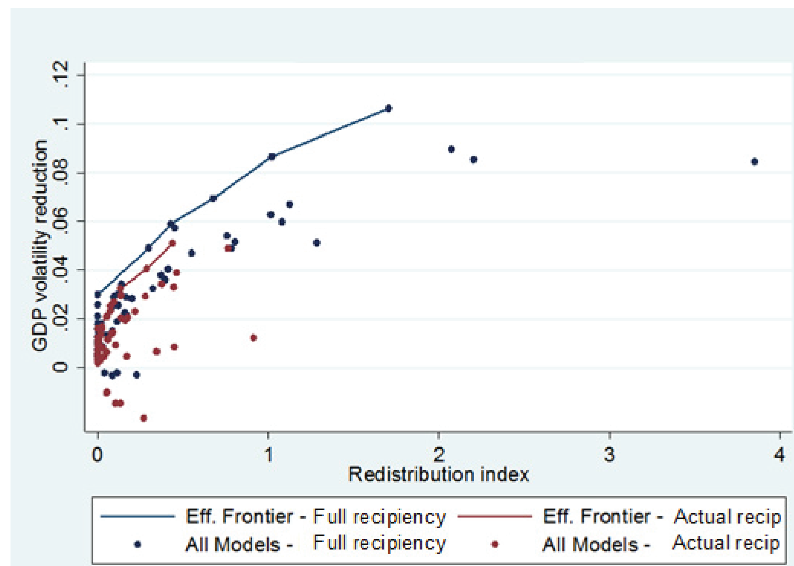
We use the European labour force survey for ten euro area (EA) countries in the 2002-12 period to simulate all the schemes obtained by combining the possible features of the NEUI (chart 1). We find that in the majority of cases, the scheme implying the lowest cross-country redistribution for a given level of stabilisation features a notional benefit equal to 50% of the average wage for all employees experiencing a job termination, eight months maximum duration and a trigger based on employment dynamics (chart 2). Even systems that do not redistribute resources

between countries can have a non-negligible stabilisation impact in the medium run. Finally, our results on the preferable scheme are robust to the choice of the multipliers and to changes in the estimation period.

We then compute the financial flows across countries implied by the working of the preferable scheme (chart 3). While with full experience rating each country's position would be balanced over time, with partial or no experience rating Spain and to a lesser extent Portugal would be the main beneficiaries of such a scheme in absolute terms over the 2002-12 period; France and Germany would be the greatest contributors. Italy would also be a contributor even if affected by a large increase of unemployment during the debt crisis. This is due to the higher incidence of self-employment and long term unemployment, which are not covered by the envisaged scheme. The direction of financial flows strongly depends on the reference period. In fact, considering the pre-crisis period 2002–08, Spain and Germany would be the biggest beneficiaries, while France and Italy would remain the biggest contributors. This evidence is a warning that the conclusions on cross-country redistribution are highly sensitive to the simulation period, and the related fears might be excessive. In the period between 2002–12, the stabilisation offered by the NEUI might be up to one fourth the level of the one made possible by the cyclical adjustment of the budget balance provided for by European fiscal rules. Thus, the stabilisation achievable by the shock absorber is not negligible, especially if compared to the very limited cross-country financial flows involved: Luxembourg, the country contributing the most to the scheme relative to domestic product, would have transferred resources worth 0.09 of its GDP.

The incentives for national authorities to improve benefit take-up rates – to take full advantage of supranational transfers – and to standardise national UB systems – which would facilitate the reallocation of workers and hence macroeconomic stabilisation within the EA – are two positive side effects of the NEUI. Yet, its main goal would be providing a tool for smoothing business cycles which is at the same time a visible example of European solidarity.

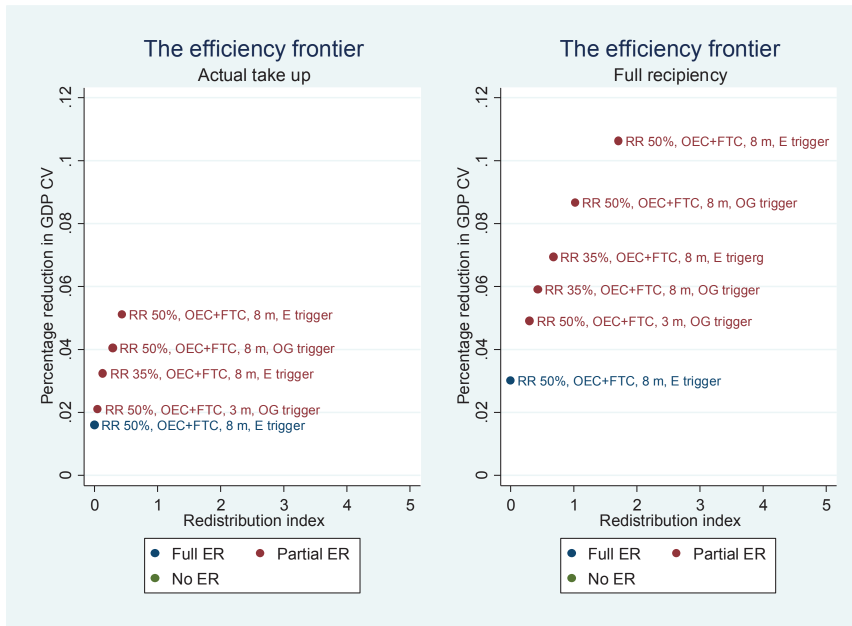
Chart 1: The efficiency frontier



Source: Authors' elaboration on EU-LFS data.

Note: Each point represents the Redistribution-Stabilisation pair of one of the 72 different notional UB schemes simulated in the paper. The GDP volatility reduction is equal to the reduction in the GDP coefficient of variation. The redistribution index is equal to the sum of the squared deviations of the unique contribution rate that balances the system for the area as a whole from the contribution rates that balances the system for each country, multiplied by a million. Under full recipiency we assume that all the eligible for the common UB actually get the transfer. Under actual recipiency we use the actual take-up rate of national unemployment systems measured in the EU-LFS.

Chart 2: Schemes on the efficiency frontier

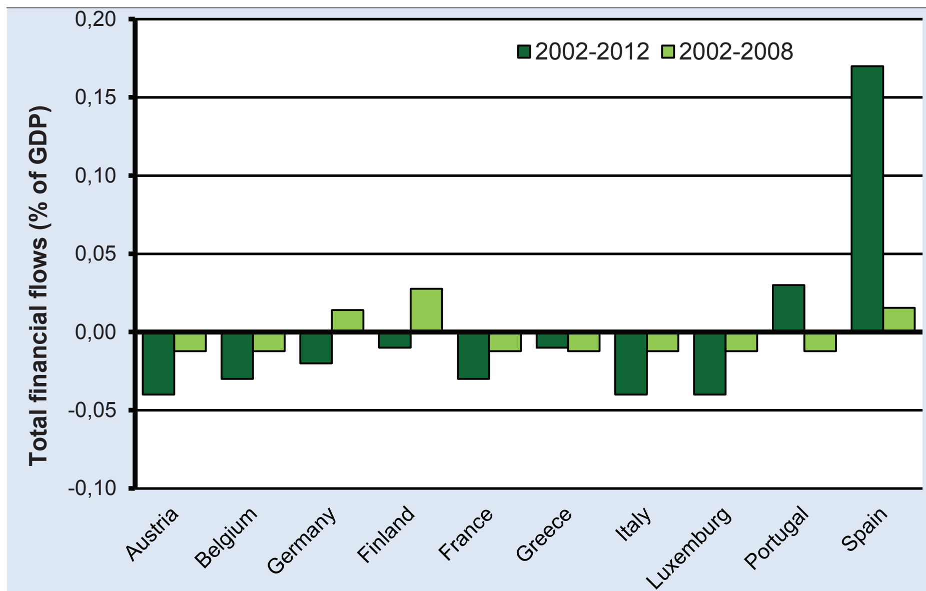


Source: Authors' elaboration on EU-LFS data.

Note: Values estimated over the 2002–2012 time interval, multiplier equal to 0.4 for outflows and to 0.9 for inflows. Legend: benefit replacement rate (RR), labour force coverage (OEC: termination of open-ended contract; FTC: termination of fixed-term contract); months of maximum duration (m); activation trigger variable (E: employment; OG: output gap); experience rating (ER). Under full recipiency we assume that all the eligible for the common UB actually get the transfer. Under actual recipiency we use the actual take-up rate (the proportion of eligible which actually get the transfer) of national unemployment systems measured in the EU-LFS.

Chart 3: Financial flows implied by the preferable scheme for the 2002–2012 and 2002–2008 periods

% of GDP



Source: Authors' elaboration on EU-LFS data.

Note: Financial flows are those implied by simulating the preferable scheme which has a replacement rate of 50%, covers terminations of open-ended and fixed-term contracts, has a maximum duration of 8 months and is activated by an employment-based trigger in at least one of the considered countries. We consider a regime of partial experience rating as financing scheme of the supranational fund: the contribution rate is such that each country has a balanced position over the considered time period (contributions=transfers, regime of full experience rating) up to a yearly threshold of 0.2% of GDP. To make up for the loss in contributions and keep the fund balanced over the whole interval, countries below the cap contribute to the fund an additional fixed proportion of their GDP relative to what they would pay under a full experience rating.

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