Abstract

The euro crisis has led to a resurrection of the debate about a "fiscal capacity" for the European Monetary Union (EMU). While already early policy papers on the EMU, such as the MacDougall report of 1977, had argued that a monetary union would need a fiscal capacity for stabilization purposes, the issue has not been discussed widely for a long time since the actual implementation of the EMU in 1999.

The basic predominant argument during the first years of the EMU was that a fiscal capacity for stabilization would not be necessary as international and inter-temporal risk-sharing could be achieved through private and public access to the capital markets. For the private sector, cushioning macroeconomic shocks was supposed to be reached by cross-border diversification of investments. For the public sector, it was assumed that national policymakers could just borrow on international financial markets during a recession and repay in a recovery, hence using the national fiscal policies as an effective macroeconomic stabilizer.

However, the buildup of large imbalances in the euro area and its culmination in a crisis have highlighted that these arguments were empirically wrong. First, fiscal policy in Europe prior to the crisis did not address cyclical divergences adequately. Especially governments in countries with large real-estate booms used the extra revenue in good times to expand government expenditure or to cut taxes and social security contributions, thus fueling the boom. In the recent crisis, many governments saw themselves forced by market pressure to consolidate their budgets pro-cyclically. Second, cross-border holdings of

assets were too small for the largest part of the population to really help cushion the recession.

Consequently, in a number of recent policy papers, the need for a fiscal capacity has again been underlined, with Herman Van Rompuy's "roadmap" being the most prominent one. All across Europe, ministries and think tanks are now working on blueprints for fiscal capacities.

One possibility for achieving a stabilization of the national business cycles would be the introduction of a basic unemployment insurance for the euro area. The underlying idea is that this new European unemployment insurance would replace part of the existing national unemployment benefit systems. More precisely, those becoming unemployed and having contributed to the scheme for a certain number of months would be eligible to receive unemployment benefits from the scheme.

The exact amount of the contributions to the scheme as well as the unemployment benefits received would be a function of current and past income. The level of this European safety net would be chosen so that it does not expand the overall generosity of social protection so as not to create new incentives for delaying job search by individual unemployed. So, the level would be close to the smallest common denominator.

One possible setup of parameters here would be to pay the unemployed who have prior contributed to the insurance for 12 consecutive months over the past two years and to pay a replacement payment of 50 percent of average wages for up to 12 months. However, such a scheme would not mean a harmonization of benefit levels across Europe. In addition to the basic European unemployment insurance, each country could continue to top up these payments and thereby maintain the current level of overall protection.

As the contributions to such a scheme would replace part of the national contributions and the payouts would replace part of the national payouts, this scheme should neither increase the overall burden in terms of social security contribution on labor, nor should it increase the outlays for unemployment benefits in the euro area as a whole.

Macroeconomically, this scheme would stabilize national business cycles. In good times with low unemployment, individual countries would pay more into the system than their unemployed would receive in benefits. This would drain purchasing power from the country in question and would thus dampen a boom and help prevent boom-and-bust cycles, such as the ones we have observed in Ireland and Spain. In bad times, increasing unemployment would lead to net transfers from the system to individual countries, which would help stabilize economic activity there.

The macroeconomic impact would work through the national budgets: Different from the current situation, national policymakers would not be able to use cyclical surpluses in the unemployment insurance for lowering contributions, cutting taxes or increasing other public expenditures. In a recession, they would not be forced to cut either unemployment benefits or other public expenditures in order to pay for the shortfall in the unemployment insurance.

With a look at the United States of America's unemployment insurance, it has sometimes been argued that the potential stabilization effect of an unemployment benefit system is not large. However, this argument neglects the fact that the U.S. unemployment insurance has been designed to not share risks between individual states. A construction as proposed above, in contrast, would have significant stabilization effects.

Depending on the assumptions used, between 1995 and 2011, the proposed unemployment insurance would have an annual financial volume of an average of about €50 billion. While due to the lack of up-to-date data and the ongoing nature of the euro crisis, the stabilization impact for this specific crisis cannot be simulated, for past recessions, the potential stabilization is impressive: For some countries, the stabilization effect especially in the Great Recession of 2008/2009 would have reached 25 percent of the downturn.

While no country would have been a net recipient or a net payer over the whole period, over the simulation period, some countries would have ended up with a positive balance with the European unemployment insurance and some with a negative balance. However, this is mainly due to an extremely deep recession with a sharp increase in unemployment in some countries, such as Greece and Spain, in 2008 and 2009. Over a longer horizon, it should be possible to calibrate the system in such a way that permanent net transfers are prevented.

This setup of a European unemployment insurance has a number of advantages over other recently discussed stabilization instruments, such as budget transfers linked to the output gap or to meeting certain triggers for unemployment. The first advantage over schemes building on the output gap is that it would not rely on a statistical measure, such as the output gap, which can be subject to severe revisions that can lead to positive net transfers into still overheating countries. Second, because the transfers go directly to the unemployed and do not run through the national budgets and therefore the national budget-setting processes, there is less risk that the funds cannot be appropriated to their final use in a timely manner. Third, as its payments are linked to a widely appreciated European social achievement, an unemployment insurance, it might help improve the social image of the European Union.