Luiss
School of European Political Economy

Response to Covid-19: Mechanisms against unemployment

Pier Carlo Padoan

Policy Brief 20/2020

LUISS

April 16, 2020

Response to Covid-19: Mechanisms against unemployment

Pier Carlo Padoan

At the Eurogroup meeting of April 9 it was decided to introduce new tools to support the economy and/or to strengthen the existing ones to deal with the very serious emergency caused by the Covid-19 shock. These are tools created to respond to the different aspects of the crisis we are experiencing: emergency response, the recovery of growth, and the strengthening of sustainability (including health).

In recent weeks the debate on the response to the coronavirus crisis has taken on a "toxic" pitch. In Northern Europe the toxic term was "eurobonds", in southern Europe it was "ESM" (European Stability Mechanism). After the Eurogroup meeting on April 9, the debate seems to be going differently. The issues on the table include what the objectives of European economic policy must be to combat the crisis and afterwards what the instruments should be. In this context, the overall effectiveness of the toolbox) as well as the impact of the individual tools, must be assessed.

Which tools are we talking about?

1) The reactivation of the Emergency Support Instrument justified by the outbreak of COVID-19. This instrument can provide support of up to 2.7 billion euro from the Union budget. This amount can be increased by voluntary contributions from member states. This is an emergency management tool, as the term says.

2) A strengthening of the role of the EIB, which could increase its space to finance investments (including in the health sector).This is done through a pan-European guarantee fund of 25 billion euro, which could support investments of up to 200 billion euro with particular attention to SMEs and possibly with the support of national development banks.

3) The activation within the ESM of the Pandemic Crisis Support, based on the ECCL, which is a precautionary credit line, but with conditionality limited to the use of resources aimed at containing the pandemic or in any case at strengthening the health systems.

4) The Recovery Fund. The most ambitious and most controversial tool, it is designed to prepare and support the recovery after the pandemic crisis and to guarantee solidarity towards the member states most affected by the crisis. It could be financed by various instruments, including innovative instruments (eurobonds) possibly with the support, yet to be defined, of the Union budget. Also in this case, the instrument is temporary, and with adequate resources to deal with the seriousness of the crisis. According to some assessments, it would be worth over 1,000 billion euro.

5) SURE, the employment support mechanism. (Support to mitigate Unemployment Risks in an Emergency). It is an emergency and temporary mechanism, as reported in the Eurogroup statement.

"In the spirit of solidarity and in light of the exceptional nature of the COVID -19 crisis, we agree on the need to establish, for the duration of the emergency, a temporary loan-based instrument for financial assistance under Article 122 of the Treaty on the Functioning of the European Union... In this context, we welcome the Commission proposal of 2 April to set-up a temporary instrument supporting Member States to protect employment in the specific emergency circumstances of the COVID-19 crisis. It would provide financial assistance during the time of the crisis, in the form of loans granted on favourable terms from the EU to Member States, of up to EUR 100 billion in total, building on the EU budget as much as possible, while ensuring sufficient capacity for Balance of Payments support, and on guarantees provided by Member States to the EU budget."

The instrument could strengthen the protection of workers and jobs while leaving responsibility for social security to national authorities. However, support for some health system related functions is also envisaged. Therefore, SURE could also support extraordinary training and human capital support programs. These are items that are normally classified as current expenditure, but should be seen as investment expenditure to replenish human capital. Access to the tool will be interrupted once the COVID-19 emergency ceases.

Support for employment. SURE and EUBS

Let us reflect on the support mechanism for employment and compare SURE with a similar proposal put forward by the Italian government in 2015/16 (MEF 2016), conceived in a period prior to the COVID-19 crisis in the wake of the euro crisis. SURE belongs to the class of mechanisms known as the "rainy day fund". This is a fund set aside to be used in times of crisis. Different variants can be imagined: with temporary or permanent duration. As we have seen, SURE was conceived as a temporary tool. However, there are some common features with other mechanisms, including permanent ones, which are worth emphasizing in order to better understand how SURE could operate.

First of all, the motivation of such a mechanism: to have, including in normal conditions, a stabilization tool that focuses on the labor market. In a monetary union, monetary and exchange rate policy are absent and therefore the relevant shocks fall on employment (and wages). Even in the absence of major crises, the damage caused by a significant fall in employment goes beyond the short term. In fact, even in presence of cyclical or short-term events, a strong shock can produce permanent effects (hysteresis) on the affected country, and possibly on the rest of the Eurozone, with consequences ranging from the deterioration of human capital, to the reduction of participation in the labor market, to the closure of plants and businesses. In the current situation this risk is particularly high. The effects of the protracted recession, which will occur, are likely to be consolidated, thus increasing the risk that the recession will persist over time and degenerate into stagnation.

There are other positive aspects, including, the finalization of public resources, national or European, through a tool dedicated to a particular "mission". This reduces the need to use other national resources, or to resort to the Union budget.

Finally, there are more general reasons: solidarity and social sustainability; support for the weakest; support of economic integration in the Eurozone; making the value of the European institutions more evident to citizens and increase consensus for the European project.

How the EUBS Fund works

Of course, an important aspect is the Fund's operating rules. Since SURE is still being developed to get a more precise idea of how the instrument would work, it is useful to make a comparison with the proposal made by the Italian Ministry of Economy and Finance a few years ago (MEF 2016, mimeo) for a cyclical unemployment insurance system, the EUBS (European Unemployment Benefit System). This is a mechanism similar to, but not coinciding with, the SURE proposal.

First, how do countries access the Fund's resources? This aspect is linked to the risk, feared by many countries, especially in Northern Europe, of kicking off a mechanism of permanent transfer of resources from low unemployment to high unemployment countries. This is not inevitable, nor desirable. It is in fact possible to design the rules for the use of the Fund's resources in such a way that there are no net beneficiary countries or net contributors in the medium to long term. Access to the Fund can be very simple. The country can automatically access resources when cyclical unemployment exceeds a "threshold" value (which can be measured in various ways). The Fund is activated both in the event of asymmetric shocks and of symmetrical shocks. However, this also requires imposing rules for the repayment of funds to the Fund.

In the EUBS scheme, resources must be used only to support employment, taking into account the different characteristics of the national labor markets and within a maximum limit of 200% of the resources initially paid. Resources transferred from the EUBS to member countries would be managed by national labor market institutions. On average, the EUBS resources should be able to guarantee coverage of social safety nets for 6/8 months and up to 40% of the wages received. The only conditionality for accessing the resources is that these are used for labor policies, active or passive. This type of conditionality could be used to encourage harmonization of national labor policies, possibly in accordance with the recommendations of the macroeconomic imbalances procedures and more generally with structural policies, also in order to avoid hysteresis. However, the functioning of social safety nets should not be affected. In other words, the EUBS should not be used to address structural distortions or shocks, for which ad hoc tools should be used.

The access mechanism to the Fund leads to a measurement problem. In the event of a shock affecting the labor market, it is necessary to identify the unemployment share attributable to the cycle and that deriving from structural factors.

The cyclical driver of transfers by the EUBS would also provide a protection against the possibility of permanent transfers from countries with varying degrees of structural rigidity. Finally, it would also be an incentive to strengthen the structural reform effort. Moreover, as the simulations reported in the abovementioned MEF document indicate, the cyclical motivation for transfers in support to employment would mean that, in the medium term, all countries would be in a position to benefit from the transfers. There would therefore be no permanent resource transfer mechanisms.

As mentioned, the amount of transfers which a country could draw would be limited to 200% of the contribution that the country provides to the financing of the EUBS Fund. The relatively modest size of the financing space derives from the idea that the Fund should finance asymmetric shocks, that are by definition limited to one or a few countries at the time. If the EUBS were to intervene also in the event of symmetric shocks, resources would have to be increased.

The nature of the shock to be considered also influences the reference variable to calculate the deviation in unemployment. The reference value could be the time trend of employment in the country in question or the average value of employment in the group of countries. The first value would be relevant in the case of symmetric shocks, while the second would be relevant especially in the case of asymmetric shocks. The calculation of the deviation could be weighted according to the two criteria. The suggested measure for the size of the EUBS Fund was 0.5% of the euro area GDP, around 50 billion euro at 2015 values. But the value would have had to be significantly increased if EUBS had had to respond also to symmetric shocks.

The EUBS should have been financed by transfers from member states to be completed within five years on the assumption that the EUBS should only deal with asymmetric shocks. In the event of having to deal also with symmetric shocks, the Fund should have/could have issued low-return and risk-bearing bonds. It should be stressed that the issue of common bonds would not be dictated by reasons of debt mutualization but by the need to finance a common objective. Alternatively, the bonds could be issued by the European Union through the Commission with the Union's budget as guarantee. EUBS beneficiary countries should still return the amounts received after the shock ends.

Finally, it should be stressed that the creation of the EUBS does not require a change of the Treaties. The European Union can set up funds to strengthen social cohesion and can also operate outside the existing funds (Article 175, Paragraph 3, Treaty on the Functioning of the European Union). The EU would operate under ordinary legislation. The scope of the fund could be limited to Eurozone member states according to Article 136 of the TFEU. Or the establishment of the fund could be supported by the flexibility clause. In this case, the Council should vote unanimously and obtain the approval of the European Parliament.

Some simulation results

An idea of how the EUBS works can be derived from the simulations reported in MEF 2016. The simulations show that the mechanism would not produce permanent transfers from one group of countries to another because in the long run all the eurozone countries could, sooner or later, benefit from the fund's resources.

The simulations, which cover the 1999-2015 period, were carried out both in the case of asymmetric shocks and in the case of combined, symmetric and asymmetric, shocks. In both cases the Fund's disbursements are distributed relatively evenly across countries. Of course, the large countries are both the major contributing countries and the major beneficiary countries.

Finally, according to the simulations, only in 2005 and 2006 would the Fund have run a deficit and would have had to finance it through the issue of bonds of up to 2 percent of its budget.

It should be underlined that the simulations do not take into account the possible positive effects deriving from the stabilization of the GDP in member state. Such effects therefore could reduce the intensity of the shocks and the need to resort to the support of the fund.

The EUBS. Criticisms

Obviously, there are critical aspects, both technical and political. On a technical level, the difficulties of estimating cyclical variations in unemployment should be mentioned. This is a difficulty similar to the estimate of the potential output necessary to measure the output gap and that has led many to criticize the Stability and Growth Pact.

Politically, the aforementioned risk of permanent transfers is evident. There is a long-standing distinction between low and high unemployment countries and hence the different interests to introduce a tool such as the EUBS. This is a specific case of the general criticism against the policy of dealing with risk sharing without first reducing the risk, criticism that has characterized the debate on the reform of the monetary union in recent years.

There is also the risk of moral hazard. For example, it is feared that structural reforms and in particular those of the labor market will be discouraged following the introduction of the EUBS. We should recall that the mechanism does not change national welfare systems but the greater availability of resources that the EUBS Fund provides should be able to allow for greater margins of adjustment of the national systems. In the 2015 proposal, the fund operates automatically according to the unemployment intensity indicators. The resources transferred to the beneficiary country are proportional to the intensity of the shock.

EUBS and SURE compared

EUBS and SURE are two different mechanisms. In the case of the EUBS, this would be a permanent but "cyclical" mechanism, that is to say, activated when the intensity of symmetric or asymmetric shocks is not far from the size of a cyclical slowdown, even if larger than normal.

In the case of SURE, the employment shock that the mechanism should help tackle would not, by definition, be of a cyclical nature such as that to be taken into account for the activation of the EUBS. But, in terms of depth and duration, it would be a "structural" shock in the sense that it impacts on the structural foundations of the economy. To realize this, we consider that the depth of the employment shock would be commensurate with the production shock. There are plenty estimates of the size of the shock from Covid-19 and all are very worrying. The duration could be limited, in the case of a "V" recession but could also result in stagnation (i.e. an "L" fall) and the risk of unemployment becoming structural would be high. In this case, structural measures would have to be activated alongside cyclical measures. Such measures could include expenses for the formation of human capital (as well as incentives for innovation, though this would concern other tools). From this point of view, the two systems are very similar, with the main difference being that of the permanent or temporary nature of the mechanism.

A key aspect for the comparison of the two systems concerns the financing of the mechanism. In principle, the SURE Fund should be a Eurozone "budget line" within the Union budget to provide a stabilization tool. However, as we know, the proposal to include a stabilization instrument in the budget has been rejected for the moment. The instrument to support convergence and competitiveness has been privileged. In reviewing the size and structure of the budget, this aspect should be reconsidered.

In the proposal put forward by the Eurogroup, the initial funding of SURE should come from member states on a voluntary basis and should be up to €25 billion. The possibility of additional resources coming from the EU budget and/or the possibility of issuing bonds guaranteed by the initial allocation of resources remains open. The issuance of bonds would be justified by the fact that the Fund faces symmetric shocks. It is clear that this issuance should not be considered a form of debt mutualization but the shared financing of a common mission. Also from this point of view the differences between EUBS and SURE are limited.

Conclusions

The set of proposals made by the Eurogroup constitutes a significant enrichment of the toolbox to deal with COVID-19. The introduction of a tool to combat unemployment is an important step forward which fills a gap already present in the eurozone well before the Coronavirus crisis. The SURE mechanism in many aspects follows proposals that have already been advanced but is placed in a context of crisis, one of a completely exceptional scale. For this reason, the size of the resources provided for the SURE mechanism appears insufficient if considered separately from other instruments. Although significant, these resources could only finance the pressure on the labor market brought on by the crisis for a few months. To be effective, therefore, they should be supported by other instruments. In other words, the SURE mechanism must support and interact with other instruments to boost growth and employment. There is the Recovery Fund, the size of which should exceed well over 1,000 billion euro, in addition to a reinforced EIB action in financing large infrastructures. This interaction is fundamental both for the leverage effect of financial resources and for the definition of a project of sustainable growth also from a social point of view, as well as the revitalization of the internal market. In short, it is a question of connecting instruments against unemployment with the updated and European version of the Marshall Plan (De Michele, Messori 2020). As in the case of other instruments, the SURE Fund should be able to issue bonds for its financing. There would be economic prerequisites, as SURE would issue bonds to finance a very clear "mission" to counteract the pressures on the labor market produced by the crisis. There would be institutional prerequisites as the issues could be guaranteed both by the resources of the countries joining the Fund and by the Union budget. Finally, as already mentioned in the case of the EUBS, revision of the Treaty would not be required for its introduction.

References

De Michele, Messori 2020 SEP PB Marshall Plan…

Ministero dell'Economia e delle Finanze. "Un *rainy day fund europeo* contro la disoccupazione", mimeo 2016