Q&A on the concept of "basic European unemployment insurance" as advocated by Commissioner Andor

26/08/14

Q1: Why are fiscal transfers between EMU Member States needed?

- The need for fiscal union is directly linked to the functioning of a monetary union. In a monetary union, it is impossible for a country to counteract economic shocks through the nominal exchange rate or through changes in national monetary policy, since these are set for the whole Union.
- Fiscal policy has thus a key role to play in alleviating the economic and social impact of economic crises occurring in parts of the monetary union, notably through lower tax collection and/or increased social expenditure.
- Available estimates show that fiscal stabilisation channels in the Euro area are currently relatively weak.[1]
- The current EMU architecture is based on decentralised national fiscal policies governed by common rules set out in the Stability and Growth Pact and does not provide for an automatic fiscal stabilisation capacity shared by countries committed to using the euro, although such fiscal capacity has been foreseen e.g. in the Four Presidents' report and the Commission's Blueprint of 2012 (see also Q2).
- An EMU-level fiscal capacity would make it easier to implement structural reforms in Member States that are necessary to foster growth and create jobs in Europe. Such reforms are often associated with a short-term contraction in GDP, which could be avoided through a fiscal stimulus provided at the same time.

Q2: Is this the view of the Commission or just one Commissioner?

- The importance of a common fiscal capacity in the EMU has long been recognised in the Commission's analysis (e.g. “Marjolin Report”, 1975; “MacDougall Report”, 1977) as well as in academic work done specifically for the Commission[2].

[1] See e.g. IMF work from September 2013 (figure 6 page 14) - https://www.imf.org/external/pubs/cat/longres.aspx?sk=40784; Bruegel work (section 4.3) from March 2014 - http://www.bruegel.org/publications/publication-detail/publication/821-cross-country-insurance-mechanisms-in-currency-unions/

[2] See e.g. documents for the conference "Economic shock absorbers for the Eurozone. Deepening the debate on automatic stabilizers", 20 June 2014, http://europa.eu/!HF89ry.

- This Commission's Blueprint for a deep and genuine EMU (2012), the Four Presidents' report (2012) and the Commission Communication on strengthening the Social Dimension of the EMU (2013) stress the creation of an EMU-wide fiscal capacity as a longer-term step to improve the stabilisation of EMU economies, in particular in case of asymmetric shocks and also underline the need to proceed in parallel with a process of political integration.
- According to the Blueprint, steps towards more responsibility and economic discipline should be taken in parallel with more solidarity and financial support. The whole Commission has therefore made it clear that a smooth functioning of EMU, including from a social point of view, requires more solidarity and mutualisation mechanisms among the members of the euro area, including via a fiscal capacity for the EMU.
- Now that the establishment of the Banking Union has reached a certain stage, it is important to further discuss what should be the next steps to create a genuine and deep EMU.

Q3: Is this not a French idea?

- There are actually a large number of academic experts of various nationalities, including a number of German ones, and policy-makers that are supportive of the idea. The most well-known academic proponent is Prof. Sebastian Dullien from Berlin. The Bertelsmann Stiftung has organised conferences and sponsored expert debates on the issue. Furthermore, various experts from different backgrounds have expressed support for partial sharing of fiscal risks at the EMU level, such as the "Glienicker Gruppe" of German economists and experts from the IMF, as well as the "groupe Eiffel" from France.
- On the political level, it is true that there has been at several occasions some expression of interest from France in favour of a fiscal capacity for the EMU.

Q4: Will the new Commission continue working on this?

- The political guidelines of the Commission's President-Elect, Jean-Claude Juncker, state that: "I want to launch **legislative and non-legislative initiatives to deepen our Economic and Monetary Union** during the first year of my mandate. These would include a stability-oriented review of the “six-pack” and the “two-pack legislation” (as foreseen in this legislation); proposals to encourage further structural reforms, if necessary through additional financial incentives and <u>a targeted fiscal capacity at Euro zone level</u>; and a proposal for a more efficient external representation of our Economic and Monetary Union."
- The need for a fiscal capacity in the EMU is also mentioned in a joint paper from Chancellor Merkel and President Hollande in May 2013 (although not specifically in the

form of European unemployment insurance). The European Commission's Blueprint for a deep and genuine EMU clearly foresees an EMU-level fiscal capacity for the longer term.

- In mid-July, 2014, ideas on unemployment-based automatic fiscal stabilisers for the EMU were debated by EU Ministers for the first time, at the initiative of Italy's Presidency of the Council. Most Ministers of Labour have been encouragingly open to such proposals and have called on the Commission to further work in this area (e.g. by delivering a Green Paper). Finance Ministers may get to debate options for an EMU-level fiscal capacity during the autumn.

Q5: Would this turn the EU into a transfer union?

- One needs to reflect on what a "transfer Union" means. Strictly speaking, the EU can actually be already seen a transfer union, since it has a budget amounting to around 1 per cent of EU GDP supporting the functioning of the single market, and there are countries that always pay in more than they receive and others that always receive more than they pay in.
- But a monetary union needs fiscal instruments effective in the short term, so that they can immediately counter economic shocks before they develop into a larger economic crisis. The EU's structural funds finance long-term investments (planned well in advance) and they can only play a very limited countercyclical role.
- The point is that a monetary union implies a stronger need for a fiscal capacity (i.e. more transferable funds) in order to ensure **short-term macroeconomic stabilisation** during the economic cycle (counteracting the decline in aggregate demand and GDP). This can be achieved through limited, short-term transfers at a time when a stimulus is most needed. Such short-term transfers can take place on the basis of clear and transparent rules, for instance in a basic European unemployment insurance scheme, where net transfers would for a short time flow into countries which momentarily experience a sharp increase in short-term unemployment.
- No long-lasting net transfers are needed over the whole economic cycle to ensure such strengthened stabilisation: transfers from and to individual countries can be balanced over the cycle as every downturn is normally followed by a recovery at some point. What an EMU-level fiscal capacity could achieve is to make economic crises shorter and less severe, which would benefit whole Europe, including those Member States that are doing momentarily well.

Q6: How can you ensure that a basic European unemployment insurance scheme would not translate into permanent transfers to Member States with generally weaker employment and economic performance, such as structurally higher unemployment rates?

- The scheme would focus exclusively on short-term unemployment, which mostly reflects cyclical developments (rate of GDP growth or decline). It would not deal with structural unemployment related to skills obsolescence or poorly functioning labour market institutions.
- The risk of "lasting transfers" can be further minimised through two mechanisms, which already exist elsewhere in the world, namely "experience rating" and "clawbacks".
  - Experience rating means that the contributor vs. beneficiary profile of each Member State in the scheme is monitored, and the contribution or drawdown parameters can be adjusted at the beginning of each period so as to bring the Member State closer to a projected balance with the scheme over the medium term.
  - Clawbacks, on the other hand, enable to neutralise net transfers ex post, meaning that Member States are allowed to be net beneficiaries for several years, but then their contribution and/or drawdown rates are modified so as to compensate for the net transfers that have occurred.
- Similar safeguards feature for instance in the US federal unemployment insurance system. They limit its macroeconomic stabilisation power to some extent, while maintaining the basic function as an automatic fiscal stabiliser against asymmetric cyclical shocks in a diverse monetary union.
- On 19 July 2014, the Commission launched a tender for a study on the feasibility and European added value of a European unemployment benefit scheme, including on mechanisms to limit lasting transfers.

Q7: How would Germany benefit?

- The volume and duration of net cross-country transfers in any EMU-level automatic fiscal stabilisation scheme would depend on the design of the scheme and on the specific parameters selected. Given the short-term and countercyclical character of such schemes, it is most likely that **different countries would be direct net beneficiaries at different points in time**.
- Projections on whether any country would be an overall beneficiary or contributor to such a scheme should only be made over the horizon of the full economic cycle (at least a decade). Such projections show that Germany would have been a direct beneficiary in the early 2000s.
- But even in periods when Germany would pay in more than received overall, it would benefit from being situated in a more stable and cohesive Euro area economy, with notably much higher GDP and employment growth and lower risks of political crisis and breakdown. An automatic fiscal stabiliser at the EMU level would help the euro zone to avoid the repetition of the severe economic crisis experienced since 2010 (when

domestic demand significantly decreased). In such case, Germany would also be able to export more to those other countries who would be net direct beneficiaries of the scheme at the given moment, since their domestic demand would be strengthened.

Q8: Wouldn't fiscal transfers discourage countries from pursuing structural reforms?

- To the contrary, countercyclical fiscal transfers would help to strengthen demand and maintain overall GDP while reforms are being pursued. Structural reforms are typically accompanied by short-term economic contraction (e.g. more workers lose their jobs and it takes time before they find new ones), which is why finding a political agreement on them is often so difficult.
- The EU has considerably strengthened its coordination and surveillance of national fiscal and structural policies over recent years, but does not yet have the tools to ensure that while some EMU countries consolidate their budgets, the aggregate EMU fiscal stance remains favourable to growth.
- Furthermore, the functioning of a fiscal capacity could include some incentives (or conditions) to adopt common features, such as for national unemployment systems to be associated with high-quality jobseeker activation and training measures.

Q9: Isn't structural unemployment by far the biggest problem, rather than cyclical unemployment?

- Economic policies should cope with both structural and cyclical unemployment and it can be noted that much of today's unemployment has in fact cyclical causes (a prolonged economic downturn and a weak recovery). Remedies are actually complementary and it is generally less costly to counteract an economic downturn swiftly, before an economic crisis deepens and cyclical unemployment becomes structural (i.e. before because people lose their skills and become much harder to re-employ). Prolonged cyclical unemployment can become structural unemployment in a process known in economics as 'hysteresis' or 'scarring'.
- Furthermore, in most proposals that have been made, the European unemployment insurance scheme would focus on short-term unemployment, thus leaving untouched Member States' responsibility to deal with structural long term unemployment.
- While long-term unemployment has grown during the crisis, it can also be addressed through investment in re-skilling and possibly hiring subsidies, which the EU can co-finance from the existing structural funds.

Q10: Would the introduction of basic European unemployment insurance lead to changes in the competencies of Member States as regards their national unemployment benefit systems?

- At this stage, it is rather too early to consider what would be the details of any European unemployment insurance scheme and thus a possible change of EU or national competencies related to the introduction of a fiscal capacity and a European unemployment system.
- It can nevertheless be noted that most proposals that have been made leave most competences regarding the management and design of national unemployment benefit systems to national authorities. Even if financing of the 'core part' of unemployment insurance would be shared between EMU countries, it would still be national authorities who dealt with individual jobseekers (and in all likelihood provide an additional national unemployment benefit on top of the low basic European unemployment benefit).
- That said, most experts consider that sharing the financing of a basic European unemployment insurance scheme among EMU countries would require some type of Treaty change or the creation of a specific new Treaty.

Basic references:

- The Commission's Blueprint for a deep and genuine EMU (2012): http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52012DC0777
- The Four Presidents' report (2012): http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52012DC0777
- The Commission Communication on strengthening the Social Dimension of the EMU (2013): http://ec.europa.eu/commission_2010-2014/president/news/archives/2013/10/pdf/20131002_1-emu_en.pdf
- Commissioner Andor's article in the *Interneconomics* journal entitled "**Basic European Unemployment Insurance - The Best Way Forward in Strengthening the EMU's Resilience and Europe's Recovery"**, July/August 2014, http://intereconomics.eu/archive/year/2014/4/designing-a-european-unemployment-insurance-scheme/
- Commissioner Andor's speech in Berlin on 13 June 2014 where he explains the proposal for a shock-absorbing fiscal capacity for the EMU in the context of the euro zone crisis and analyses why such a fiscal capacity was not foreseen already during the EMU's creation 20 years ago: http://europa.eu/rapid/press-release_SPEECH-14-455_en.htm?locale=en