An unemployment insurance scheme for the euro area? A comparison of different alternatives using micro data

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Executive Summary

The Great Recession and the resulting European debt crisis have revived the debate about deeper fiscal integration in the European Economic and Monetary Union (EMU).[1] The EMU is an atypical monetary union because monetary policy is decided at the central (European) level while fiscal policy is carried out at the sub-central (member state) level (Bordo et al., 2013).[2] Some observers argue that national automatic stabilizers provided insufficient income insurance during the crisis as some EMU member states lost access to private capital markets and conclude that common fiscal stabilization mechanisms are necessary to make EMU

[1] The executive summary is based on Dolls et al. (2015).

[2] In the following we equivalently use "EA", "EMU" and "euro area" to refer to the 18 member states of the European Monetary Union that had introduced the euro in 2014.

more sustainable and more resilient against asymmetric macroeconomic shocks (Bertola, 2013; IMF, 2013). The main concerns in this debate relate to the issues of permanent transfer flows within the currency union and moral hazard. In particular, national governments might neglect structural reforms or fiscal consolidation.

How could a fiscal risk sharing mechanism in the euro area be designed? In the so-called Four Presidents' Report published in 2012, the former President of the European Council, Herman van Rompuy, has suggested the following: "An EMU fiscal capacity with a limited asymmetric shock absorption function could take the form of an insurance-type system between euro area countries. [...] The specific design of such a function could follow two broad approaches. The first would be a macroeconomic approach, where contributions and disbursements would be based on fluctuations in cyclical revenue and expenditure items [...]. The second could be based on a microeconomic approach, and be more directly linked to a specific public function sensitive to the economic cycle, such as unemployment insurance." (Van Rompuy, 2012). The European Commission and more recently Jean-Claude Juncker in the Five Presidents' Report built upon this initiative with own blueprints for EMU (European Commission 2012, Juncker 2015).

Since then, the perspectives of a European fiscal union and different reform proposals along the lines of the Four Presidents' Report have been analyzed in various studies. For the *macroeconomic approach,* suggestions include a cyclical shock absorber based on output gaps (Enderlein et al., 2013) and a stabilization fund for the euro area (Furceri and Zdzienicka, 2015). For the *microeconomic approach,* the discussion has focused on the idea of a common EMU-wide unemployment insurance system (henceforth EMU-UI) as proposed among others by Deinzer (2004), Dullien (2014) and Andor (2014).

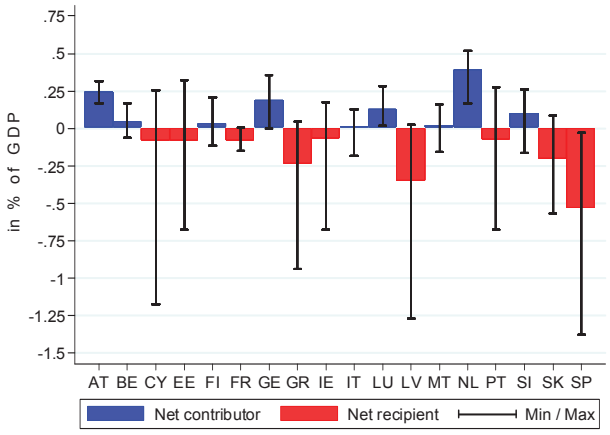
Our paper (Dolls et al., 2015) is the first to provide a comprehensive and systematic analysis of a wide range of design options for an EMU-UI system based on household micro data. Our counterfactual experiment covers the period since the start of the euro in 1999 until 2013. The analysis includes the current 18 euro area member states (EA 18) and simulates a sample of repeated cross-sections for each member state combining micro data from the EU Statistics on Income and Living Conditions (EU-SILC) and the EU Labor Force Survey (EU-LFS). We focus on redistributive and stabilizing effects of a basic EMU-UI scheme that partly replaces national UI systems. We quantify the coverage and stabilization gaps. These are defined as the differences in coverage and stabilization between i) the benchmark scenario of national UI alone and ii) a reform scenario where EMU-UI and national UI coexist as explained further below. Coverage and stabilization gaps are calculated at the aggregate household level as well as for different socio-demographic groups within each country. Automatic fiscal stabilization effects are decomposed into household income and government budget stabilization. In addition, we explore the effects of experience rating and compare the basic EMU-UI scheme to a variant

with *contingent,* i.e., trigger-based benefit payments that provide income insurance only if the labor market situation deteriorates significantly in a given member state. Moreover, we run several sensitivity checks regarding coverage and generosity levels of the scheme. We also discuss various concerns and potential adverse effects of an EMU-UI system, in particular the view that such a system would lead to a transfer union in Europe and moral hazard issues. Importantly, the aim of our paper is not to serve as a policy proposal but rather as a conceptual experiment, providing general insights into the effects of various design options for a basic EMU-UI.

Our main results are as follows. We find that a basic EMU-UI scheme with a replacement rate of 50% , a maximum duration of benefit receipt of 12 months and a broad coverage of all new unemployed with previous employment income could be implemented with a relatively small annual budget. Over the period 2000-13, average benefits would have amounted to roughly EUR 47 billion per year, financed by a uniform contribution rate across member states of 1.56% on employment income. The scheme is not designed to give rise to permanent redistribution across countries because only short-term (rather than structural) unemployment is insured. Nevertheless, our simulations reveal that a small number of member states would have been net contributors or net recipients in each year of our simulation period.

Chart 1 shows that Austria, Germany and the Netherlands would have been the largest net contributors with average yearly net contributions of 0.19%–0.39% of GDP. Latvia and Spain are the largest net recipients (average yearly net benefits of 0.36% and 0.54% of GDP).

Chart 1: Average yearly net contributions from 2000 to 2013



Source: AMECO, EU-LFS and authors' calculations based on EUROMOD.
Note: Net contribution = SIC – BEN. Contribution rate uniform across member states. Scheme is revenue-neutral over the simulation period.

We show that a basic EMU-UI scheme can provide insurance by stabilizing household incomes and government budgets. We compare automatic stabilization effects under dual insurance (the combination of national UI and EMU-UI) and the status quo. For 2009, the year with the most significant surge in unemployment across EA member states, we find that the average (unweighted) stabilization gap, that is the potential gain in stabilization through an EMU-UI for household incomes, would have amounted to 12% of the gross income shock at the EA-level. Largest gaps are found for Southern European countries (e.g. 18% in Italy, 17% in Greece) and the Baltics (22% in Latvia). Government budgets would have been stabilized by on average 6% of the gross income shock in 2009. This is because governments would have spent less on national UI. The combined stabilization impact on household incomes and government budgets would have equaled 0.3% of GDP on average, with values up to 1.1 (0.9)% in Latvia (Estonia). Schemes with lower coverage ratios and generosity levels generate smaller cross-country transfers but also reduce desired insurance effects.

Turning next to within-country heterogeneity, we find the largest coverage and stabilization gains for the young and, perhaps surprisingly, also for high-skilled unemployed. The reason for the former is that the young often do not meet eligibility conditions of national UI while they are covered by the simulated EMU-UI. The result for the high-skilled is due to a higher proportion of short-term relative to long-term unemployed (who are not eligible to EMU-UI) among them. Finally, we consider a contingent benefit scheme which is activated if the unemployment rate in a given member state is 1 percentage point higher than in one of the previous three years. Under this system no member state would have been in a permanent net contributing/receiving position. With EUR 22 billion per year, the overall budget and thus the amount of cross-country redistribution would have been less than half as large as under the non-contingent scheme in the baseline.

One should note that the simulations assume revenue-neutrality over the entire time span considered (2000–2013), but not in each period. This raises the issue of whether the EMU-UI would be allowed to issue debt. In our calculations the EMU-UI would have produced a surplus in its early phase, so that reserves would have been available to finance higher benefits in the crisis. But there is, of course, a concern that political pressures would build up to let the EMU-UI accumulate more and more debt until it needs to be "bailed out" by the member states. Clearly, while a balanced budget in each period would limit the ability of the system to act as a fiscal stabilizer, an effective debt limitation would be needed. One possible approach would be to start by deliberately accumulating reserves which would provide a buffer in the next recession.

We should emphasize that our analysis has a number of limitations which should be taken into account in the interpretation of the results. Most importantly, it is not the objective of our paper to establish whether or not the introduction of an EMU-UI

scheme is desirable in terms of overall welfare. Our analysis focuses on the financial flows implied by different unemployment insurance schemes and the ability of these flows to act as an automatic stabilizer. In so far our analysis is purely positive, rather than normative. In addition, we take economic behavior as given. If EMU-UI had the desired stabilizing effects, the financial flows in the system would differ from those calculated here; the redistributive effects would probably be smaller. However, if the moral hazard effects dominated, the financial flows from contributors to recipients could also be larger. Adding behavioral effects to the analysis is a promising subject for future research.

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