

# On the Design of a European Unemployment Insurance System

By Abraham, Brogueira de Sousa, Marimon and Mayr

Discussion by  
Roel Beetsma (UvA & European Fiscal Board)



## Introduction

- Well-written and very rich paper
- Proposals for some (central) stabilization function for euro area have featured prominently in policy debate since outbreak of crisis
- Proposal for an EUIS is timely in view of priorities set by new European Commission President
- Paper deviates from stabilization motive and focuses on reducing inefficiencies in tax – transfer systems
- Risk sharing is briefly addressed, but is “out” at moment
- Unlike most related contributions, this paper provides solid micro-foundations, hence accounts for incentive effects

## Introduction

- Advantages of European unemployment insurance scheme
  - Reduce countercyclical impact of unemployment spending on national budgets
  - Strengthen cohesion and solidarity across Europe
  - Harmonization: improve labor market mobility and market integration
- Problem is structural differences in labor market institutions
  - Equilibrium unemployment differs systematically across countries
  - However, equilibrium unemployment is not directly observable, hence hard to agree upon
  - Some existing proposals solve this with “double condition”: unemployment being higher than in past 15 years and increasing fast

## Where does paper stand in terms of debate and policy proposals?

- Ideas and proposals abound, also by official bodies such as IMF
  - rainy day funds
  - unemployment insurance schemes: Arnold et al. (IMF, 2018)
  - investment stabilization funds
  - export-based stabilization capacity (Beetsma et al., 2019)
- Differences in equilibrium unemployment – double condition (Commission / Martinez-Mongay):
  - unemployment higher than average over past 15 years
  - unemployment rising fast

## Where does paper stand in terms of debate and policy proposals?

- May 2018: Commission tables proposal for Multiannual Financial Framework (MFF) 2021 - 2027
  - European Investment Stabilisation Function (EISF) € 30 bn. of loans with interest subsidy
  - Reform Support Programme (RSP)
    - Reform Delivery Tool: € 22 bn
    - Technical support instrument: € 1 bn
    - Convergence facility: € 2 bn

## Where does paper stand in terms of debate and policy proposals?

- November 2018: France and Germany propose Eurozone budget with instruments for competitiveness and convergence
- December 2018: Euro-group tasked to work on design and timing of a budgetary instrument for convergence and competitiveness (BICC) for euro area; instrument to be part of EU budget, consistent with other EU policies, strategic guidance from euro area member states
  - proposal to be ready by June 2019
  - EISF is stuck in Council, which gives priority to BICC: may seem strange, because BICC is more redistributive
  - BICC expected to be included in the Commission legislative proposal of RSP, which is part of legislative process new Multiannual Financial Framework

## Where does paper stand in terms of debate and policy proposals?

- Political guidelines new Commission President:
  - Further deepening of the Economic and Monetary Union
  - BICC for euro area to support Member States' growth reforms and investment
  - Full use of flexibility allowed within Stability and Growth Pact
  - **Propose a European Unemployment Benefit Reinsurance Scheme:**
    - “This will protect our citizens and reduce the pressure on public finances during external shocks”

## Where does paper stand in terms of debate and policy proposals?

- Authors could be more explicit in where paper stands in relation to the current debate and the developments on the policy front
- Specifically, while much of discussion is about stabilization tools at the EU level, this paper is primarily on the benefits of an EUIS from the perspective of reducing inefficiencies in tax – transfer systems
- This may actually be strong point of proposal, as stabilization is “out” (at the moment) and focus is on BICC



## Comments – political acceptability

- More attention to political acceptability:
  - Country blocks diametrically different positions: “Hanseatic” countries are opposed to common EU arrangements, Southern European block in favor
  - Main argument against: moral hazard resulting in permanent redistribution
  - Mistrust may even prohibit Pareto improvements or arrangements that do not elicit moral hazard
  - Acceptability may require being part of broader package, including risk reduction
  - For this specific proposal:
    - Differentiating contribution rates for same benefit seems difficult to sell
    - How can they be “objectively” determined? Experience rating only feasible in future; countries have incentive to talk down equilibrium unemployment level

## Comments – moral hazard

- Major obstacle to EU-level arrangement is fear of moral hazard: net cross-border transfer related to unemployment benefit reduces incentive for politically-costly labor market reform at national level
- Paper mentions moral hazard at individual level
- Little attention to moral hazard at level of government
- Since there systematic redistribution is largely absent from proposed scheme, it may do well in terms of avoiding moral hazard at government level
- Authors could raise this point more forcefully

## Model – main assumptions

- Multi-country dynamic general equilibrium model
- Completely segmented labor markets, integrated capital market closed at the level of the union
- Job arrival rate, job separation rate and disutility of active job search are all country-specific and exogenously given
- Benefit duration and replacement are country-specific and optimized over
- Individuals differ in productivity, assets (productivity history) and labor status: employed, unemployed eligible, unemployed non-eligible, non-active
- Unconditional productivity distribution same across individuals

## Model – main assumptions

- Unemployed search for job, inactive do not, i.e. have lower job arrival rate
- Eligible unemployed are subject to exogenous probability of losing unemployment benefit
- Once benefit has been lost, it can only be obtained back by working first
- Unemployment benefit depends on individual productivity
- Total factor productivities differ across countries
- No shocks at country level

## Analysis: optimal national reforms

- Actual data exhibit substantial differences in benefit duration, replacement rates and tax rates across countries
- Optimal national arrangement generally very different from actual arrangement:
  - Unlimited benefit duration: search effort given, so no incentive effect, hence only insurance benefit
  - Lower replacement rates: lowers outside option and stimulate accepting job offers
  - Optimal replacement rate is higher if difference job arrival rate unemployed versus inactive is larger – more incentive to accept job because of risk benefit loss
- Specific role of analysis of optimal national arrangement is not entirely clear to me: is its purpose merely to provide intuition? More explicit motivation would be welcome

## Analysis: EUIS in different steps

- Compared to *current* national systems, an EUIS with a low replacement rate, infinite benefit duration and uniform payroll tax rate would be beneficial for most countries, even though there are systematic transfers; reason is that this is closer to optimal scheme for most countries
- Allowing for country-differentiation in tax rates can make all countries better off
- Adding optimal national top up not only makes each country better off at aggregate level, but makes all groups inside a country better off (Table 10)
- Welfare effect of optimal national top up generally is small

## Analysis: EUIS in different steps

- Is system with the additional national top up included *identical* to the optimal national system? (Table 9)
  - It should at least be close, because general equilibrium effects of national top ups are ignored
  - Optimal EUIS part was derived internalizing general equilibrium effects, so maybe there are small differences?
- General equilibrium effect of implementing all top ups:
  - Substantial negative effect on saving: would it be possible to characterize the optimal coordination in setting national top-ups?
  - Can each country and every group still be made better off?
  - Answer seems important for political acceptability of EUIS

## Analysis: risk sharing from EUIS

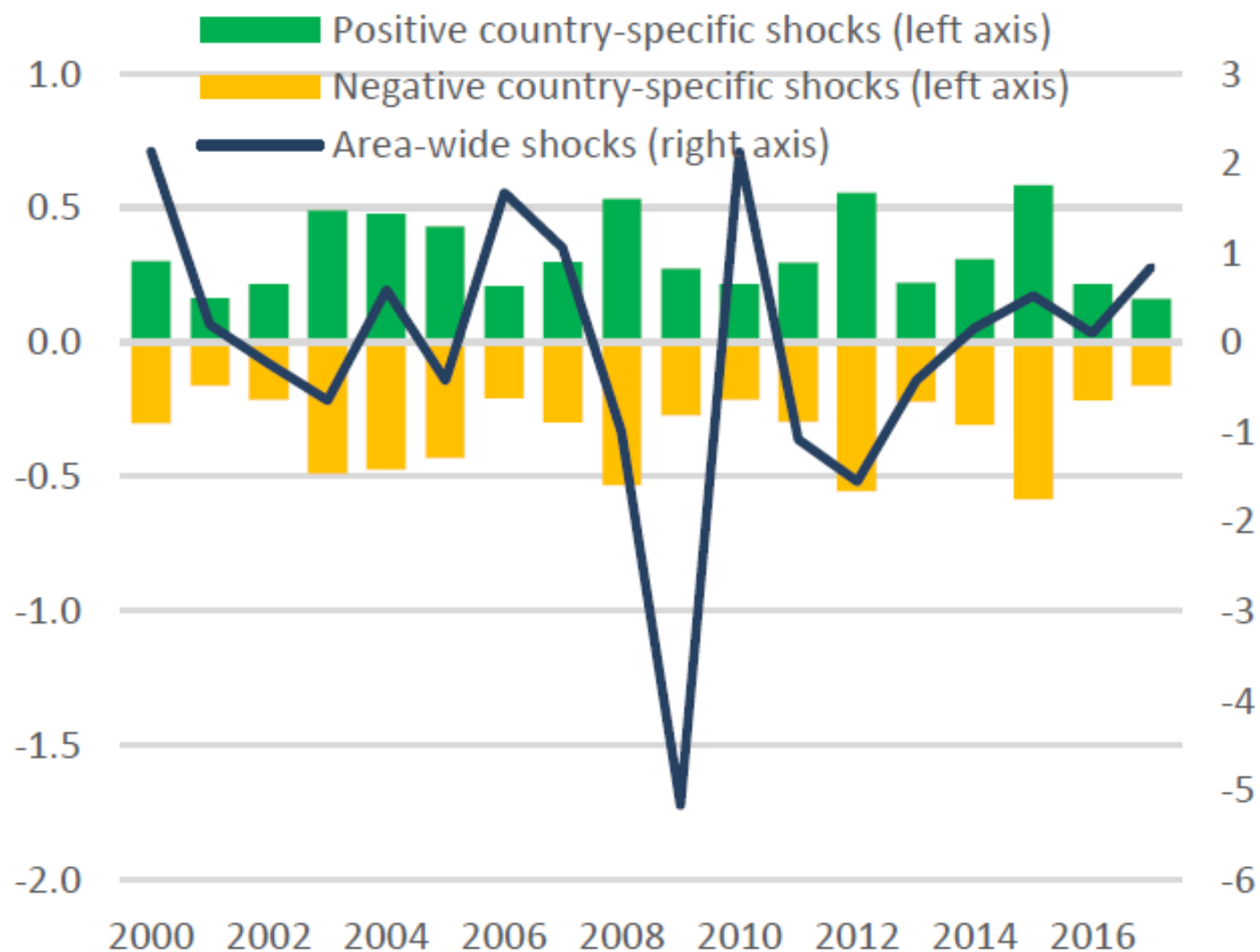
- Shock hits a country as complete surprise
- Country is small, so effect of the shock can be completely insured (tax kept constant), holding rest of union at steady-state status quo
- Comparison financial autarky and full insurance via EUIS
- Gains from insuring country-level fluctuations are found to be small
- Calculated gains are presented as an upper bound
- Is paper not understating benefit from risk sharing?



## Analysis: risk sharing from EUIS

- Is paper not understating benefit from risk sharing?
- Assumed risk aversion (log utility) is on low side
- Benefit is based on one-time shock – consumption equivalent measure calculates effect in terms of lifetime consumption change, so risk-sharing benefit is thinly spread over long horizon
- More appropriate assessment might allow for country-specific shocks hitting each period
- Union-wide shocks seem to be more relevant (EFB, 2018) – what role could EUIS play here?

## Analysis: risk sharing from EUIS



*Source:* European Fiscal Board calculations.

*Note:* Country growth shocks, as share of euro area GDP, are the residual of the regression  $Y_{i,t} = a_i + \alpha_i Y_{i,t-1} + \beta_i Y_{i,t-2} + \varepsilon_{i,t}$ , where  $Y_{i,t}$  is GDP growth

## Comments – systematic differences across individuals

- Paper shows that reform of national benefit systems (replacement rate and benefit length) may yield substantial benefits
- Question is why, in practice, we do not observe these reforms?
- Assumption is that individuals are identical in productivity distribution
- Systematic “ex ante” individual differences may help to explain differences in current arrangements?
- Systematically higher chance of low productivity + higher systematically higher likelihood of unemployment + utilitarian perspective may justify higher replacement rate, hence help rationalize actual arrangement and explain national reform resistance
- Paper could pay more attention to (political) feasibility of reform national benefit systems

## Comments – more fundamental labor market reforms

- National reform is limited to benefit length and replacement rate
- More fundamental, and potentially more important, reforms are not considered (which authors admit)
  - In model this would amount to reforms affecting job arrival (reduced employment protection) and separation rates and disutility of active job search (e.g., training programs)
- One would expect optimal national regimes to become more similar, which should be conducive to introduce common EUIS

## Comments – potential extensions

- Relaxing government balanced budget assumption
- Endogenous search effort dependent on benefit duration (threat of termination benefit at some point will induce more search effort) – optimal replacement rate could be higher, because incentive to accept job would be stronger
  - Optimal national schemes closer to current ones?
  - Benefit from EUIS relative to current national scheme smaller?
- Cross-border risk sharing – this would increase benefit from EUIS
- International labour mobility – would likely stimulate national labour market reform

## Comments – exploiting veil of ignorance

- Case for EUIS could be strengthened if there is a commitment to introduce it in the future, rather than now; the current state of an individual becomes less relevant, the further the introduction is pushed to the future.
- This can be important, because introduction takes time in any case; the scheme could be foreseen for the multi-annual financial framework after 2027.

## Conclusion

- Rich and well-written paper
- Very timely – also in view of agenda new Commission President
- Be more explicit where it stands in relation to current proposals
- Current political strategy at EU level: create a euro area instrument for convergence and competitiveness; size and purpose can evolve over time
- How could proposal fit into this strategy?
- More explicit attention to potential political obstacles to accepting proposed EUIS



# Thank you!

Link EFB review report:

[https://ec.europa.eu/info/publications/assessment-eu-fiscal-rules-focus-six-and-two-pack-legislation\\_en](https://ec.europa.eu/info/publications/assessment-eu-fiscal-rules-focus-six-and-two-pack-legislation_en)