Public Hearing, Committee on Employment and Social Affairs, European Parliament on the Social Dimension of the Economic and Monetary Union: European Unemployment Benefit Scheme

Automatic Stabilizers at Euro Zone Level
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1. Counter-cyclical stabilization policies: Conditio sine qua non for a sustainable EMU

The idea of complementing European Monetary Union by automatic stabilizers at European level is all but new. Centred around the discussion about the prerequisites for an “Optimum Currency Area” presented by Robert Mundell in 1969, the European Commission’s so-called “McDougall Report” advocated the introduction of countercyclical fiscal stabilizers at European level to tackle regional asymmetric shocks already in 1977. Sixteen years later, in its report “Stable Money – Sound Finances. Community Public Finance in the Perspective of EMU” from 1993, the Commission proposed the creation of a shock-absorption mechanism based on changes in national unemployment rates to support Member States in stabilizing the business cycle in the Euro area – a suggestion that already comes close to introducing a European Unemployment Benefit Scheme.

It goes without saying that since the establishment of Monetary Union in 2002 the question of how to improve the capacities of its member states to cope with excessive cyclical fluctuations and country-specific shocks has considerably gained economic and political virulence – 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 for the euro zone, the risk of cyclical divergences between its member states has even grown. There remains only one nominal interest rate fixed by the ECB which 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), it may be expected therefore that, at least for some time, the single monetary policy contributes 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, different from federal systems like the United States, there are still extremely low levels of cross-border mobility and rather strong impediments to wage and price flexibility in the euro zone, member state governments are mainly left with fiscal policy to stabilize their economies if they are asymmetrically hit by country-specific shocks. This also applies to exogenous shocks affecting the euro zone as a whole since the impact of that kind of shocks is different in...
individual member states depending, for example, on the extent of labour market flexibility they have implemented at home and the specific features of their fiscal system. If, however, fiscal policies are key for stabilizing business cycles in the euro zone after country-specific or Euro-wide shocks, this may happen in two ways: by discretionary fiscal policy or by automatic fiscal stabilizers.

2. **Growing constraints of discretionary fiscal policies at national level**

As regards discretionary fiscal policies there seems to be a growing consensus that there is a high risk of pro-cyclical government action due to considerable decision lags. 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. Moreover, the primary goals of discretionary fiscal policy are income distribution and resource allocation, not stabilization.

Beyond that and perhaps even more important are, however, the constraints resulting from 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 which ensures the long-term stability of public finances. The new “Fiscal Pact” even goes further and sets a legally binding maximum structural deficit of 0.5% of GDP while the maximum actual deficit must not exceed 3% of GDP. This leaves little room for counter-cyclical discretionary fiscal policy at 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 manoeuvre. Instead of being able to use national budgets as stabilizing instruments, in the current crisis many countries saw 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 servicing public debt.

3. **Pros and cons of automatic fiscal stabilizers at EMU level**

It is against this backdrop that the debate on efficient mechanisms of shock-absorption has not only moved to the highest policy circles in 2012 – as indicated by the Commission Blueprint and the Report of the President of the European Council for a “Genuine Economic and Monetary Union” – but has also shifted its focus from discretionary national fiscal policy to how to improve automatic fiscal stabilizers in the euro zone. Regarding the increasing restraints discretionary fiscal policies have to face with regard to their stabilizing function for the economic cycle this shift of focus is perfectly justified. What is much less clear, however, is the answer to the question whether automatic stabilizers should primarily remain a national instrument which ought to be strengthened or whether and to what extent there should be new stabilizing mechanisms at euro zone level.

Those in favour of a European solution argue that keeping the shock absorption function only at the national level is not efficient from an EMU-wide point of view. Accordingly, the President of the European Council argues in his report about a “Genuine Monetary Union” in favour of a new euro zone risk sharing function:
“In order to protect against negative fiscal externalities, it is important that fiscal risks are shared where economic adjustment mechanisms to country-specific shocks are less than perfect. This is clearly the case in the euro area, where labour mobility is comparatively low, capital flows are susceptible to sudden swings that can undermine financial stability, and structural rigidities can delay or impede price adjustments and the reallocation of resources.” (p. 10)

There are, however, strong counter-arguments to this position that are advanced by the supporters of the idea that the member states should remain in charge of fiscal stabilisation. To discuss these arguments we can distinguish between three basic lines of reasoning:

- a lack of need of EMU-wide automatic stabilizers,
- a lack of impact or even wrong impact of EMU-wide automatic stabilizers, and
- a lack of feasibility of EMU-wide automatic stabilizers.

a) The “lack of need” argument

One key argument of opponents to the introduction of a Eurozone budget providing automatic insurance against the asymmetric impact of economic shocks is that there is no need of automatic fiscal stabilizers at EU level. From their perspective it would be perfectly sufficient to improve the functioning of existing national stabilizers like taxes on the revenue side and particularly employment benefit schemes on the expenditure site. In addition, member states should intensify efforts to improve their shock absorption capacities, especially by making their labour markets more flexible.

As regards the European level, however, it should not strive for a strong role in fiscal risk-sharing but focus on other policy priorities to strengthen the resilience of the Eurozone to asymmetric developments in its member states. Proponents of this position are perfectly right in pointing out that the asymmetric impact of temporary demand and supply shocks can be dampened by European policies aiming at a better synchronization of national business cycles. Apart from deepening monetary integration it is particularly the completion of the single market and the banking union, as well as a further tightening of the surveillance of national budgetary policies and macroeconomic imbalances which contribute to synchronizing business circles and, in this way, reduce the danger of country-specific shocks.

b) The “lack of impact”/“wrong impact” argument

Amongst supporters of fiscal shock-absorption capacities at euro zone level the argument is rather popular that in federal states like the US monetary union is always going hand in hand with a large federal budget which has a smoothening impact on asymmetric shocks. More recent academic research shows, however, that even in highly federalized fiscal systems which centralized a large part of their tax and revenue system the stabilizing impact of fiscal policy is rather limited. Critics of stronger fiscal shock-absorbers at euro zone level draw on these comparative findings to argue that the counter-cyclical impact of a future eurozone budget would even be smaller – simply for the reason that EMU and its tax/transfer system will never reach the same level of budgetary centralization as a fully-fledged federal state.
Beyond the modest impact of EMU-wide automatic fiscal stabilizing capacities their introduction might also have some unintended consequences. When discussing further fiscal integration for the euro zone, we can distinguish between the two concepts of a “fiscal union” and “a transfer union”. The purpose of a “transfer union” is to reduce gaps in income, welfare or revenue-raising potential at the sub-federal level. Different from this approach which is based on systematic and long-lasting income transfers and redistribution across different regions, a “fiscal union” is set up to provide fiscal insurance to smooth income fluctuations over time and across regions. The report of the European Council President on a Genuine Economic and Monetary Union explicitly refers to this distinction by saying that in a fiscal union “insurance means that transfers are transitory and unsystematic” (p. 41).

To what extent the dividing lines between “transfer union” and “fiscal union” are blurred depends on the specific design of the automatic stabilizers. In any case, however, it is nearly impossible to guarantee ex ante that such stabilisers will not lead to some persistent transfers between the euro zone member states.

c) The “lack of feasibility” argument

Currently, there are two basic models suggested by supporters of a stronger role of EMU in counter-cyclical stabilization: the “macroeconomic approach” favours a mechanism where contributions and disbursements would be based on fluctuations in cyclical revenue and expenditure items, or on measures on economic activity. The economic measure most frequently discussed in this context is the national output gap. The “microeconomic approach” would be more directly linked to a specific public function sensitive to the economic cycle. The public function most frequently mentioned in this context is the insurance of short-term unemployment.

Both approaches towards “fiscal union” have in common that it is questionable if they are politically feasible since there looms the risk to end with a “transfer union” through the backdoor. This will mobilize the resistance of those member state governments which expect to become long-term net payers, i.e. the economically better performing euro zone countries.

When comparing the two approaches it might be politically more promising for supporters of a stronger EMU role in counter-cyclical stabilisation to actively promote the “macroeconomic approach”. This would, however, imply a strong trade-off as regards the efficiency of the new euro zone mechanisms. Due to the considerable methodological difficulties in determining the output gap ex ante, this model has the disadvantage that it is much more prone to have an unintended pro-cyclical impact. On the other hand, introducing a European benefit scheme for short-term unemployment would have the methodological advantage that there is a particularly strong correlation between short term unemployment and the business cycle. Due to the temporary nature of transfers this model would also be the better choice for implementing a “fiscal union”. At the same time, however, the introduction of such an EMU-wide unemployment insurance system would most probably have to be accompanied by the setting of European minimum standards for national unemployment benefit schemes – particularly as regards the duration of benefits, the coverage (types of labour contracts), eligibility rules and benefit levels/replacement rates. It is rather improbable that interferences of the European legislator in these sensitive national policy issues will simply be accepted by all member state governments of the euro zone.
4. **Weighing the arguments: Should there be shock absorbing mechanisms at euro zone level and, if so, how should they look like?**

As regards the issue of political feasibility we are thus confronted with the paradoxical situation that the more efficient approach towards establishing a “fiscal union” with a strong role in shock-absorbing stabilisation policies, i.e. the introduction of a European short-term unemployment scheme, would most probably have to overcome stronger objections by member state governments than the much less convincing “macroeconomic approach”. Nevertheless, we think that the high political hurdles for implementing such a benefit scheme are not sufficient in themselves to exclude this option from the very beginning. Key for our assessment whether there should be automatic fiscal stabilizers at European level and how they should look like is the question to what extent they may contribute to the efficiency and sustainability of EMU and to its democratic legitimacy.

At first glance, the arguments against introducing mechanisms of automatic fiscal stabilization weigh heavily. There are doubtlessly quite a lot of other policy issues which should be addressed by European policymakers to dampen the asymmetric impact of cyclical shocks, like the completion of the Internal Market and the Banking Union. A more flexible application of the SGP could contribute to widening the leeway for counter-cyclical fiscal action at national level. At the same time member state governments should spend more energy in increasing the flexibility of labour markets at home as well as in enhancing the automatic stabilizer function of their tax systems on the revenue side and in particular their unemployment schemes on the expenditure side.

As regards the expected impact of an EMU-wide stabilization mechanism it will be necessary to further elaborate on approaches that are apt to minimize the risk of introducing a “transfer union” through the backdoor. Moreover, any approach should pay due respect to more recent empirical findings that the contribution of fiscal policy to smoothing asymmetrical crisis impacts has diminished in recent years, while the role of capital markets in absorbing shocks has grown. To a large extent it seems to be financial, not fiscal integration which provides the largest contribution to risk sharing in existing federations. Capital market channels like the cross-holding of credits and assets of individuals and firms have triggered this development and induce investors from other countries to participate in country-specific shock relief. This is to say that the more capital markets are integrated the better they contribute to risk sharing also between euro zone members. Against this backdrop it is once again the completion of the Banking Union which is of outstanding importance for a more resilient EMU.

Despite of these observations, however, there remains the question if they are sufficiently strong to exclude the option of a new euro zone shock-absorbing mechanism. The blank spot of the “lack of need” and the “lack of impact”/“wrong impact” arguments is that they only raise the issue of economic rationality and efficiency. They completely ignore the question to what extent the introduction of a European stabilization mechanism could contribute to overcoming the severe legitimacy crisis the EU and the Euro are currently suffering from.

Especially the introduction of a European unemployment benefit scheme along the lines sketched by Sebastian Dullien\(^2\) could contribute to restoring public support for European (Monetary) integration and the establishment of a fiscal union. The basic features of this model look as follows:
All employees in EMU are insured; they contribute a share of their wage sum up to a certain threshold, linked to each country’s average income.

Average insured wage is 80 percent of the average wage in each country.

Replacement payment is 50 percent of the insured wage and can be topped up by the national insurance system - in case of a national preference for a higher benefit in the initial period of unemployment.

Over the cycle, contributions to the scheme cover all payouts.

The unemployment insurance can build up reserves and borrow in the capital market.

Unemployment benefits are paid for 12 months.

By its focus on short-term unemployment and the limitation of benefit payments to up to twelve months this model would minimize the risk of persistent redistributive transfers between member states. According to Dullien’s simulations no single euro zone country would slip into the role of a permanent receiver or payer.

Another strength of Dullien’s approach is that he explicitly refers to the “little impact” argument and provides for some rather persuasive methodological reasoning why his simulations come to the opposite result and indicate a rather strong stabilizing impact. Actually, his calculations including the downturn period after the onset of the US subprime crisis in 2008/9 show for Spain in the period 2007-2009 that his model for a European unemployment benefit scheme would have mitigated 23.9% of the downturn, for Ireland (2007-2009) it would have made up for 9.6% and for Greece (2008-2011) it would still have been 7.7%. Especially the last two figures may not appear particularly impressive. But Dullien convincingly introduces several qualifications to explain this outcome: First, he argues that his impact simulation is based on an assumed multiplier of 1 which might be too conservative when applied to the situation in crisis countries. A multiplier of 2 would already have doubled his stabilization estimates. Second, he stresses that his model for a European unemployment insurance scheme would not require any new revenues or expenditures on the side of national governments. Thus, we share his conclusion that

“[a]chieving a stabilization of even only 10 percent in crisis countries (with significantly higher values for single countries) in this manner comes close to the proverbial free lunch.”

If we add the potential “legitimacy gains” to these estimates this gives additional clout to his European short-term unemployment scheme whose introduction should, of course, be accompanied by the other policy measures at European and national level that were outlined above - and which would additionally enhance the shock absorption capacities in the euro zone.

Apparently, this line of action would bring to the fore the tricky “lack of feasibility” argument. The introduction of a European unemployment benefit scheme would most probably require a full revision of the EU Treaty. The only alternative option might be the conclusion of a separate intergovernmental agreement amongst those member state governments willing to participate in the scheme (similar to model of the “Fiscal Pact”). It is for this reason that the
introduction of that kind of EMU-wide automatic fiscal stabilizer will only be possible in a longer term perspective. Until this point of time is reached the European level should give medium term priority to establishing and implementing the second and third pillar of the Banking Union, i.e. a European bank resolution fund and a European deposit insurance.

