Bertelsmann Stiftung (ed.)

A European Unemployment Benefit Scheme

How to Provide for More Stability in the Euro Zone

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Sebastian Dullien

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Foreword

The idea of complementing the European Economic and Monetary Union (EMU) by automatic stabilizers is not new at all. Already in 1977, the European Commission published the so-called "MacDougall Report," which advocated the introduction of counter-cyclical fiscal stabilizers at the European level in order to tackle regional asymmetric shocks. Sixteen years later, in 1993, Commission experts wrote about the possible creation of a shock-absorption mechanism based on changes in national unemployment rates. This suggestion came already quite close to the idea of introducing a European Unemployment Benefit Scheme, as proposed in this book by Sebastian Dullien.

Since the completion of the EMU in 1999, however, the question of how to improve the capacities of its member states to cope with excessive cyclical fluctuations and country-specific shocks has gained considerable economic and political momentum – due to the profound changes of the macroeconomic policy framework we have gone through since then. In the euro zone, monetary policymaking is centralized and delegated to the European Central Bank (ECB). Due to the introduction of a single monetary policy, the risk of cyclical divergences between euro-zone member states has even grown.

The nominal interest rate fixed by the ECB has different impacts on countries in different stages of the economic cycle: For countries in recession and with low inflation, the given nominal interest rate is prone to be too restrictive and to further weaken output growth. In booming countries with high inflation, the same interest rate is too low to counter the risk of an overheating economy. Even if this aberration may be corrected by adaptations of the real exchange rate in the longer run (which depends on the flexibility of prices and wages), this means that, at least in the short term, the single monetary policy may contribute to amplifying booms and recessions in its member states.

At the same time, the sole responsibility of the ECB for monetary policy implies that euro-zone members have to rely on non-monetary counter-cyclical adjustment mechanisms if they are hit individually by idiosyncratic shocks. Taking into account that (unlike in federal systems such as that of the United States) there are still extremely low levels of cross-border labor mobility and rather strong impediments to wage and price flexibility in the euro zone, it is mainly by means of fiscal policy that member-state governments can stabilize their economies if they are hit by asymmetric country-specific shocks. This also applies to exogenous shocks affecting the euro zone as a whole since the impact of that kind of shock is different in individual member states depending, for example, on the extent of labor market flexibility they have implemented and the specific features of their national fiscal system.

It is against this backdrop that interest in the role of automatic stabilizers as mechanisms of shock-absorption has considerably grown in the past few years. As regards discretionary fiscal policies, there seems to be a growing consensus that there is a high risk of procyclical government action. Tax and expenditure changes have to go through lengthy parliamentary decision-making processes and are politically difficult to reverse if circumstances change due to an economic shock.

However, beyond that (and perhaps even more important) are the constraints resulting from the EMU itself for any kind of shock-absorbing discretionary fiscal policy solutions. In the euro zone, fiscal policy is to be carried out within the boundaries of the "Maastricht criteria" and the Stability and Growth Pact (SGP). In a nutshell, the SGP requires member-state governments to avoid excessive deficits and to achieve a medium-term objective that ensures the long-term stability of public finances. The new "Fiscal Pact" goes even further and sets a legally binding maximum structural deficit of 0.5 percent of GDP, while the maximum actual deficit must not exceed 3 percent of GDP. This leaves little room for counter-cyclical discretionary fiscal policy at the member-state level.

In recent years, this dilemma has even been aggravated by the woes of the sovereign debt crisis. The fear of insolvency has further limited national governments' room for counter-cyclical fiscal maneuver. Instead of being able to use national budgets as stabilizing instruments, many countries have seen themselves forced to further cut expenditures or increase taxes in the downturn – i.e., to act pro-cyclically – to restore market confidence in their ability to service public debt.

It is for all these reasons that a growing number of experts consider the lack of automatic fiscal shock absorbers at the euro-zone level to be one of the main construction flaws of the EMU – although the issue remains a highly controversial one. Opponents of EMU-wide shock absorbers continue to argue that fiscal stabilization should remain the responsibility of national governments, and that the introduction of such mechanisms at the euro-zone level might result in permanent transfers to so-called periphery countries.

As the Bertelsmann Stiftung, we agree that this risk of permanent transfers has to be minimized. At the same time, however, we support the idea of complementing the EMU by the introduction of automatic shock-absorption mechanisms. Our foundation welcomes the analysis of the European Commission's "Blueprint for a Deep and Genuine EMU" and the "Four Presidents' Report" from 2012, which found that there are strong arguments in favor of transnational automatic stabilizers for the euro zone – and that, at least in the longer run, exclusively national solutions will prove insufficient to provide for a more resilient and robust EMU. Accordingly, from our perspective, avoiding permanent transfers is crucial for overcoming pertinent political opposition against the introduction of such European mechanisms.

Hence, from our point of view, the debate about automatic stabilizers for the euro zone should primarily focus on the "how," not on the "if": What kind of European shock-absorption mechanisms do we need, and how should they be designed to mitigate the risks of permanent transfers and moral hazard?

Over the last year, we have closely collaborated with the European Commission and several research institutes to answer this question, and we have identified three particularly intriguing responses on how to best stabilize the euro zone:

Some researchers favor the instrument of a European "Cyclical Shock Insurance" that would be automatically triggered by deviations of national output gaps to counter excessive cyclical fluctuations.

Another proposal follows the logic of mitigating only particularly severe economic slumps by establishing a "European Re-insurance Fund" for national unemployment benefit schemes.

The third – and, in our view, most promising – approach is Sebastian Dullien's proposal for a European Unemployment Benefit Scheme, which is outlined in this book.

In two conferences and several workshops jointly organized with Commissioner László Andor and the Directorate-General for Employment, Social Affairs and Inclusion of the European Commission between October 2013 and June 2014, we will be taking a more in-depth look at the pros and cons of these different approaches.

There is, however, one specific feature of the European Unemployment Benefit Scheme proposed by Dullien for which we have chosen his model as key reference point of our discussions. Beyond its economic rationale, this solution could also help restore citizens' trust in the EU and mobilize public support for a fiscal union.

Europe is currently not only experiencing a financial and economic crisis. Perhaps even worse, it is facing a severe democratic crisis characterized by a sharp decline in public confidence in the EU and its institutions. The rise of anti-European and Euroskeptic parties clearly illustrates the explosive political power of this alarming development. In order to counter this trend and to prove the added value of Europe for its people, we think that we have to enhance the EU's capacities to address the everyday concerns of its citizens. In this context, the introduction of a European Unemployment Benefit Scheme might also be an important step toward a more "caring Europe" that really lives up to the expectations of its citizens.

It is for both reasons – the possible contribution of a European Unemployment Insurance Scheme to more stability in the euro zone and its potential to mitigate the EU's democratic crisis – that we have asked Sebastian Dullien to prepare this book. In this way, we also hope to inspire more open-mindedness in a political and public debate that is dominated, so far, by massive doubts about whether there is a need for EMU-wide automatic stabilizers at all and whether their introduction is politically feasible.

Aart De Geus
Chairman and Chief Executive Officer
of the Bertelsmann Stiftung

Foreword

In the last six years, Europe has been tormented by an unprecedented financial and economic crisis. It has caused record high unemployment and a social emergency in the more peripheral countries and regions of the euro zone, and raised existential dilemmas for the European Union as a whole.

It was a malfunctioning, risk-blind international financial system that brought us into this quagmire in the first place. However, it is the imperfect architecture of the Economic and Monetary Union (EMU) that made this crisis persist so long in Europe, causing a second recession and creating dangerous imbalances.

The fragility of the Maastricht model was not recognized early enough. As the crisis deepened, careless politicians made the situation worse by creating uncertainty about some countries' membership in the euro zone, thereby themselves contributing to additional instability and endangering the future of the euro itself. If we have to choose between preserving the inherited model of the EMU and safeguarding the current composition of the euro zone, we have to opt for the second and build an EMU 2.0.

The extraordinary ECB interventions since 2012 have resulted in a period of relative tranquillity in European financial markets. However, ongoing socioeconomic divergence in a context of low or negative growth might yet call into question the sustainability of this heterogeneous monetary union.

This book by Sebastian Dullien is therefore a very timely and highly valuable contribution to a much-needed debate. Experience since 2010 has clearly shown, among other things, that Europe's EMU needs a transnational fiscal capacity alongside the already strengthened framework for coordinating national fiscal and structural policies. What we should discuss is the right design of such fiscal capacity.

Fiscal risk-sharing and capacity to dampen asymmetric shocks would clearly strengthen confidence in the euro's future. Even more importantly, EMU-wide automatic fiscal stabilizers would help to prevent losses of output and the related social hardship during future downturns. They would help to optimize the EMU's functioning so that it actually delivers on the objectives of full employment and social progress set out in the EU's treaties, as expected by Europe's citizens.

The European Commission's Blueprint for a Deep and Genuine EMU and the Four Presidents' Report of 2012 clearly foresee transnational fiscal shock absorbers for the EMU in the long term. To get there, preparatory work has to start now. This is why I strongly appreciate the intellectual and educational effort of Sebastian Dullien and others who have invested their time and efforts to explore possible designs of EMU-level automatic stabilizers long before this issue appeared on the political agenda.

For a long time, such work has also had to counter the skepticism of those who considered that the EMU *should not* involve transnational fiscal transfers or *cannot* possibly ever achieve sufficient political unity to establish them. Progress in designing and implementing the Banking Union, however slow, offers encouragement and inspiration. It also should be understood that the Banking Union will most likely not complete the process of EMU reconstruction.

Despite the complexity of the debate, and inevitably difficult political dynamics among and within EU member states, the European Commission has been explicitly looking into the merits of, and options for, EMU-level automatic stabilizers since 2012, building on its much earlier expert work in the 1970s and early 1990s.

From the various options proposed in the recent debates, an EMU-wide scheme of basic unemployment insurance appears to have several obvious advantages. Unemployment is an easily observed and understood indicator of cyclical developments. Data is available and reliable, and maintaining unemployment compensation spending in a downturn has a high macroeconomic stabilization potential, as learned from national experience (that of federal states, in particular).

Unemployment insurance cannot replace an investment stimulus, but it mitigates the otherwise inevitable fall in demand among households with jobless people, who happen to spend most of their income. Partial pooling of unemployment insurance systems could therefore help reduce the severity of downturns and give EMU governments greater fiscal space to implement structural reforms and invest where needed for the affected economies to durably recover.

In a nutshell, partial pooling of unemployment insurance systems in the EU would provide a much safer, more predictable and more legitimate support mechanism for adjustment processes in the EMU than sequential bailouts of troubled countries. The U.S. has a credible rule in place on non-bailout of individual states, also because it has a large federal budget.

The currently debated EMU-wide scheme of basic unemployment insurance would have a much more modest volume of around 1 percent GDP. Nevertheless, it could already significantly improve the economic and political dynamics of adjustment processes within the EMU. From a longer-term perspective, this would also help to prevent asymmetrically distributed short-term downturns from developing, through hysteresis, into long-lasting loss of productivity and structural disparities between core and periphery.

While the urgency of EMU reconstruction is widely felt, further analysis and debate are needed around the subject. The sourcing options can be contentious even among supporters. How to take into account cyclical and structural aspects of unemployment is not just a theoretical, but also a very practical issue. Where does the legitimacy of automatic, i.e., unconditional, support come from? Is the loss of autonomous fiscal and monetary policy sufficient basis for the creation of automatic stabilizers in order to function alongside other, more conditional transfers? What is the minimum level of solidarity in the EMU, and where are its justified limits?