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Journal of Public Economics 90 (2006) 2161 – 2186

JOURNAL OF PUBLIC ECONOMICS

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Europe vs America: Institutional hysteresis in a simple normative model ☆

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Received 21 March 2006; received in revised form 30 March 2006; accepted 2 May 2006
Available online 24 July 2006

Abstract

We show how the differences in US and European institutions can arise in a *normative* model. The paper focuses on the labor market and the government's decision to set unemployment benefits in response to an unemployment shock. The government balances insurance considerations with the tax burden of benefits and the possibility that they introduce adverse "incentive effects" whereby benefits increase unemployment. It is found that when an adverse shock occurs, benefits should be increased most when the adverse incentive effects of benefits are largest. Adjustment costs of changing benefits introduce hysteresis and can help explain why post-oil shock benefits remained high in Europe but not in the US. Desirable features of the model are that we obtain an asymmetry out of a symmetric environment and that the mechanism yielding hysteresis is both simple (requires the third derivative of the utility function to be non-negative) and self-correcting. Empirical evidence concerning the role of corporatism is discussed.

JEL classification: J6
Keywords: Optimal unemployment benefits; Labor market institutions; Hysteresis

1. Introduction

A distinguished tradition in economics has tried to explain the differences in economic organization across Europe and America. The different historical circumstances, ranging from

☆ We thank Fernando Alvarez for generous ideas and suggestions as well as Tim Besley, Alan Manning, Juan Pablo Nicolini, Jorn-Steffen Pischke, Julio Rotemberg and Justin Wolfers as well as seminar participants at London School of Economics, MIT (macro), Harvard (labor), UTDT, Stanford (political economy), University of Pennsylvania (economics), the Milan (2000) conference of the European/American Association of Labor Economists.
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doi:10.1016/j.jpubeco.2006.05.013

immigration to the role of the frontier, have been used to construct a variety of positive theories of economic systems. One example of this literature concerns itself with the contrasting labor market performance of the US and Europe, particularly after the oil shocks of the 1970s. In brief, unemployment rates went up in both places, but only came down in the US. Persistently high unemployment rates in Europe, or 'Eurosclerosis', during the 1980–90s combined with many governments' reluctance to undertake reforms, led observers to blame 'inflexible' labor market institutions that were not being set to raise public welfare. Instead they were often viewed as being determined by a political economy process designed to protect the interests of one group over another. A typical example of a politically influential group is the employed majority of voters. They may gain from inflexible institutions that protect their own jobs and be *unwilling* to fund investments in resources to help get an underclass of long-term unemployed back to work.[1] Although capable of explaining why reforms may be blocked, this explanation on its own also predicts that the US should have experienced similar problems to Europe. Another strand of research has instead argued that the median European voter has different preferences to their US counterpart making her particularly *willing* to help the poor and unemployed. In this view European voters have a preference for institutions designed to benefit the less fortunate. Such a pattern could originate in differences in beliefs concerning the determinants of labor market outcomes (luck versus effort), or to differences in racial distance to the average welfare recipient.[2] However why dramatic changes occurred in these institutions during and after the oil shocks in the 1970s is not clear, especially if preferences are assumed to be slow moving.

The purpose of this paper is to study the design of the welfare state in the presence of unemployment shocks from a normative perspective in which public welfare is aggregated across *all* citizens. In particular, we present a simple model where the government sets the level of taxes on employed workers to pay out benefits to the unemployed. The economic environment implies that the current rate of unemployment depends on the generosity of benefits (due to "incentive effects") and a shock. A key feature of our model is that, for some simple cases, we can evaluate the effects of an increase in the level of risk in the economy. Since unemployment benefits are supposed to provide insurance, the level of risk is a key parameter in the formulation of the problem. One key advantage of the model is that it is highly restrictive. It places welfare weights on the employed and unemployed that must be identically equal to their proportions in the population and makes strong identifying predictions: if unemployment rises, benefits should also rise provided insurance (vis-à-vis tax) effects dominate. The political economy models of, for example, Wright (1986) and Atkinson (1990) are different: they predict that benefits should always be cut whenever unemployment goes up and the government wants to keep taxes low on its supporters.[3] But we know of many historical episodes where unemployment benefits rise in response to an increase in unemployment even when there is a right-wing party in power. For example, during the Republican Nixon Administration from 1969 to

[1] See Saint-Paul's (1996) review which argues that European labour market rigidities may exist *"simply to benefit politically powerful groups and organized interests at the expense of the rest of society."*

[2] Alesina et al. (2001) document differences in beliefs and also argue that lower racial heterogeneity in Europe compared to the US (where welfare beneficiaries are disproportionately black) makes redistribution to the poor more appealing to the majority of voters. Luttmer (2001) uses General Social Survey data to show how support for benefit spending in the US is lowered by racial fragmentation.

[3] Neither of these models, however, considers the role of incentive effects (which can be thought of as the coefficient on benefits in an unemployment regression). Hassler et al. (1999) show how different initial distributions of human capital can yield multiple (politico-economic) steady-state equilibria: a (European) type with high unemployment/high insurance and an (American) type with low unemployment/low insurance. Saint-Paul (1996) presents a good review of positive models, and discusses other institutions, such as job security provisions.