Cyclical and Cross-Sectional Unemployment

If the job finding rate falls:

- Workers become less choosy: the reservation wage falls.
- Direct effect: fewer unemployed workers find jobs.
- Direct effect dominates, so unemployment rate rises and unemployment spells get longer.
- This seems to characterize the recent recessions.

If unemployment benefits increase:

- Workers become more choosy: the reservation wage increases.
- No direct effect on separations or job finding rates.
- Unemployment rate rises and spells get longer.
- This seems to characterize differences between US and Europe.

Comparing the US and Europe

The following are facts about unemployment outcomes in the two continents:

- In the 1950s and 1960s, unemployment rates were persistently lower in Europe than in the U.S. The difference was accounted for by a higher inflow rate into unemployment in the U.S.
- After the 1970s, unemployment became persistently higher in Europe
- Inflow rates into unemployment were roughly constant across periods within both Europe and U.S.
- In Europe, average durations of unemployment were low in the 1950s and 1960s, but became high after the 1970s. Average duration in the U.S. stayed low.
- In Europe, since the 1970s, hazard rates of leaving unemployment fall with increases in the duration of unemployment.

Comparing the US and Europe

There were two key differences in labor market policies:

- In both periods, government supplied unemployment insurance were generous with long durations in Europe, but they were stingy with short durations in the U.S. - US: unemployment insurance ends after 26 weeks. Extended to 39 weeks by federal government during recessions. Replacement rate capped at 40% (in Wisconsin) - France: The duration of benefit payments depends on job and age. The minimum period is 122 days. Maximum period is 730 days for private-sector employees under 50, and 1,095 days for employees over 50. Minimum replacement rate: 57.4 %
- ② Government mandated employment protection (rules and regulations for firing and layoffs, firing taxes) was stronger in Europe throughout both periods.

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Labor market turbulence increased after the 1970s:

- Displaced workers studies document substantial human capital destruction after involuntary job loss (Jacobson et al. (1993), Farber (1997, 2005)).
- ② There is evidence of increased volatility of earnings (Gottschalk and Moffitt (1994), Katz and Autor (1999)).
- There has been an increase in occupational and industry mobility (Kambourov and Manovskii (2005)).

We can use a search model of the labor market to analyze the differences between the US and Europe. The relevant facts (for recent years) are:

- **()** The job finding rate p is higher in the US
- **2** The separation rate s from jobs is higher in the US
- **③** Unemployment benefits b are higher in Europe
- There is more wage dispersion (more spread in the distribution of wages) in the US.

What will be the impact of these four facts (separately) on his reservation wage (relative to an American in the same situation)?

- A lower job finding rate in Europe will *reduce*,
- ② A lower separation rate in Europe will *raise*,
- **③** Higher unemployment benefits in Europe will *raise*,
- **4** A lower wage dispersion in Europe will *lower*

the reservation wage of European workers (relative to their US counterparts).

What will be the impact of these four facts (separately) on the steady state unemployment rate in Europe (relative to the US)?

- A lower job finding rate in Europe will *raise*,
- 2 A lower separation rate in Europe will *reduce*,
- Higher unemployment benefits in Europe will *raise*,
- **4** A lower wage dispersion in Europe will *reduce*
- the European unemployment rate (relative to the US).