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A Joint Unemployment Insurance for the European Economic and Monetary Union?

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ABSTRACT

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More and more policy makers tend to declare that the loss of exchange rate adjustments within the European Economic and Monetary Union (EMU) has to be compensated by an increase in fiscal policy. A joint unemployment insurance is seen as one opportunity. After comparing a basic design with a "kicking-in" style unemployment insurance, we recommend the latter as it captures the main motivation of such a transnational transfer mechanism, combating credit market constraints.

JEL Classification: J65, J68

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Introduction[1]

The ongoing crisis in the European Economic and Monetary Union sheds light on the importance of increased fiscal cooperation. Besides proposals for an intensified fiscal coordination in areas like taxation, for example, shock-absorbing mechanisms are often considered to substitute for the lost capacity of exchange rate adaptation. Solutions are presented for different economic levels, but the common denominator is always about redistribution, either in the short term or in the long term. The introduction of an EMU-wide unemployment insurance mechanism is one proposal where contributions could be redistributed in the short term. The introduction of an EMU-wide unemployment insurance was already being discussed in 2012 by Van Rompuy, Barroso, Juncker and Draghi in "TOWARDS A GENUINE ECONOMIC AND MONETARY UNION":

> *"An EMU fiscal capacity with a limited asymmetric shock absorption function could take the form of an insurance-type system between euro area countries (…) based on a microeconomic approach, and be more directly linked to a specific public function sensitive to the economic cycle, such as unemployment insurance."*

At least two proposals have been debated until now: 1. A basic EU-wide unemployment insurance which provides a permanent minimum level of insurance that is directly contributed to by employees and employers and disbursed to the unemployed. Countries could increase the generosity of such a system by national contributions. 2. A second proposal provides an enhancement, or a prolonging of, already existing national unemployment insurance schemes in cases where a certain threshold of a determined indicator is reached, e.g. the unemployment rate. Both proposals raise the risks of moral hazard and manipulation, which is why the design is of main interest. However, existing proposals do not capture the main motivation of such a scheme in their design, which is to combat credit market constraints. Considering these constraints, we present an unemployment insurance which "kicks in" and introduces the interest rate as a threshold indicator as opposed to a basic insurance.

[1] We are grateful to Alexander Spermann for helpful comments.

The feasibility of an EMU-wide unemployment insurance system is determined by its core mechanisms, i.e. the way resources are allocated. If exogenous shocks, like recessions would be homogenous between countries, the financial basis of such a scheme would be in danger. Thus, the convergence of EMU founder countries is of interest in this paper. However, first it is useful to explore whether automatic stabilizers have the ability to absorb exogenous shocks.

Automatic stabilizers

Besides discretionary fiscal policy, automatic stabilizers are primary instruments for demand substitution and thus stabilize output and employment in recessions (Dolls, Fuest, Peichl 2010). Social transfers are typical examples for automatic stabilizers. Discretionary fiscal policy could also contain social transfers, however, but this then depends on specific situation-dependent policy decisions.

In fact, every measure is adopted by policy makers in constantly changing economic environments. Besides the political process needed to adopt certain measures, active decisions depend on different actors' awareness of economic changes, which require corresponding data. This explains why a delay occurs between economic changes and the moment when measures take effect. Thus, irrespective of the amount of resources available, the stabilizing effects of discretionary fiscal policy depend on its accuracy. The inevitable time lag may lead to a situation where policy makers adopt discretionary measures based of obsolete information. If, however, policy makers would have more recent data they would act different. If, however, an automatic stabilizer is in place, there is no such a delay between economic changes and corrective action because the time spent processing data and adopting measures is very limited.

Regardless of whether it is in place due to discretionary fiscal policy decisions or as an automatic stabilizer, the stabilizing effects of social transfers always depends on the consumption behavior of receiving individuals. This is why effects differ for income and consumption stabilization. For example, consumption during unemployment differs due to savings. If a household has high savings it is able to smooth its consumption on its own

without requiring any transfer. In such a case receiving transfers would not contribute to additional consumption stabilization, whereas in contrasts households with low or no savings would spend the additional money to smooth their consumption (Browning, Crossley 2001) leading to additional stabilization of output and employment. A decrease of taxes or social contributions would work in a similar way. Additionally, there is also a direct link to job match efficiency because social transfers can help unemployed individuals overcome possible liquidity constraints in job searching behavior. This therefore can lead to better job matches because individuals have more time to search for a job (Chetty 2008).

Discretionally fiscal policy also comprises direct government expenditures. From a macroeconomic point of view both increased direct government expenditures and social transfers have the ability to stabilize consumption. However, their mode of action differs. Increased direct government expenditures aim at holding demand constant at the firm level in order to enable firms to stabilize their demand for labor. In the case of social transfers this mode of action is rather indirect since it may smooth consumption at the individual level. This is why it tends to hold output and thus labor demand constant at the firm level. One advantage of social transfers in comparison to direct government expenditures is the accuracy concerning liquidity constrained job searching behavior. In case of direct government expenditures it is unclear if they prevent possible liquidity constraint or unconstraint employees from getting unemployed. However, social transfers could be linked to liquidity constrains.

Due to their immediate and targeted impact, automatic stabilizers are powerful instruments to cushion economic downturns. On the one hand, job matches are improved wherefore economies become more resistant. On the other hand they substitute for income losses, thus stabilizing aggregate demand. Of course, the financial base of transfers - regardless of whether they are automatic or not - depend on revenues generated from taxes or social contributions, thereby reducing consumption capacities of those liable to contribute. Although costly, such a policy approach might increase economic efficiency since other inefficient costs such as transaction costs can be reduced. For example, suppose a firm decides to let go several employees based on faulty information that underestimates transaction costs of employment. They may not have dismissed these employees had they known the actual transaction cost.

Although several advantages of automatic stabilizers exist it is still unclear if such a scheme is adequate between countries. Thus, the necessity and feasibility will be discussed in the following.

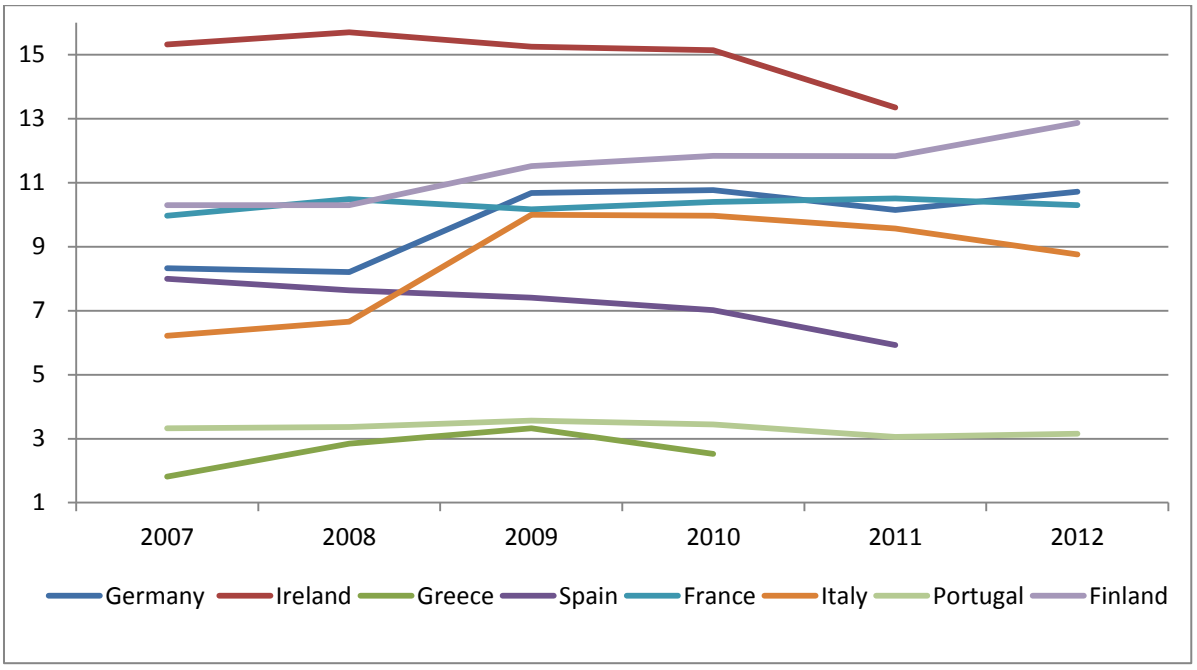
A transnational transfer mechanism

Before developing specific proposals for an EMU-wide unemployment insurance scheme it is essential to elaborate if, in general, a transnational transfer mechanism is necessary and feasible.

The average amount of income replacement and support per unemployed person increased at the beginning of the crisis in countries such as Italy, Germany, Finland, Austria and Greece (Figure 1). This was mainly driven by the large share of dismissed long-term employed persons who were entitled for relatively high and long unemployment insurance benefits. However in the further development during and after the acute crisis, labor market expenditures for income replacement reached their maximum in 2010 and decreased in most countries because of expired entitlements.

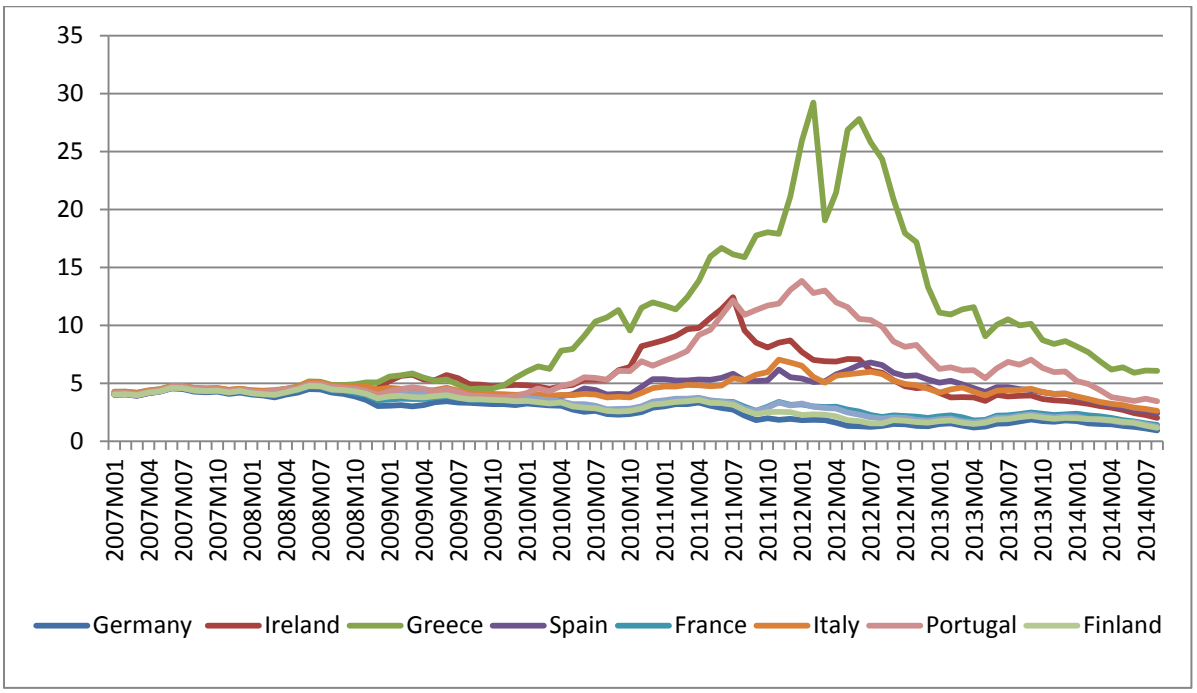
Bank lending constraints, which became manifested in high interest rates in the recent crisis (Figure 2), are a major reason why a transfer mechanism in the form of a transnational automatic stabilizer is of interest. Credit market constrained countries like Greece, Spain, Portugal and Ireland were not able to stabilize out-of-work income maintenance and support per unemployed person. The strongest effect of a transnational transfer mechanism would therefore exist in strong recessions since such a transfer would ease budget constraints due to a partial substitution of national transfers.

Figure 1: Out-of-work income maintenance and support per unemployed person, € thousands per year



Source: Eurostat, own calculation

Figure 2: Quarterly Maastricht criterion interest rates (%)



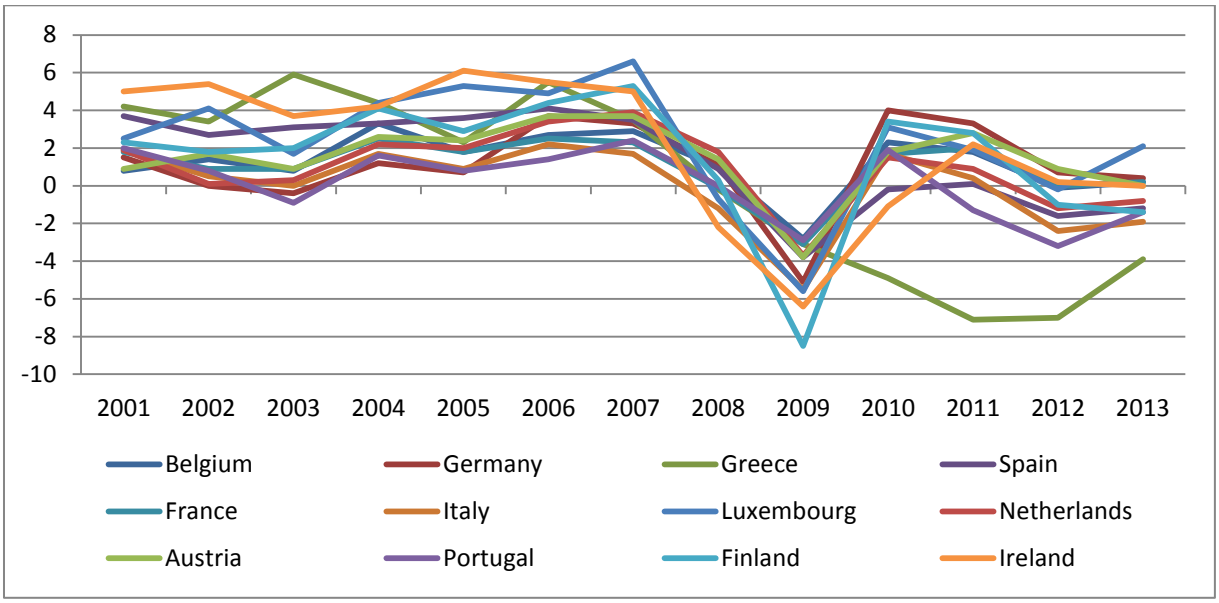
Source: Eurostat

In recent years the heterogeneity of the European Union was more and more perceived as a curse rather than a blessing. This seems to be especially true in a static economic comparison since living standards differ dramatically within the EU. This is definitely true between Eastern and Western parts but also between North-Western and South-Western countries, not least due to the recent recession. However, from a dynamic point of view economic heterogeneity offers opportunities, such as fostering convergence at a static cross comparison or at least hampering divergence.

Dynamic heterogeneity is a main driving force of insurance markets or transfer mechanisms. Without diverse development levels of possible net payers and net revenue takers, such schemes could not exist because of the lack of a financial basis. For a transnational transfer mechanism, such as social benefits or unemployment insurance, such a development could be, in an extreme case, a homogenous external shock (e.g., a deep recession) that affects all contributors or beneficiaries equally, leading to maturity for all insured countries.

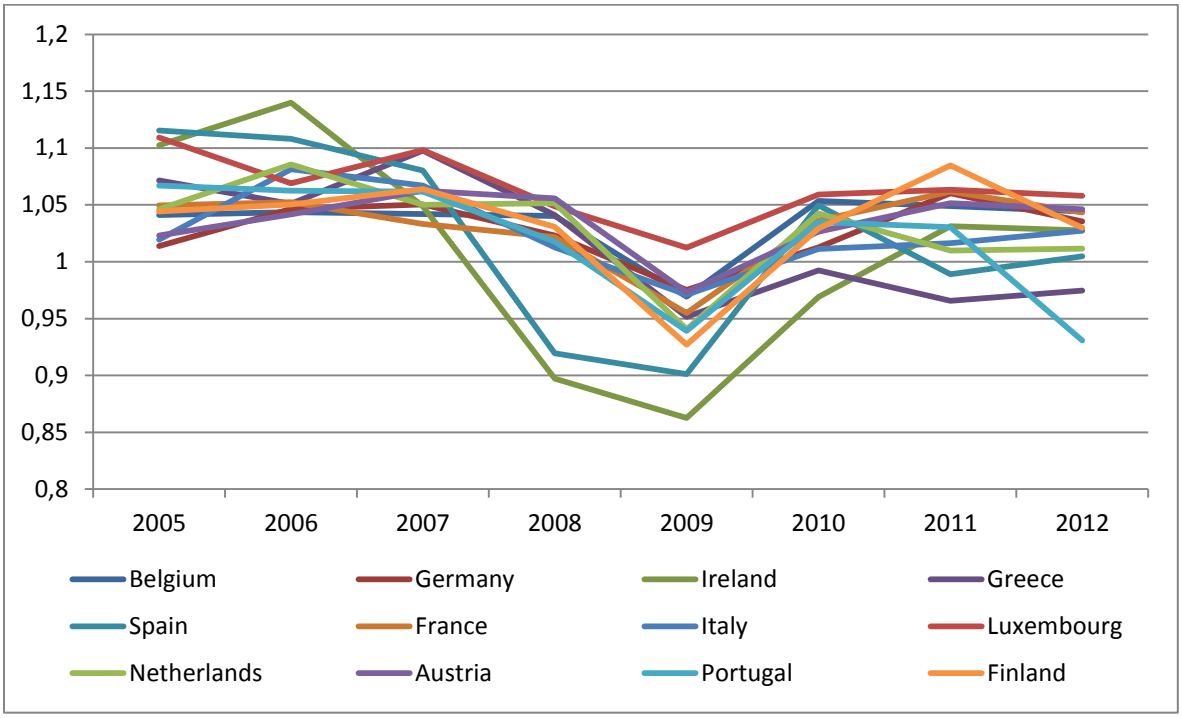
Many authors share the idea that an increase of interactions between countries will lead to a convergence of their business cycles, e.g. Clark & Wincoop (2001). This conclusion, though, is also bolstered by empirical results (Abbott & Xing 2008). In cases where every country is similarly affected, transferring taxes from one suffering country to another seems to be at least politically questionable. Especially in a situation like the one shown in Figure 3 where in 2009 every founder country of the EMU had a decreasing GDP and therefore decreasing tax and contribution income (Figure 4), except for Luxembourg. Thus it is quite useful to examine the economic convergence of EMU founder countries.

Figure 3: GDP growth rates (%) per year



Source: Eurostat

Figure 4: Tax income growth rates (%) per year

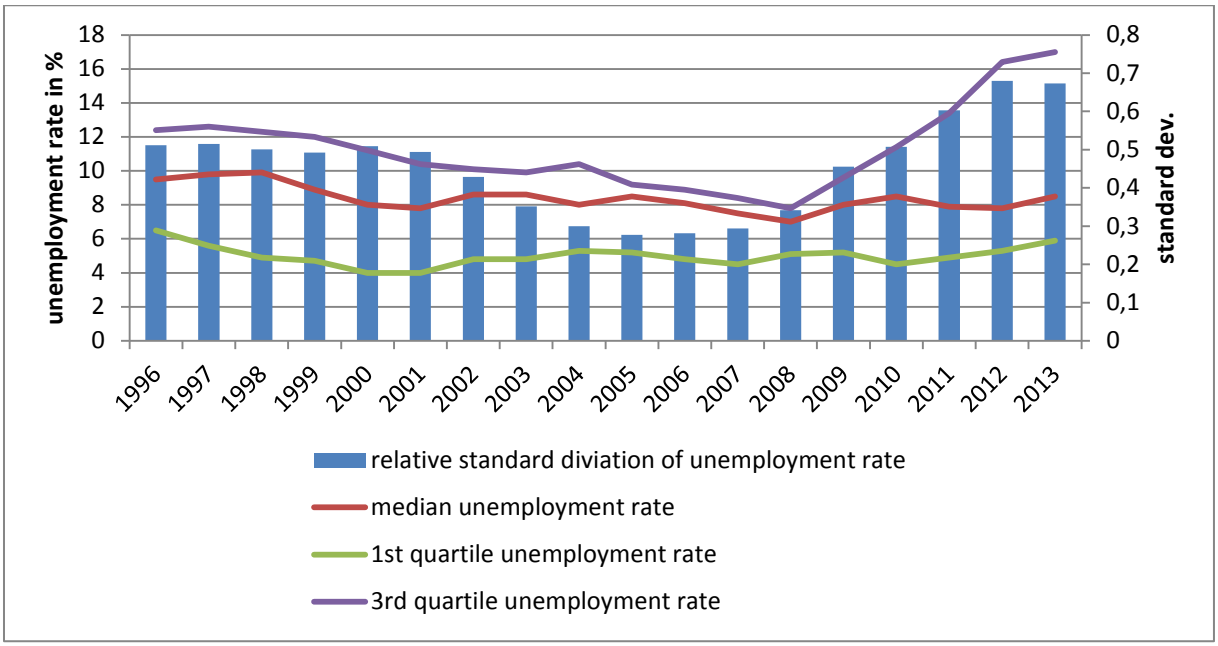


Source: Eurostat

Convergence

With regard to labor market-dependent transfer mechanisms one main variable of interest, due to its link to payoffs, is the unemployment rate. Convergence between observations can easily be estimated by the standard deviation since it is a measure of dispersion. In Figure 5 the relative standard deviation is used to estimate the dispersion of unemployment rates of EMU founder countries. The scale on the left-hand side of Figure 5 refers to the unemployment rate which is presented by the line, whereas the scale on the right-hand side refers to the standard deviation presented by the pillars. As it is time series data, meaning that observations may vary in time at a higher absolute level, it is reasonable that the extent of dispersion increases if the absolute level of observation increases, as is observed during recessions concerning unemployment rates. The relative standard deviation eliminates this issue, however, as it is divided by the mean of the observations.

Figure 5: Relative standard deviation and quartiles of unemployment rates of EMU founder countries



Source: Eurostat, own calculation

Since the beginning of the EMU, the cross country median unemployment rate has usually remained between 8% and 9%, even in the recent crisis (Figure 5). Therefore, there is at least always 50% of the founder countries who seemingly do not have the need for high amounts of transfers. The standard deviation shows that the dispersion between 1996 and 2001 of the EMU unemployment rates stayed more or less the same. However, in 2002 it started decreasing until 2005 where it reached its minimum. This seems to confirm the hypothesis that countries which share a great amount of economic activity tend to converge. However, with the beginning of the crisis unemployment dispersion started to increase, reaching the former level of the mid-1990s again in 2010 and its maximum in 2012.

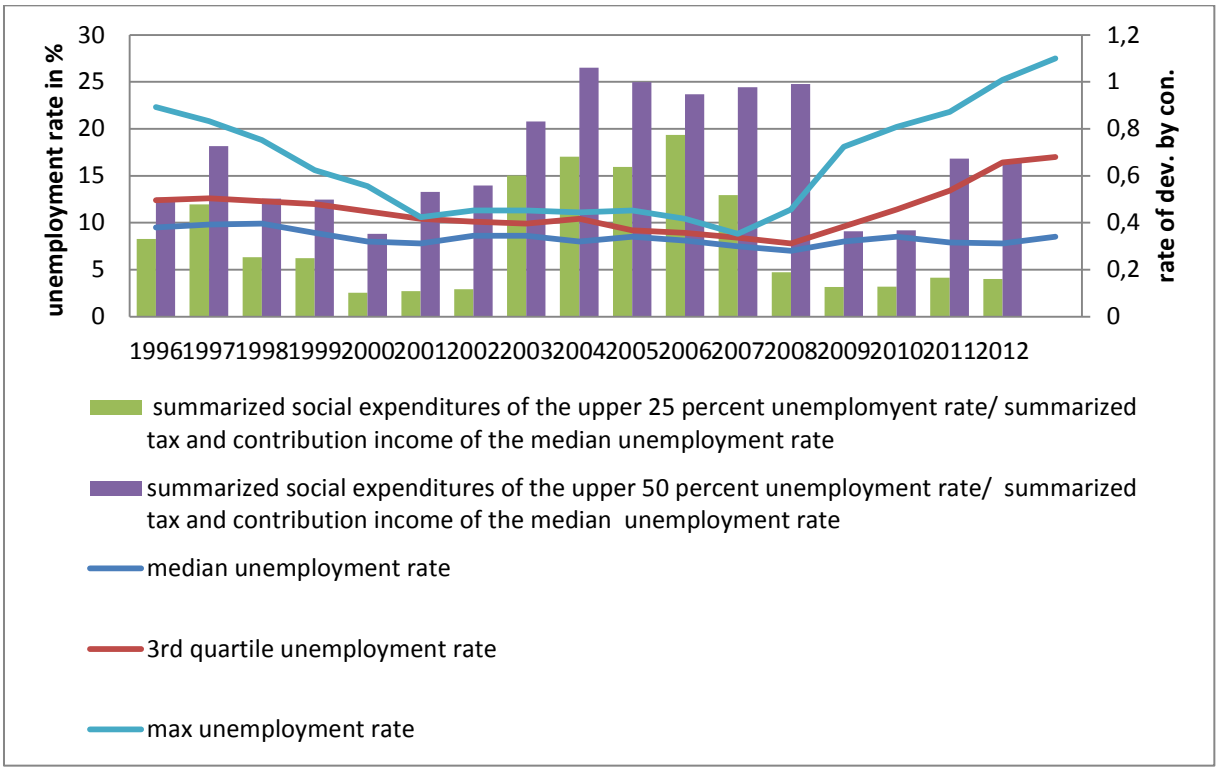
With regard to transfer mechanisms, the reason for an increase in dispersion is of particular interest. First of all, an increase in dispersion is something good in strong recessions because it indicates that not all countries suffer the same. If unemployment strongly increases and the relative standard deviation stays constant, all countries would be in need of transfers which would result in an unsustainable situation. Nevertheless, whereas the first quartile of unemployment rates between EMU founding countries has remained constantly lower than six percent, over time the third quartile has risen up to 17% in 2013. On the one hand, this means that even in crisis some countries were able to maintain relatively robust labor markets and were therefore able to transfer labor market related contributions to other countries. However, on the other side 25% of the founder countries face an unemployment level of at least 17%.

Concerning the data, the content related to the financial feasibility of any transnational transfer mechanism is limited since unemployment levels are neither weighted nor is any transfer approach taken as a basis, which is why costs cannot be calculated. This is the reason that the dispersion offers just the necessary condition for a transnational transfer mechanism but does not tell us something about the sufficient conditions. The sufficient condition depends on which countries are net takers and which countries are net givers. However, since dispersion has increased rather than decreased in the EMU during the recent crisis and the median unemployment rate has remained relatively constant between 8% and 9%, at least one main requirement of the expenditure side of a transfer mechanism is reached.

Combining unemployment rates with fiscal income and expenditures leads to a clearer picture. In Figure 6 taxes and contributions of the EMU founder countries are summarized, representing the median unemployment rate. This amount is used to divide the summarized social expenditures of those countries which represent the highest 25% or the highest 50% of the unemployment rates of the EMU. The scale on the left-hand side refers to the unemployment rate, represented by the blue and red lines. The scale on the right-hand side refers to the green and violet pillars which represent the rate of expenditure divided by contributions.

Fiscal income and expenditures are good indicators for the feasibility of a transnational transfer scheme, since transnational transfer mechanisms would substitute or complement a percentage of this amount

Figure 6: Fiscal income and expenditures and unemployment quartiles of EMU founder countries



Source: Eurostat, own calculation

Figure 6 makes clear that despite a strong increase in unemployment rates for the 25% of countries with the highest unemployment rate, the ratio of social expenditures of these countries in relation to the tax and contribution income of those countries, which represent the median unemployment rate, is at a relatively low level in the recent crisis (green pillar). Social expenditures for that quarter of countries with the highest unemployment rates represent between 13% and 17% of the tax and contribution income of those countries which represent the median unemployment rate within the recent crisis. In combination with the relatively constant median unemployment rate, there is a strong financial basis to support countries with extremely high unemployment rates. Between 2009 and 2012, social expenditures for countries in the upper 50% of unemployment rates represent between 36% and 67% of the taxes and contributions of the lower 50% of unemployment rates. In 2012, the rate of social expenditures for the upper 50% of unemployment rates as a percentage of the lower 50% was about four times the rate of the upper 25% of the social expenditures. This means that doubling the amount of countries which represent the social expenditure calculation base leads to an expenditure/contribution rate which is four times higher. Therefore, countries with very high unemployment rates would have been less of an issue for the feasibility of an EMU-wide unemployment insurance in the recent recession. The amount of countries in the third unemployment rate quartile is a much greater strain.

Between 2003 and 2007 the expenditure/contribution rates were much worse than in the recent crisis mainly due to the fact that Germany was in a bad economic situation. The imbalance between expenditures and contribution were thus much higher. However, the general level of unemployment was comparatively low, since the highest rate was about 11.3% in this period. For example, in 2004 social expenditures of the 50% countries with the highest unemployment rate, and thus between 8% and 11.3%, were higher than the tax and contributions income of the 50% of countries with the lowest unemployment rates below 8%. Unemployment rates in general were not as high within this period of time, which is why countries had the ability to manage payments on their own. If however a basic EMU-wide unemployment scheme would have existed which substitutes a percentage of the national scheme, it would have been strongly burdened even without a crisis.

Besides moral hazard issues, which are discussed below, these findings already challenge the idea of an EMU-wide unemployment scheme. The expenditures of the third quartile of

unemployment rates within the crisis and the relatively high unemployment rate of Germany in the pre-crisis period shields light on the importance of well-considered threshold values and contributions for an transnational unemployment scheme. Otherwise, the joint unemployment insurance scheme would run into trouble. Nevertheless, it could be shown that necessary conditions are fulfilled to implement an EMU-wide unemployment insurance. Thus, it is useful to have a look at a specific design in the following that tackles another major issue in case of an EMU-wide unemployment insurance, which is moral hazard.

Implementation and moral hazard

One proposal for an EMU-wide unemployment insurance is that a basic level of benefits is guaranteed.

> *"Under such a scheme, eligible unemployed in the member states would receive individual benefits from a European unemployment insurance, financed by contribution paid on the wage sum of covered workers. The level of benefits would be set at a common minimum level (relative to a country's wage level) and could be topped up by national insurance systems." (Dullien 2013)*

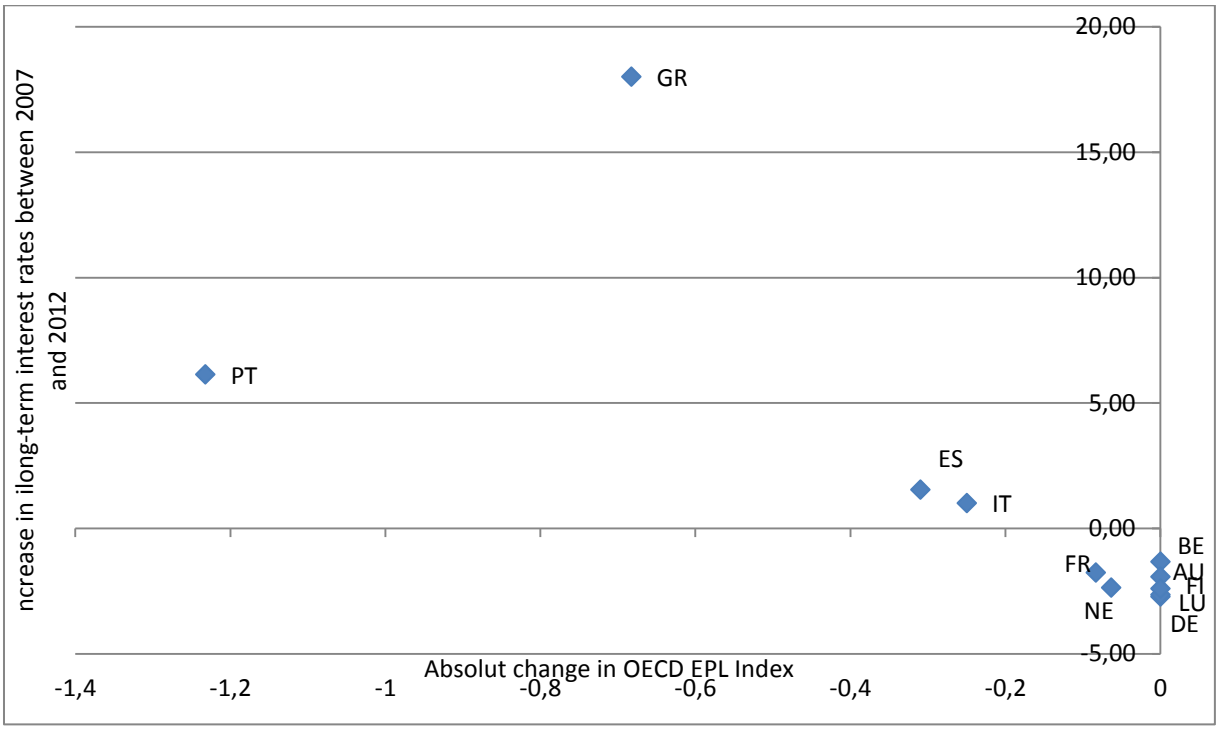
There is no reason to doubt that such a scheme would stabilize an economic downturn in a receiving country, ceteris paribus, since this process is already well documented with existing national schemes (Dolls, Fuest, Peichl 2010). This stabilizing effect is confirmed by Xavier and Sutherland (2013) who simulated the introduction of an EMU-wide unemployment insurance. If national policy makers increase the generosity of the unemployment insurance in comparison to the present amount, it is also likely that the stabilizing effect increases due to this scheme.

However, such a scheme may induce unintended incentives and thus harm economic development, which is why these incentives should be taken into account. Unintended incentives may occur for both policy makers and unemployed individuals.

An EMU-wide unemployment insurance scheme could affect cooperative behavior if unemployed individuals make a distinction between contributions of residents and non-residence. Such insider (residents) versus outsider (non-residents) behavior is evidenced by several experiments, for example (Goette, Huffman, Meier 2006). Especially due to the recent crisis and its social dislocations, it is at least questionable whether individuals make a distinction between contributors. However, whereas in experiments modes of action and payoffs are relatively clear, inducements within an unemployment insurance scheme are more complex, leading to the conclusion that insider versus outsider behavior is maybe less of an issue. In the long run it is even possible that such policies actually mitigate insider versus outsider behavior since recipients get a direct money transfer from an EMU-wide scheme and therefore perceive a direct benefit.

Since active labor market policy is rarely able to maintain its intensity in strong recessions -- due to the budget constraints of tax losses or the credit markets -- one other channel to combat the crisis on labor markets is employment protection legislation. Economic theory suggests that high employment protection increases the cost of labor due to high dismissal cost; and therefore, labor demand is consequently reduced. Figure 7 shows how the strength of labor market protection changed within the crisis, where 0 means low and 6 means high protection. A decrease in this index is therefore associated with a decrease in dismissal protection. EMU founder countries that faced decreasing interest rates like Germany, Finland, Austria, Belgium and Luxemburg did not decrease their employment protection legislation as countries in worse conditions did, such as Spain, Greece, Italy or Portugal.

Figure 7: OECD Employment protection index and Maastricht criterion interest rates

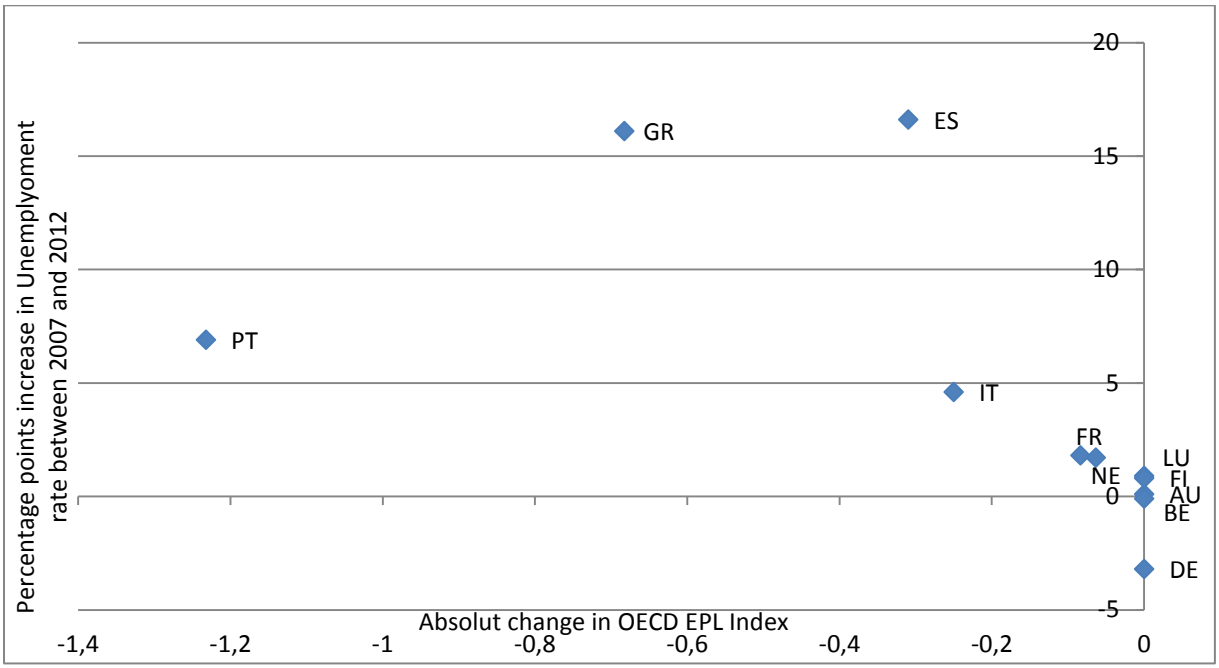


Source: Eurostat, OECD

Cuts in the employment protection legislation (EPL), quite an unpopular policy, can be expensive in political terms making policy makers reluctant to change. Economic pressure seems to be a driving force of changes in the employment protection legislation. By assuming that lower employment protection legislation is something desirable, it is arguable that budget constraints are necessary as a corrective. However, employment protection rules do have their role to play since they ensure long-range planning for employees, like family planning for example (Artazcoz at al. 2005). With this in mind, budget constraints could also lead to inefficient EPL if they are a result of a policy which only conforms to the beliefs of the credit market and competitive labor markets but does not respect the fruitful characteristics of EPL in an adequate manner.

In Figure 8 the changes in the EPL Index are plotted against the increase in the unemployment rate between 2007 and 2012. A similar picture as in Figure 7 occurs, where countries that did not face worse economic conditions -- which is this time represented by the unemployment rate -- like Germany, Belgium, Austria and Finland, did not change their EPL, whereas countries with high unemployment rates like Portugal, Greece, Spain and Portugal did.

Figure 8: OECD Employment protection index and unemployment



Source: Eurostat, OECD

It is hard to argue whether the high unemployment rates or high interest rates foster labor market reforms, not least because high unemployment leads to higher interest rates and higher interest rates lead to more unemployment when fiscal expenditures are cut. Thus it is unclear if the financial pressure of high interest rates or the political pressure of high unemployment rates is the main source of reform efforts.

A basic EMU-wide unemployment insurance would decrease financial pressure of countries which are in recession because large amounts of unemployment benefits would be paid by other countries, thus relieving national budget. Therefore, it is possible that reform efforts get hampered with possible negative effects on economic development. Besides EPL, other possible but unpopular reform options do exist (e.g., changes in the national tax and benefit system). The more unpopular the reform option, the higher economic pressure is needed to eliminate inefficient policies.

As existing proposals for a basic EMU-wide unemployment insurance suggest a (partial) substitution of short-term unemployment benefits, policy makers should be aware of the fact that transnational transfers for the short-term unemployed reduces the costs of high job turnover rates within a country. In the recent past, policy makers in Europe used forms of

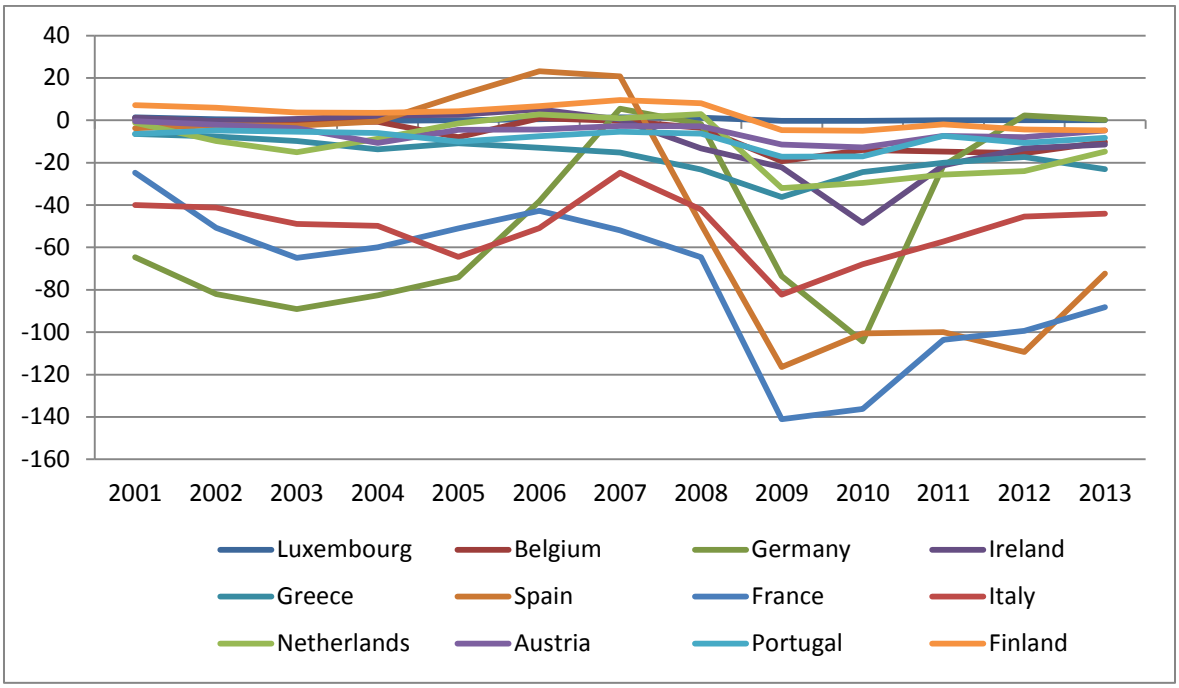
atypical employment to increase the competitiveness of their labor markets. This then lead to higher job turnover rates (Blanchard et at. 2002). A transnational basic unemployment scheme which is targeted on short-term unemployment would decrease the cost of such a policy and thus increases the probability of such acting and possible negative long run effects (Eichhorst 2014).

From a financial perspective, a transnational unemployment insurance would improve the overall situation in a country that faces higher interest rates than other member countries or even does not have access to the credit market. Otherwise, a transnational scheme does not make sense because suffering countries could borrow money directly at the credit market (or raise taxes). Therefore, they would not be borrowing indirectly via transfers from other member countries who themselves have to borrow money at the credit market because their national budget is partly financed by credits (Figure 9).

Even if differences in interest rates between countries exist a priori, the overall interest effect could be zero. Whereas receiving countries would possibly face an interest rate advantage, contributing countries would conceivably face higher interests since they need more debts to compensate their outflows, although outflows are defined as contributions in case of a basic unemployment scheme. For the total account it does not matter whether contribution or taxes pay the budgetary planning, which is why outflows to other countries have to be compensated.

As already seen (Figure 9), interest rates differ in recessions, whereas they tend to be equal in economically good times. From this perspective it is not clear why a permanent basic unemployment insurance scheme is needed.

Figure 9: Total government expenditure minus total government revenues, € billions per year



Source: Eurostat

Even if an overall interest rate advantage exists in the long term, it is quite unclear what nations would do with their saved interests. Countries might possibly decrease their tax burden for labor to enhance their competitiveness while holding the generosity of their individual benefit system constant. This would lead to a situation where contributing countries subsidize their own competitive disadvantage. Such a behavior might be useful in economic terms, as a redistribution scheme for example, but may enhance political tensions if not intended and thus not declared. Although politically still a long way off, a coordinated fiscal policy could erase the possibility of such an issue.

With regard to the mentioned issues, an EMU-wide unemployment insurance which comes into place if a strong recession hits a country is less vulnerable if its kick-in is linked to restrictive indicators, which is why it is called a kicking-in scheme. This insurance could either augment or prolong national systems, and receiving countries could pay lowered or suspend contributions to enhance the stabilizing mechanism of the national unemployment insurance to relieve the national budget. A simple substitution of national schemes is also conceivable. In the latter case, the entire amount of unemployment benefits would be

financed by other member countries, which would give receiving countries financial room to maneuver.

As already mentioned, in the case of basic unemployment insurance, constraints on credit markets are the main arguments for the introduction of an EMU-wide unemployment insurance. This is why it seems appropriate to link the payout mechanism of a kicking in scheme to a specific threshold of interest rates that a country is facing at the credit market for a certain bond, as interest rates reflect credit market constrains. To be sheltered against manipulation or moral hazards of politicians, this threshold could be related to a certain amount of newly borrowed money in relation to the national budget. In that case, manipulation or a moral hazard would generate country specific equivalent direct costs due to interest payments. To be more restrictive, interest thresholds could be linked to country specific average interest rates in the past. High interest rates would lead to a higher threshold, which is why moral hazards or manipulation would become even more costly. In fact, sheltering against moral hazards or manipulation decreases the stabilizing effect of such an insurance scheme, thus there is a trade-off between stabilizing and preventing misuse. The interest rate threshold could be combined with an unemployment rates threshold to ensure that high interest rates reflect a country's bad economic condition and not something else.

Consideration could also be given to whether a kicking-in scheme could be linked to a commitment to structural reforms. This could be done by restricting payouts conditional on the implementation of pre-determined structural reform recommendations, in addition to threshold values. The pre-determination of such recommendations is important because it ensures the overcoming of time lags and thus the main advantage of automatic stabilizers. Moreover, such country-specific recommendations already exist as part of the European Semester. Countries would have to agree that receiving transfers of a kicking-in scheme would be bounded to the implementation of their individual country-specific recommendations made by the European Commission.

In order to keep the structure of an automatic stabilizer, countries would be unable to reject these recommendations if they are in need of transfers. In other words, even before the implementation of a kicking-in scheme, countries would have to commit to unavoidable structural reforms prior to reaching the threshold level which triggers payouts. Because the

agreement would be linked to the implementation of policy recommendations which are unknown at the time of the agreement, this proposal would likely have strong negative effects on the acceptance by national policy makers. On the other hand, national policy makers could potentially pass responsibility and blame on to European policy makers in the case of such unpopular but necessary reforms. This, in contrast, could have positive effects on the proposal's acceptability.

In general, an increase in unemployment benefits could increase a population's acceptance of structural reforms if the increase is perceived as compensation for possible burdens (Duval 2008). Thus, increasing unemployment benefits through a kicking-in scheme could have positive effects on the acceptance of structural reforms.

Additionally, an increase or extension of benefits within a kick-in scheme is less susceptible to moral hazards at the individual level. This is due to the fact that individuals are more wary of being unemployed in times of recession since it is not as easy to find a new job compared to normal economic situations when moral hazards are relatively costly (Krueger & Meyer 2002).

The stabilizing effect of a kicking-in system in comparison to a basic scheme does not depend on the scheme but on national configurations. In the case of a basic scheme, increases in generosity and stabilization need an accompanying increase of national contribution, taxes or credits because the basic scheme only ensures a minimum level of benefits. Policy maker awareness concerning the positive impact of automatic stabilizers would be needed. A kicking-in scheme would start if a country is already in a strong recession. However, as in the case of a basic scheme, strong additional stabilizing effects at the beginning of a downturn could be generated if policy makers are aware of the positive impact of automatic stabilizers and thus increase the generosity of their national scheme, independent of a kicking-in system.

In times of low liquidity constraints, policy makers could increase the generosity of both schemes by taxes, contributions or credits. This is why the stabilizing effect at the beginning of a recession does not depend on the EMU-wide unemployment scheme but on national configurations. Regardless of how it is financed, somebody has to pay it: either residents via higher contributions, taxes or interest or non-residence where fiscal outflows increase the need for new debts in contributing countries and therefore interest payments. This is under

the reasonable assumption that almost every country has a deficit or at least a balanced national budget (Figure 9). Thus, liquidity constraints are the only justification of such schemes, which is why the kicking-in scheme is appropriate. If countries are constrained by the credit market, the mode of action is similar for both schemes as they both tend to take the pressure off national budgets. The great advantage of the kicking-in scheme is the prevention of moral hazards or manipulation in times without credit market constraints.

Summary

The recent crisis showed how vulnerable the European Economic and Monetary Union is if hit by an exogenous shock. An increase in fiscal cooperation is seen as a remedy for the lost capacity of exchange rate adjustments. The introduction of an EMU-wide unemployment insurance is one proposal to increase cooperation and stabilize EMU economies when hit by exogenous shocks. Existing national unemployment schemes are capable of moving in that direction to the extent that they are not overburdened.

One main requirement of insurance schemes, regardless of the insured risk, is the heterogeneity of the insured risk. If every insured risk is in need of payments, the system would collapse. Therefore, the convergence of EMU countries is of interest. It could be shown that convergence increased in times without recession but decreased within the crisis. The requirement of heterogeneous risks was therefore reached in the recent recession. However, recessions in big economies, such as Germany for example, would generate a heavy strain for an EMU-wide unemployment scheme.

One major problem for strong crisis shaken countries was the constraints at credit markets due to high interest rates. Even if economically necessary, countries were not able to increase the generosity of their automatic stabilizers since social contributions broke away and credit markets were constrained. A bolstered stabilizing effect failed to appear. The EMU unemployment insurance would get rid of such constraints since contributions would now be paid by countries in better economic condition. An EMU unemployment insurance which kicks in if a pre-determined threshold of interest rates is reached captures the main motivation of such a transnational transfer mechanism – combating the credit market

constraints. It is therefore preferable to a basic scheme, which is more susceptible to moral hazards and manipulation on a policy level. Such a kicking-in scheme should extend the entitlement period to keep consumption constant over a longer period of time and to cope with decreased probabilities of finding a job. Moral hazard behavior at the individual level, induced by extended entitlement periods, is reduced in recessions, making it is less of an issue.

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