

AUTOMATIC STABILIZERS FOR THE EURO AREA AND THE EUROPEAN SOCIAL MODEL

Frank Vandembroucke | *Adviser at the Jacques Delors Institute and Professor at the University of Amsterdam*

The debate on the creation of automatic stabilizers for the Euro area is definitely on the agenda. This tribune focuses on the relationship between the proposals of automatic stabilizers and the social dimension of the EU, including the recent Commission initiative to launch a ‘European Pillar of Social Rights’.

With the Five Presidents’ Report on the completion of the European Economic and Monetary Union, the debate on the creation of automatic stabilizers for the Euro area is definitely on the agenda.¹ Former European Commissioner László Andor, inspired by pioneering work by the German academic Sebastian Dullien, advocated the organization of a European unemployment benefit scheme as the best option for a European automatic stabilizer. Meanwhile, the idea of a European Unemployment Benefit Scheme has been the subject of a various papers and conferences.² The European Commission funded a thorough and broad-ranging research project on its added value and feasibility, led by the Centre for European Policy Studies (CEPS), which final results are to be delivered soon.³ The European Parliament is discussing a report on the matter. Therefore, the summary of different proposals for automatic stabilization in the Euro area presented in a recent Delors Institute Policy Paper by Nathalie Julia Spath is useful and timely (Spath, 2016). This tribune follows up on Spath’s policy paper; it focuses on the relationship between these proposals and the social dimension of the EU, including the recent Commission initiative to launch a ‘European Pillar of Social Rights’. On the national level, automatic stabilizers are a key feature of welfare states; hence, there is an intrinsic link between our conception of automatic stabilizers at the Eurozone level on one hand and our conception of the EU’s role in social policy on the other hand: defining the design of automatic stabilizers implies defining the respective role of the EU and member states in a key systemic function of welfare states, unemployment insurance. This link necessitates a careful discussion, which – as I hope to show – should avoid simplistic dichotomies and undue ‘symbolism’. To make

this case, we first need a slightly technical detour, for which Spath’s policy paper is particularly helpful.

1. Three logic models

Spath organizes the discussion on the basis of three ‘logic models’: a Cyclical Shock Insurance (CSI); a European Unemployment Insurance (EUI); a Reinsurance mechanism (for which we will use ‘Reinsurance’ as a short-cut). The CSI model is not related to either data on unemployment or unemployment benefits; it is based on the relative output gap in member states and only caters for asymmetric shocks, by means of budgetary transfers between member states. CSI does not allow to issue debt at the Eurozone level. EUI and Reinsurance are variants of a European unemployment benefit scheme: they establish a direct relation with unemployment in the member states. In Spath’s organization of the ‘logic models’, EUI and Reinsurance can respond both to asymmetric and symmetric shocks, as they allow building up debt.

The difference between EUI and Reinsurance is two-fold. First, in EUI, individual citizens who are short-term unemployed receive an individual benefit from a European fund, whilst Reinsurance operates with lump sum budgetary transfers between a European fund and member states. Second, in Reinsurance, member states receive transfers on the basis of a trigger (based on the deviation of current short-term unemployment in the member state from its past trajectory in that same member state); in EUI there is no specific trigger for the scheme to start disbursing money (any short-term unemployed individual in a participating member state receives a benefit, independent of

the level or growth rate of short-term unemployment in that member state). In this tribune, I will discard CSI and focus on the EUI and Reinsurance model. My main argument is that the difference between the two models is, in a sense, less clear-cut than Spath 'logic models' might suggest: both models require a significant degree of convergence in the regulation of unemployment across the participating member states; yet, the extent of the convergence that is required and the method to achieve it are very different.

The imperative of social convergence is linked to the problem of institutional moral hazard associated with both EUI and Reinsurance. The expression 'institutional moral hazard' refers to moral hazard at the level of member states as collective, institutional actors. Simultaneously, the introduction of a 'trigger' in the system is a game-changer with regard to this problem of institutional moral hazard.

2. Institutional moral hazard

In essence, moral hazard occurs when a person (or an institution) takes more risks because someone else (or another institution) bears the costs of those risks. Moral hazard means that the insured individual can manipulate the liability that the insurer incurs, by influencing the frequency and/or the importance of the insured risk. In yet other words, the risk is influenced by behavior and choice – or, in the case of institutional actors, influenced by deliberate policies –, rather than being purely exogenous and 'beyond control'. Moral hazard can be reduced by a careful design of the insurance policy, but it can never be totally excluded: it is inevitable, to some extent, in any context of insurance. This traditional understanding of moral hazard is what Spath labels 'ex ante moral hazard'. Is it a relevant concern in the context of Euro area stabilizers? The answer is positive, but nuanced. A European intervention in national unemployment insurance systems, in the form of EUI or Reinsurance, would create a multi-tiered regulation of unemployment in Europe, with both the member states and the EU⁴ playing a role in it. A detailed survey of eight countries in which the regulation of unemployment has a multi-tiered architecture, with central levels of government assuming a role of 'insurer', shows that institutional moral hazard emerges in all these countries as a relevant policy concern, to different degrees and with different types of solutions (Vandenbroucke and Luigjes, 2016).

The possibility for member states that benefit from a European unemployment benefit scheme (whether it takes the form of EUI or Reinsurance) to become 'lax' with regard to the activation of the unemployed and (re)employment policies at large, generates an obvious risk of institutional moral hazard; this risk cannot be dismissed out of hand. This *caveat* about institutional moral hazard is important for our thinking about EUI and Reinsurance, but one should be aware that moral hazard is, in any system of insurance, 'a price to pay' to obtain risk pooling and stabilisation. Hence, the objective is to mitigate the trade-off between stabilisation capacity and institutional moral hazard: for desirable levels of stabilisation capacity, institutional moral should be minimised. One conclusion from our examination of national experiences with multi-tiered unemployment regulation and their extrapolation to a European unemployment benefit scheme is that *minimum requirements*, defined at the EU level, *with regard to the quality of activation policies* would be an important instrument to reduce institutional moral hazard (Vandenbroucke and Luigjes, 2016, p. 35). This is not to say that it would be the only instrument to mitigate institutional moral hazard. In order to minimize institutional moral hazard, the financial design of the system must be such that permanent transfers in favour of certain countries are impossible: 'experience rating' is a prime example of a mechanism to avoid permanent transfers and to minimize the possibility for any country to be, on average, a net beneficiary of the scheme⁵; a trigger-based system can also be very helpful in this respect, as we will explain below. But first we focus on the role of minimum requirements for national policies.

Next to 'ex ante moral hazard', Spath (2016) mentions 'ex post moral hazard risks', by which she means that the financial support provided by the European scheme is used by member states in a way that is not effective in terms of the stated aims of the scheme.⁶ If the aim of the scheme is stabilisation, a logical corollary is that the stabilisation capacity of the *national* unemployment benefit schemes must be sufficient: maintaining (and, in some countries, reinforcing) the stabilisation capacity of national systems is the political *quid pro quo* for organising European support. The stabilisation capacity of unemployment benefits depends on their generosity (notably in the short term) and their coverage; countries like Italy, where the effective coverage of unemployment insurance was traditionally very low, also featured a poor stabilisation capacity (for a comparison of the stabilisation capacity of welfare states,

see Dolls et al, 2012). Hence, minimum requirements with regard to the effective coverage and the generosity of (short-term) unemployment benefits in the participating member states, are part and parcel of any European unemployment benefit scheme.

In short, *minimum requirements with regard to both the 'activation quality' and the 'stabilisation quality' of member states' unemployment benefit system* (from now on, we will use 'minimum requirements' as a short-cut for this twofold concept) are key to fight different forms of institutional moral hazard arising in the context of a European unemployment benefit scheme, next to *financial mechanisms* to avoid permanent transfers and minimize the possibility for any country to be, on average, a net beneficiary of the scheme. The need for minimum requirements applies both to the EUI and the Reinsurance model, as defined by Spath. Minimum requirements would impose convergence in unemployment regulation across the member states participating in the scheme. Pursuing convergence in social policies is a well-known challenge in the EU, certainly with regard to activation: the European Employment Strategy and the Open Method of Coordination have been testing grounds with regard to the potential of so-called 'soft law' in this domain. Much literature exists on the results of the Employment Strategy and Open Coordination, showing mixed results. An *effective* soft convergence process with regard to the quality of activation (the Youth Guarantee might be an example) and with regard to the quality of unemployment benefits (not existing today but mentioned, in very generic terms, in the Five Presidents' Report on the future of EMU) might be seen as a first step towards the establishment of such minimum requirements. The European Pillar of Social Rights, launched by the European Commission in March 2016,⁷ also includes principles on the quality of unemployment regulation, both with regard to activation and the quality of the benefits. Hence, there is an intrinsic and important link between the debate on the European Pillar of Social Rights and the perspective of a European unemployment benefit scheme.

3. Social convergence: a choice of ways and means

EUI and Reinsurance share this challenge: both models require more social convergence, based on a common normative conception of the European social model; in this sense, I do not agree with Spath that only EUI would 'provide for a clear vision of political and social integration of the EU'. Such a sharp dichotomy is to be

avoided in this debate. Admittedly, creating a direct link between unemployed Europeans and a European fund, by means of a genuine individual transfer system operated by the EU, would have a high symbolic value *per se*. But the social convergence that is a prerequisite of any Reinsurance model would be far from a merely 'technocratic' exercise: its political saliency is not to be underestimated.

EUI and Reinsurance differ in terms of the method and flexibility with which convergence in the benefit systems is pursued. In EUI, convergence with regard to the quality of the benefits is imposed directly by the fact that a European fund becomes a co-insurer at the national level, cashing out benefits on a uniform basis. In Reinsurance, convergence with regard to the quality of the benefits is not imposed directly, but would need to be the subject of a parallel process of minimum requirements for the existing national schemes; such a parallel process of minimum requirements, be it in the form of soft coordination or hard law, allows the flexibility that is necessary to accommodate national diversity. In other words, with a view to convergence of the national benefit schemes, EUI is a rather 'rigid' solution, whilst Reinsurance leads to a rather 'flexible' solution. The 'rigid' solution of EUI implies administrative and technical complexities, which are not to be underestimated⁸. The 'flexible' solution is easier to implement; it can build on existing processes and be closely associated with recent initiatives, such as the European Pillar of Social Rights.

The *First preliminary outline of the European Pillar of Social Rights*, published by the European Commission underscores the role of unemployment benefits in economic stabilisation, next to their role in fighting poverty and creating security. The outline observes that "[i]n some cases the coverage of unemployment benefits is very low due to strict eligibility requirements. The duration of benefits in some Member States, as well as the enforcement of conditions for job search and participation in active support are a concern.", and proposes the following principle: "Action to support the unemployed shall include the requirement for active job search and participation in active support combined with adequate unemployment benefits. The duration of benefits shall allow sufficient time for job search whilst preserving incentives for a quick return to employment." Obviously, this statement is very general. Minimum requirements with regard to the stabilization quality of national unemployment benefits would need to be more precise in

terms of the minimum coverage that is required and the generosity of benefits for short-term unemployed. However, the debate on the European Pillar of Social Rights provides an opportunity to elaborate upon this theme; well-formulated general principles with regard to unemployment benefits should be linked with incisive benchmarking of member states' performance in this domain.⁹

4. Arguments in favour of a trigger-based system

In Spath's presentation of 'logic models', the operation of Reinsurance is based on a trigger, which is not the case with EUI. There is indeed logic in this difference: if a European fund pays basic unemployment benefits to short-term unemployed citizens, which can be topped up by national governments, these European transfers constitute individual rights that cannot be made conditional on a trigger, such as the fact that short-term unemployment exceeds a certain level or that its growth rate is higher than a certain percentage. To formulate it more precisely: if the symbolic character of an EU-funded individual social right is deemed politically important, its disbursement cannot be made conditional on macro-indicators.¹⁰ In contrast, Reinsurance does not interfere with the individual benefits that citizens receive, but cashes out budgetary transfers to member states in support of national systems; a trigger is a natural feature in such a design. Importantly, a trigger creates additional possibilities to fight ex ante institutional moral hazard. For instance, if the trigger is based on relative deviations of the national level of short-term unemployment from its historical trajectory, countries with a high structural level of short-term unemployment will not 'benefit' from this (by drawing on more EU support); in EUI, countries with a high structural level of short-term unemployment obviously receive more EU support - which then has to be counteracted by mechanisms such as

experience rating. In other words, Reinsurance allows a broader set of possible design features that reduce institutional moral hazard.¹¹ In addition to the sheer administrative complexity of EUI, the fact that it is more difficult to protect it against institutional moral hazard (compared to Reinsurance) is a high price to pay for the symbolism of a direct European transfer to individual European citizens.

Conclusion: Need for a careful and thorough debate

Analytically, the case for a Euro area stabilisation capacity is compelling; politically it is no doubt an uphill battle in today's Europe. We therefore need a careful exploration of different scenarios and a thorough understanding of how they can fit into the broader challenge of developing a European social union. Various arguments militate in favour of a European unemployment benefit scheme. EUI and Reinsurance are two variants of this idea: both require a significant degree of social convergence, but the governance method and the flexibility with which convergence is pursued in these models are very different. Reinsurance not only allows more flexibility and offers more scope to mitigate the risk of institutional moral hazard; it also seems a less complicated option. Politically, the reinsurance option may be more true to the idea that a European social union should be a 'union of welfare states', rather than a European welfare state (Vandenbroucke, 2015). Because it presupposes the definition of minimum requirements with regard to the 'activation quality' and the 'stabilisation quality' of national unemployment insurance systems, a useful link can and should be established with the debate on the European Pillar of Social Rights; such a link can create additional momentum for this debate.

1. *Completing Europe's Economic and Monetary Union*, Report by J.-Cl. Juncker, in close cooperation with D. Tusk, J. Dijsselbloem, M. Draghi & M. Schultz, June 2015.
2. The idea that the monetary union should be equipped with a stabilisation capacity in the form of common unemployment insurance has already a long pedigree; see the short historical account in Andor (2016); relevant papers are listed in Spath (2016, footnote 1).
3. The results of this research project encompass econometric and legal analyses; they are not yet published. For some first publications see <https://www.ceps.eu/topics/unemployment-insurance>
4. EUI and Reinsurance would apply to the Eurozone; here, and in the remainder of the text, we use 'EU' as a short-cut for Eurozone.
5. 'Experience rating' ensures that the contribution which member states have to pay to the European fund differs on the basis of their past unemployment record; another possible mechanism is 'claw back', which deals with long-term positive (negative) net contributions by a member state by increasing (decreasing) the amount that the member state has to pay in the European fund. The CEPS-led research consortium on the added value and feasibility of a EUBS examines different variants of such mechanisms in detail, which leads to a preference for experience rating.
6. In her discussion of ex post moral hazard, Spath formulates the objective as 'to increase business cycle convergence' (Spath, 2016, p. 17), which suggests that the main emphasis is on asymmetric shocks. I prefer to define the objective as 'increasing stability'.
7. See http://ec.europa.eu/priorities/deeper-and-fairer-economic-and-monetary-union/towards-european-pillar-social-rights_en
8. For this reason, the implementation of an EUI model might also have to allow for some flexibility, to accommodate insurmountable differences in the existing national schemes. This reinforces my argument that the distinction, in terms of rigidity versus flexibility, between EUI and reinsurance might in practice be less clear-cut than between the 'logic models' presented by Spath.
9. Therefore, it is important to establish a clear relationship between the European Pillar of Social Rights and the new social benchmarking initiative announced by the Commission in its Work Programme 2016 and its Communication of 21.10.2015 on the follow-up of the Five Presidents' Report.
10. Two nuances are important in this respect. First, it is in principle possible to conceive of a scheme whereby citizens are entitled to individual benefits that are (i) funded by the EU when a macro-indicator exceeds a certain threshold, and (ii) funded by the member states when the threshold is not exceeded. Such a scheme would generate a set-up that is quite different from the EUI discussed by Spath: it presupposes that the EU imposes a specific and detailed uniform 'basic' benefit system on member states (which they can only top up), without necessarily funding it all the time; but it also reduces the symbolic 'European' nature of those benefits. Second, in existing multi-tiered systems individual transfers and triggers are combined: in the United States the federal level supplements the unemployment insurance systems of the states by paying individual unemployment benefits to American citizens, on the basis of a trigger (and, additionally on the basis of discretionary political decisions); however, these individual benefits extend the duration of unemployment benefits and thus constitute a federal top-up of basic state systems rather than a federal basic scheme topped up by the states. In a 'top-up' scheme (which the US system in essence is), the combination of an individual-level intervention and a trigger becomes a feasible option. In contrast, the EUI presented by Spath is a 'basic' scheme, topped-up by the Member States.
11. Spath thinks that a trigger-based system cannot operate automatically, but only on a semi-automatic basis. If this assessment is correct, this would be a problem indeed. However, automaticity and a trigger are not incompatible. The indicators on which the trigger is based can be established on a relatively simple and robust empirical basis, with no need for additional 'political deliberation' (in contrast to what Spath supposes). Moreover, since the system might be in operation frequently, with many member states being in a position to benefit from time to time, it will not allow the kind of ad-hoc politically-based decision-making which we see, for instance, in European budgetary surveillance.

References

- Andor, L., "Towards shared unemployment insurance in the Euro Area", *IZA Journal of European Labour Studies* 5:10, 2016.
- Dolls, M., C. Fuest and A. Peichl, "Automatic Stabilizers and Economic Crisis: US vs. Europe", *Journal of Public Economics*, Vol. 96, No. 3-4, 2012, pp. 279-294.
- Spath, N.J., "Automatic stabilizers for the euro area: what is on the table? Promises and problems of three proposals for cyclical stabilization", Policy Paper 166, Jacques Delors Institut - Berlin, June 2016.
- Vandenbroucke, F., "A European Social Union: Unduly Idealistic or Inevitable?", *European Debates*, 7, European Investment Bank Institute, September 2015.
- Vandenbroucke, F. and C. Luigjes, *Institutional moral hazard in the multi-tiered regulation of unemployment and social assistance benefits and activation. A summary of eight country case studies*, Brussel: Centre for European Policy Studies, February 2016.

On the same themes...

IS THERE SUCH A THING AS "SOCIAL EUROPE"?

Sofia Fernandes and David Rinaldi, *Tribune*, Jacques Delors Institute, September 2016

ACCESS TO SOCIAL BENEFITS FOR EU MOBILE CITIZENS: "TOURISM" OR MYTH?

Sofia Fernandes, *Policy paper No. 168*, Jacques Delors Institute, June 2016

AUTOMATIC STABILISERS FOR THE EURO AREA: WHAT IS ON THE TABLE?

Nathalie Spath, *Policy Paper No. 166*, Jacques Delors Institut - Berlin, June 2016

SOCIAL BENEFITS AND CROSS-BORDER MOBILITY

Frank Vandenbroucke, *Tribune*, Jacques Delors Institute, June 2016

WHY THE EUROZONE CAN'T AGREE ON CONVERGENCE. AND HOW STRUCTURAL REFORMS CAN HELP

Anna auf dem Brinke, Henrik Enderlein and Jörg Haas, *Policy paper No. 165*, Jacques Delors Institut - Berlin, June 2016

LABOUR MOBILITY IN THE EURO AREA: CURE OR CURSE?

Anna auf dem Brinke and Paul-Jasper Dittrich, *Policy paper No. 159*, Jacques Delors Institut - Berlin, March 2016

BLUEPRINT FOR A CYCLICAL SHOCK INSURANCE IN THE EURO AREA

Henrik Enderlein, Lukas Guttenberg & Jan Spiess, *Studies & Reports No. 100*, Jacques Delors Institute, September 2013

COMPLETING THE EURO. A ROAD MAP TOWARDS FISCAL UNION IN EUROPE (REPORT OF THE 'TOMMASO PADOA-SCHIOPPA GROUP')

Henrik Enderlein, Jacques Delors, Helmut Schmidt, Peter Bofinger, Laurence Boone, Paul De Grauwe, Jean-Claude Piris, Jean Pisani-Ferry, Maria João Rodrigues, André Sapir et António Vitorino, *Studies & Reports No. 92*, Jacques Delors Institut, June 2012

Managing Editor: Yves Bertoncini • The document may be reproduced in part or in full on the dual condition that its meaning is not distorted and that the source is mentioned • The views expressed are those of the author(s) and do not necessarily reflect those of the publisher • The Jacques Delors Institute cannot be held responsible for the use which any third party may make of the document • Original version • © Jacques Delors Institute