

## The Stabilisation Properties of a European Unemployment Benefits Scheme

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### Introduction

This commentary looks at the (macro-economic) stabilisation properties of a potential European unemployment benefits scheme (EUBS). Any such scheme would of course involve many other aspects, both political and economic; for instance, it could be argued that an EUBS, especially one that pays benefits directly to individuals, would constitute a powerful illustration of the benefits of 'Europe'. It might also be argued that the creation of an EUBS could foster the upward convergence of unemployment systems. But these issues are not considered here.

Our concentration on the stabilisation aspect points to one direct implication: emphasis should be placed on the *short-term* unemployed. But the short-term unemployed make up 'only' about one-half of total unemployment at present. It is thus clear that the stabilisation aspect can cover only a part of the overall unemployment problem. Moreover, the share of the short-term unemployed varies greatly over time and across countries.

This paper does not advocate the creation of an EUBS; it merely investigates the stabilisation properties of such a system, and as such constitutes a companion to "A European Unemployment Benefits Scheme: The rationale and the challenges ahead",<sup>1</sup> which makes ample reference to the vast academic literature on this issue.

### EUBS ≠ EUBS

A European unemployment benefits scheme could take so many different forms that it is impossible to generalise about its stabilisation properties. The two main conceptual types are:

**Reinsurance or 'equivalent'** schemes. Under this approach, there are no transfers to individuals or from individual economic units to the EUBS. Rather, financial transfers from

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<sup>1</sup> M. Beblavý, G. Marconi and I. Maselli (2015), CEPS Special Report No. 119, CEPS, Brussels, September ([www.ceps.eu/system/files/CEPS%20SR%20No%20119%20EUBS\\_0.pdf](http://www.ceps.eu/system/files/CEPS%20SR%20No%20119%20EUBS_0.pdf)).

Daniel Gros is Director of CEPS. This commentary is based on background material prepared for a presentation at the informal ECOFIN meeting, in Bratislava, 9 September 2016. The background material, in turn, draws on the results of a comprehensive project on the "Feasibility and Added Value of a European Unemployment Benefit Scheme", which was initiated by the European Parliament and commissioned by DG EMPL, contract VC/2015/0006.

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the EUBS occur only from and towards member states (or officially designated national funds dealing with the unemployed), usually only when triggered by a major adverse event. Under the re-insurance approach, the EUBS does not replace national schemes in any way, but rather 're-insures' them.

**Genuine** schemes. Under this approach, the EUBS would pay benefits to unemployed individuals directly, and contributions would be collected by the EUBS directly from employers and employees. Genuine schemes therefore at least partially replace national schemes (of course, only for the short-term unemployed, if one considers the stabilisation impact).

In principle, the distinction between these two types is clear, but in reality, they could be implemented in many different forms. The CEPS study cited above considered 18 variants, but even more could have been considered.<sup>2</sup>

## Key political issues

### *Moral hazard*

This is a fundamental problem. It is common to all unemployment benefits systems, and indeed all insurance schemes. If the EUBS pays out in the case of unemployment, then beneficiaries will make less effort to avoid unemployment.

The best way to take care of this problem seems to be **experience rating**, which is widely practised in the US. The basic principle of experience rating is simple: insurance rates go up for countries and sectors with high unemployment rates and/or frequent use of the system. If the link between the frequency of the benefits and contribution rates is appropriately calibrated, the moral hazard disappears. Participants in the system know that if they make less effort to avoid unemployment, they might benefit more often, but their contributions would go up accordingly, leaving them without any net benefit.

Experience rating is used in the US at the level of the firms. It is a key reason why the US unemployment benefit system, which is organised and financed by the individual states, can cope with large variations in conditions across states and sectors. The federal level provides support for individual states only in the event of a generalised recession and even these so-called extended benefits can later be 'clawed' back. In the US, the financing of unemployment insurance has thus essentially remained at the state level.

### *(Permanent) transfers*

There seems to be general agreement that any EUBS should avoid permanent transfers across member states. In genuine systems there are no transfers to member states, but the perception of net transfers to individual member states occurs when individuals in these states experience, on average, higher unemployment rates.

The CEPS study shows that, in practice, the problem might be less severe than one might first assume, given the huge differences in economic conditions between the core and the periphery of the euro area today. Both backward- and forward-looking simulation analyses suggest that, in the long run, few member states are always likely to perform better or worse than the average. With such reversals in economic fortunes over several decades, few member states remain large net contributors or beneficiaries.

Moreover, as argued above, experience rating could eliminate net transfers over time. If experience rating is too weak to prevent the accumulation of large imbalances, another

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<sup>2</sup> Ibid.

provision, also used in the US, namely claw-backs, could be applied. A claw-back is the requirement to pay back net receipts after a certain period. The use of this type of clause would ensure that net large transfers are compensated. But the 'claw', or pay-back, might be difficult to implement for genuine systems (individuals would have to pay back potentially large sums into the system).

The mechanisms that would impede permanent transfers should, in principle, have little impact on the potential stabilisation benefits because they would operate in the long run.

## Legal issues

Legal experts seem to be divided on the question of whether the creation of an EUBS would require treaty revision. There seems to be general agreement that the legal issues are less of a problem for the re-insurance option. René Repasi, the legal expert involved in the project on the "Feasibility and Added Value of a European Unemployment Benefit Scheme", reached the conclusion that a treaty revision might not be needed if there were sufficient political will.

In his view, a combination of Articles 175(3) and 352(1) TFEU (with possibly a different legal basis for collecting benefits and paying out) could serve to establish a genuine system. For equivalent systems the purpose would be only stabilisation, and Article 352(1) TFEU could provide a legal basis.

The creation of a genuine system that replaces at least partially existing national systems would clearly require significant legal changes at the national level. It is less clear what the legal consequences for equivalent systems, i.e. the re-insurance option, would be at the national level.

## Stabilisation

### *Conceptual issues*

The discussion on stabilisation often conflates two aspects:

**Spatial:** the reallocation of resources across member states within the same period, which does not require the ability to issue debt because it only entails the distribution of resources available at any point in time. Spatial insurance works well at covering the asymmetric shocks in small- and medium-sized countries, but the effectiveness in cases of both symmetric and asymmetric shocks in a significant proportion of the EU economy is quite limited.

**Inter-temporal:** the reallocation of resources across time. This type of stabilisation can be achieved if the EUBS can go into deficit at times of recession while accumulating funds in good times. Debt issuance might be needed in this case, unless a large starting fund were available. Inter-temporal insurance is important for major symmetric or extended downturns.

### *Not necessarily from poor to rich member states*

If one concentrates on systems that exclude permanent transfers, stabilisation would consist of temporary transfers from the EUBS to those countries that are worse off in terms of unemployment, but not necessarily in terms of income. Logic dictates that one would expect that the transfer would be from poorer to richer countries in roughly 50% of the transfers.

### *Stabilisation in theory, simulations*

The CEPS study simulated the stabilisation impact of all 18 variants, using both the actual data (GDP, (un)employment, etc.) over the last year and on a forward-looking basis using a macro-economic model. The general finding from these simulations is that the stabilisation impact depends hugely on some key parameters:

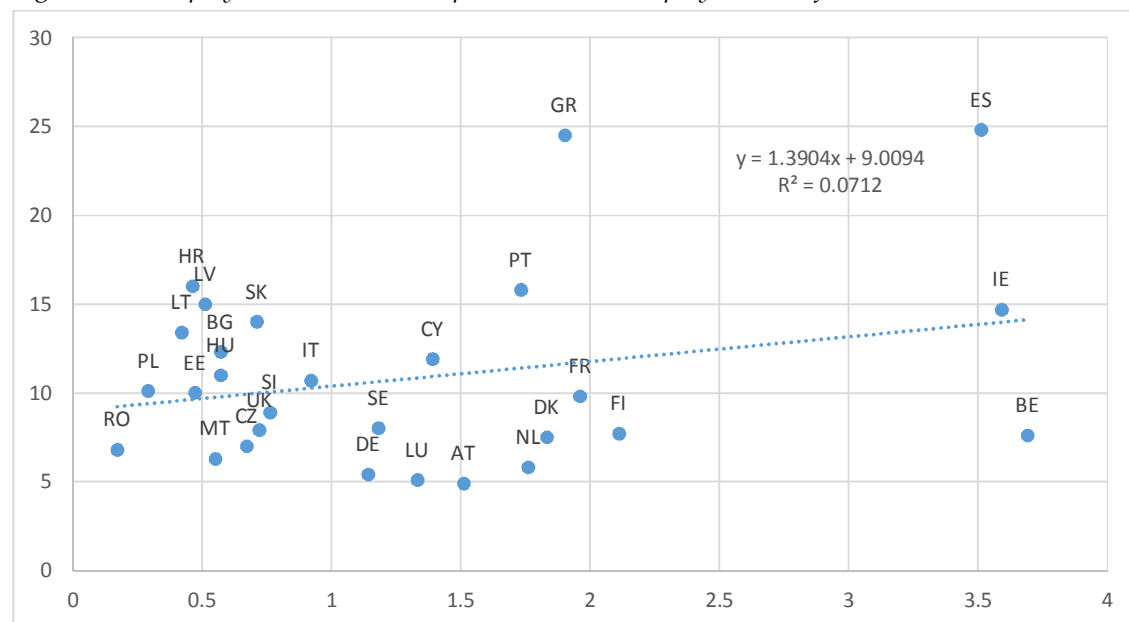
1. For genuine schemes more generosity, meaning looser eligibility criteria or higher coverage or higher replacement rates, leads to higher gross and net flows (in both directions. This also implies a higher stabilisation effect.
2. A higher degree of stabilisation in general implies a greater need for debt issuance or the accumulation of more pre-funding.
3. Re-insurance usually implies lower gross flows, but can have a bigger impact in the rare event of big recessions.

### *Stabilisation in reality and a rule of thumb*

It is surprisingly difficult to find reliable data on how much member states spend on unemployment benefits. Each country has a different way of calculating them and the actual pay-out is organised in many different ways. The only data that are comparable across countries comes from an OECD database and essentially covers the period between 2008 and 2012. There does not seem to be any comparable, cross-country data source with expenditure on the short-term unemployed, which would be key for the stabilisation issue addressed here.

The available data thus conflate the short-term and long-term unemployed. It suggests that, in reality, the link between unemployment and unemployment expenditure is tenuous. Figure 1 below, shows the data for 2012 (the latest year for which complete data are available). Each point denotes the combination of the national unemployment rate and the amount spent on unemployment benefits (as a % of GDP). There is no reliable relationship between these two variables (technically the correlation coefficient is not statistically significant). The data for other years would show a similar picture.

Figure 1. Unemployment rate versus expenditure on unemployed as % of GDP (2012)



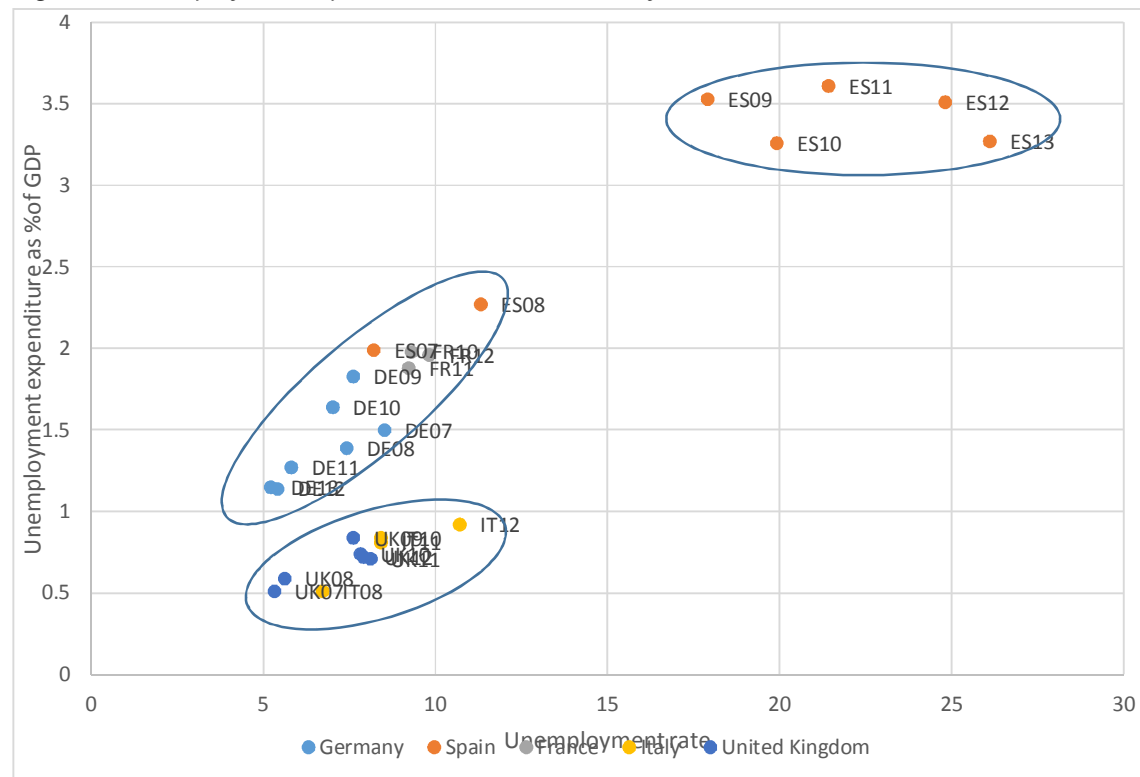
Source: Own calculations based on OECD and Eurostat data.

This lack of a relationship between overall unemployment rates and total spending on all the unemployed (both short- and long-term) is important because it shows that the unemployment systems of different member states serve very different purposes, and thus lead to very different expenditures. For example, Belgium has the highest level of expenditure on the unemployed although its unemployment rate is below the EU average, because its system is rather generous and supports the long-term unemployed with no time limit. This

implies that in Belgium unemployment benefits largely represent general social support expenditure. Other countries have stricter eligibility limits, so the long-term unemployed receive support under different income support programmes.

When one looks at the data over time, however, one can find a link between **changes** in the unemployment rate and **changes** in expenditure on unemployment benefits. For the larger member states a pattern emerges, if one considers the five years for which data are available (2008-12), as shown in Figure 2 below.

Figure 2. Unemployment expenditure and the business cycle



Source: Own calculations on OECD and Eurostat data.

From this figure one observes that there is a reasonably close relationship between the unemployment rate and expenditure on the unemployed, looking at developments over time. It is clear that this relationship differs greatly from country to country, however. Among the large member states in Figure 2 one finds, somewhat surprisingly, that the UK and Italy show a very similar pattern in terms of expenditure on unemployment, although it is widely thought that the unemployment benefits systems of these two countries are very different.

Another group is France, Germany and Spain, in which the case of Spain is especially interesting. As long as the business cycle was favourable, that country's pattern fell into the Franco-German group. But when unemployment shot up, expenditure no longer increased. This is why Spain also shows a cluster inside which expenditure did not increase above a certain level once unemployment reached a very high level. More research is needed to understand whether this was due to constraints on the budget, or whether more and more of the unemployed became ineligible for benefits as their unemployment spell lengthened.

Figure 2 also suggests that, on average, a one-percentage point increase in unemployment leads to an increase in spending of about 0.1% of GDP. This is more a rule of thumb than a

precise relationship, but it seems to describe what some of the larger member states have done in the past (this rule thus abstracts from the huge variations across all member states.)

This rule of thumb allows one to calculate very roughly an order of magnitude of the potential macroeconomic stabilisation properties of an EUBS in the usual terms, i.e. as a percentage of any shock to GDP that would, on average, be absorbed.

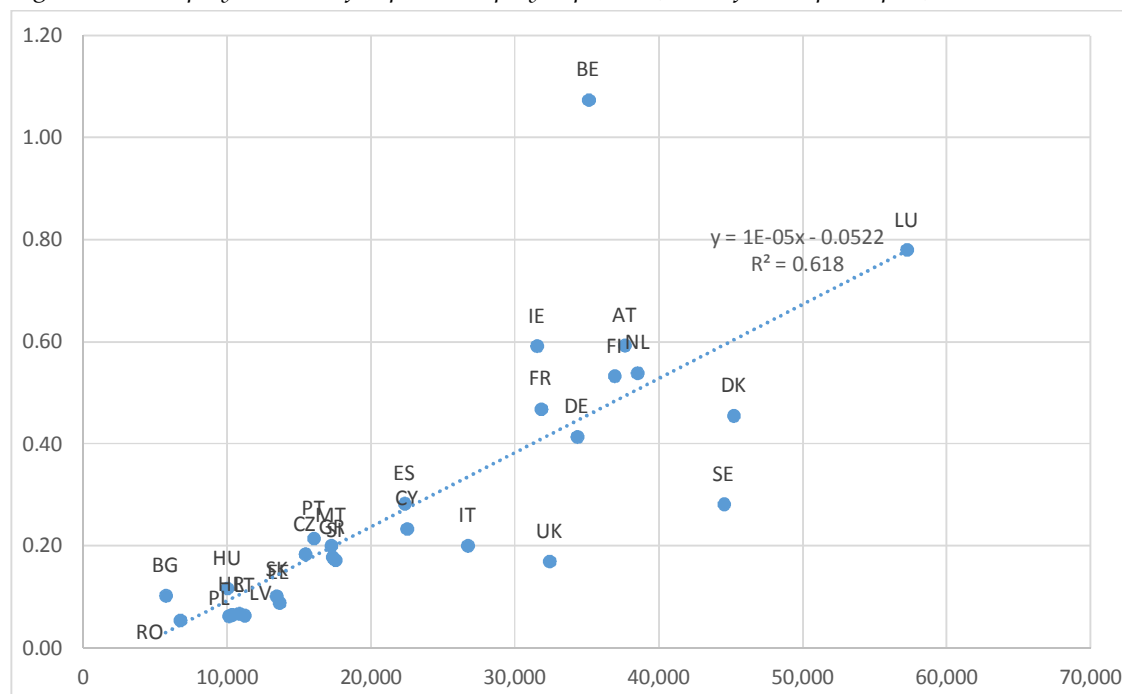
1. In genuine schemes (i.e. without thresholds), only 5% of shocks to GDP would be offset by an EUBS. This result can easily be obtained by applying a so-called Okun coefficient (a link between GDP growth and the unemployment rate) of two. A fall in GDP of 1% should thus be associated with an increase in unemployment of about 0.5%. Given the rule of thumb that unemployment benefits expenditure as a share of GDP increases by about 0.1 % of GDP with each increase in the unemployment rate of 1%, this implies that an increase in the unemployment rate of 0.5% should lead to an increase in disbursements from the EUBS of about 0.05% of GDP. In other words, the stabilisation impact would be limited. The 5% stabilisation found here is considerably less than that found in the CEPS study and what is reported in Beblavý et al. (2015). The key reason for this difference is that the official data on replacement rates do not seem to cover the wide differences in coverage rates and eligibility criteria, which explain the fact noted above that there is no close link between expenditure on the unemployed and the unemployment rate.
2. Re-insurance schemes (i.e. schemes with a threshold) could provide more stabilisation, but it would be of a different nature. Small shocks might not lead to any pay-out from the EUBS, but a large share of bigger shocks could be offset to a great extent. Disregarding some statistical issues, one could say that, again as a rule of thumb rather than a precise calculation, up to 50% of shocks could be offset by EUBS payments if the scheme had to intervene in only one-in-ten cases of negative shocks.

### *Are unemployment benefits a luxury good?*

The differences across member states in their expenditure on unemployment benefits are systematic. One observes that richer countries tend to pay proportionally higher benefits per unemployed person than poorer ones. Figure 3 below shows this by comparing income per capita on the horizontal axis to expenditure per unemployed person (again normalised by income per capita).

The scatter plot of the data suggests that countries with higher incomes tend to spend more on their unemployed than poorer ones (the outlier is Belgium which, for the reasons mentioned above, is the only member state that spends, on average, more on each unemployed person than the GDP per capita of the country).

Figure 3. Unemployment benefits per unemployed person (as % of GDP per capita)



Notes: The variable on the vertical axis is calculated on a per capita, or rather per beneficiary basis (total expenditure on unemployment benefits/number of unemployed). The euro amount spent per unemployed is then divided by national GDP per capita (since the euro amount of unemployment benefits must be compared to national average wages or income).

Source: Own calculations based on OECD and Eurostat data.

The simulations of the stabilising impact of an EUBS usually abstract from this de facto relationship between income per capita and how much countries spend on unemployment benefits. The current differences in expenditure patterns suggest that the fiscal consequences of an increase in unemployment are much stronger for higher-income countries. The stabilisation impact of the creation of an EUBS in terms of actual expenditure on unemployment might thus vary considerably across countries. Some member states might be over-compensated for an actual expenditure increase during a recession (unless they make their systems much more generous), whereas the compensation for others might only be partial.

## Conclusions

Assessing only the stabilisation to be achieved through the creation of a European unemployment benefits scheme is very difficult. There are many potential ways in which an EUBS could be implemented, with profound implications for the potential stabilisation impact, which range from the negligible to the significant.

A cursory analysis of actual expenditure on unemployment benefits reveals that member states with higher unemployment rates do not necessarily always spend more on benefits. Moreover, actual expenditure on unemployment benefits seems to react only minimally to actual increases in unemployment, at least for small cyclical variations. This suggests that, outside deep recessions, the fiscal importance of the variations of unemployment over the business cycle might have been overrated.