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Unemployment insurance: The role of electoral systems and regional labour markets

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Abstract

Levels of insurance against unemployment vary considerably across countries. Replacement rates, the ratio relating income from unemployment to what people earned when they were employed, are higher in countries with proportional electoral systems than in countries with majoritarian systems. Also, replacement rates are positively correlated with per capita income and negatively correlated with the countries' unemployment rates. I develop an electoral competition model that replicates these stylized facts.

JEL classification: J65; D72
Keywords: Unemployment insurance; Electoral system; Electoral competition; Regional labour markets

1. Introduction

Unemployment insurance systems that provide financial support for people experiencing spells of unemployment have been identified as one of the key suspects underlying high unemployment in OECD countries. See for example Siebert (1997), Nickell (1997), Elmeskov et al. (1998), Nickell and Layard (1999) and Blanchard and Wolfers (2000). In the policy debate, it seems to have been forgotten that labour market institutions were

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created in order to protect workers and households from the risk of unemployment.[1] This is a risk for which markets do not provide adequate insurance, possibly, but not only, for reasons of adverse selection.[2]

This causality running from market conditions to the creation of labour market institutions is explored in this paper. In particular, we are interested in how the interdependence of regional labour markets and countries' electoral systems shape unemployment insurance.

In order to analyze the issue, I set up an electoral competition model in which two office-motivated parties that do not exactly know voters' preferences make proposals for unemployment compensation schemes. I compare the policy choices that emerge from majoritarian and proportional electoral systems and analyze the relationship between replacement rates and employment and income per capita, respectively. The model can replicate all three types of relations that we find in the data: countries with proportional electoral systems have higher replacement rates than countries with a majoritarian electoral system, replacement rates are negatively correlated with countries' unemployment rates, and positively correlated with income per capita.

Contrary to the strand of literature that assumes labour market institutions as exogenous, reverse causality in the sense that unemployment benefit systems are a function of unemployment, or agents foreseeing the likelihood of unemployment spells, has rarely been discussed. However, evidence points in the direction of causation that I explore, namely, that unemployment insurance systems are a response to labour market conditions. Baicker et al. (1998) report on the U.S. unemployment compensation system, describing its origins and development from the mid 1930s. They present evidence that a greater degree of seasonality in the states' manufacturing employment shares in the two decades from 1909 onwards is related to higher unemployment insurance benefits in the years 1949 to 1969. Agell (2002) searches for explanatory variables for the cross-country variance in labour market institutions, finding some support for endogenous institutions.

The political economy of unemployment insurance systems has been studied by Wright (1986), Saint-Paul (1996), DiTella and MacCulloch (2002) and Hassler et al. (2002), among others. Common to all these papers is a median voter mechanism, which is thought to capture a richer political sphere in which policies are made. One purpose of this paper is to propose a model that adds more structure to the policymaking process, following the claims by Myerson (1995) and recent evidence on the role of the political system on the size and scope of governments (Persson and Tabellini, 1999; Persson, 2002).

Although the evidence on labour market institutions being the product of market conditions cannot be neglected, we do not want to rule out the consequence that institutions, once in place, may result in malperforming markets. We are interested in why these institutions were created in the first place, and especially in the reasons for the variation across countries.

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[1] Exceptions are Agell (1999), who proposes that deregulating the labour market will not necessarily solve the unemployment problem because of social norms that are independent from legal constraints, and Freeman (1998).

[2] See Hillman (2003, chapter 5).