

REFORM SUPPORT IN TIMES OF CRISIS: THE ROLE OF FAMILY TIES*

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Abstract

We argue that an important determinant of voters' support for economic reform is the strength of family ties. While the 'crisis hypothesis' predicts that crises facilitate reform, we show in a political economy model that this relation can break down, and even reverse, when agents take into account the effect of reform on their family members. Applied to southern European countries with strong family ties, the model rationalizes why the extremely high (youth) unemployment following the Great Recession has not led to more substantial labor market reforms. In such countries austerity might block rather than foster additional structural reforms. (*JEL* D64, D72, J48)

Keywords: Altruism, crisis hypothesis, family ties, insider-outsider theory, labor market reform, political economy, youth unemployment

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I INTRODUCTION

The Great Recession and the subsequent sovereign debt crisis have triggered the most severe economic downturn in several southern European countries since World War II. Unemployment, especially among the young, reached extremely high levels in the ‘crisis countries’.¹ While southern European labor markets are traditionally characterized by high youth unemployment rates, the Spanish rate of 56 percent in 2013 was nevertheless unprecedented. The data for Italy and Portugal are staggering too, reaching rates around 40 percent. These statistics illustrate severe structural problems which had been attenuated during the boom of the early 2000s. Despite revealing these problems, the crisis has not led to substantial liberalizing reforms in these countries. The Heritage Foundation’s Index of Economic Freedom shows a stagnation in ‘labor freedom’ in the crisis countries during the period 2007–2014.² This lack of reform is puzzling as a sizable body of research in political economics argues that crises should facilitate economic reform. The alleged inverse relation between the state of an economy and a society’s willingness to reform has been coined the ‘crisis hypothesis’ (see, among others, Drazen and Easterly, 2001). Rodrik (1996) even claims a tautological relation between crisis and reform: ‘[T]hat policy reform should follow crisis [...] is no more surprising than smoke following fire.’ The limited reform effort in the crisis countries is at odds with the prediction of the crisis hypothesis. To paraphrase Rodrik (1996), there is fire, but where is the smoke?

In this paper, we describe a mechanism that rationalizes this lack of comprehensive

¹In the following, when we refer to ‘crisis countries’, we think of Italy, Portugal, and Spain. We consider the case of Greece as too specific, in particular due to the continuous macroeconomic surveillance by the EU and the IMF and the sovereign default in March 2012.

²This index is a widely used measure of economic freedom (for example in Gassebner et al., 2011). See Section II and Online Appendix C for a detailed description of the index and the other data sources that we refer to in this section.

reform. We argue that an important determinant of a society's willingness to reform has been neglected in the literature: family ties, specifically altruistic links between parents and their working-age children. These links are particularly strong in southern Europe, a fact that has long been highlighted in sociological research (see, for example, Reher, 1998) and is confirmed by the results of the 'World Values Survey' (see, for instance, Alesina and Giuliano, 2011). In a political economy model, we show that family ties and the resulting intra-family transfers can affect voting behavior in a way that makes resistance to reform particularly strong in times of crisis. To provide a concrete illustration of the mechanism that relates intra-family altruism and voting behavior, we consider a labor market reform within an insider-outsider framework. We think of reforms as measures that cut back employment protection, for instance a reduction of severance pay requirements. On the one hand, such reforms lead to lower wages and/or higher risk of job loss for established insiders. On the other hand, reform incentivizes firms to hire workers, thereby increasing overall employment. The strong distinction between one insider and one outsider group is for illustration purposes only. In line with the literature (Lindbeck and Snower, 2002, Bentolila et al., 2012) we think of outsiders as those who do not have access to protected jobs with above-equilibrium wages. This group includes the unemployed, the underemployed, the fully employed on temporary contracts as well as low-wage earners.

As a first step, we develop a benchmark scenario without altruism: the individualistic case. In this scenario all outsiders are in favor of reform whereas all insiders oppose it and thus the rationale of the crisis hypothesis applies: if the economic situation deteriorates, the share of outsiders rises and so does support for reform. Next, we extend the model by introducing intra-family altruism. We first assume that agents value their family members' well-being as strongly as their own: the completely altruistic case. In this scenario it can occur that outsiders who would prefer reform

in the absence of altruism now vote against it as they take into account the effect of reform on their family members. Consider a ‘mixed family’ that consists of one insider and one outsider. Reform jeopardizes the insider’s income but improves the job perspectives of the outsider who could become an insider in case of reform. We show that, depending on the degree of altruism, the family member who is an outsider votes in favor of reform only if the improvement in employment perspectives is sufficiently good. If the outlook is not good enough, the outsider also prefers to preserve the status quo which ensures one high and secure insider income that can be shared between family members via transfers. If, however, the chances for the outsider family member to obtain an insider job through reform are relatively good, the insider family member might even support reform. Thus, strong family ties do not necessarily reduce support for reform, yet they substantially alter the relation between economic circumstances and support for reform.

This is our key insight: the implication of the crisis hypothesis might be reversed in the presence of intra-family altruism — in times of crisis opposition to the implementation of reform is strong whereas good economic circumstances might even encourage reform. This is the case even though we model the net social benefit of reform to be higher in times of crisis than in better times. In addition, we show that the crisis hypothesis still fails when family ties are weaker than in the completely altruistic case.

Whereas the preceding findings are derived under risk neutrality we introduce risk-aversion in a next step and show that it further strengthens opposition to reform. Moreover, risk aversion allows us to analyze the role of wealth as a further source of intra-family transfers. In fact, median net wealth in the crisis countries is much higher than in many other euro area countries (see ECB, 2013). In our model with family ties, the effect of wealth on mixed families’ support for reform is ambiguous. On the one hand, wealth provides some insurance against reduced family income.

On the other hand, however, wealthy mixed families are less in need of generating additional income from a second insider job and are thus more reluctant to support reform. The effect leading to reform fatigue dominates at high levels of wealth. Moreover, an unequal distribution of wealth can further strengthen resistance to reform.

This paper is mainly related to work on the political economy of reform and to the literature on the economic effects of family ties.³ In their seminal contributions, Alesina and Drazen (1991) and Fernandez and Rodrik (1991) explain delays in and non-adoption of beneficial reforms as the consequence of distributional conflict between competing interest groups.⁴ The growing interest in the economics of family ties mainly stems from the seminal contributions of Alesina and Giuliano (2010, 2011, 2014) who empirically investigate the impact of family ties on economic outcomes. They find that strong family ties tend to create various inefficiencies in the economy.⁵ Several papers explore the link between family ties and the regulation of labor markets. Alesina et al. (2015) rationalize the observed correlation between the intensity of family ties and employment protection by arguing that agents in societies with strong family ties are less mobile and therefore choose more regulated labor markets to avoid exploitation by monopsonic firms. Fogli (2004) argues that in an economy with credit constrained young agents, these choose to live at home longer in order to smooth consumption. Since consumption inside the household has a public good

³See Sturzenegger and Tommasi (1998) for an essay collection of the most relevant papers on the political economy of reform and Rodrik (1996) for a review of the literature. Alesina and Giuliano (2014) survey recent work on the impact of family ties on economic outcomes.

⁴Also see Drazen and Easterly (2001), Pitlik and Wirth (2003), Alesina et al. (2006) and Agnello et al. (2015) for empirical papers in the field.

⁵Daniele and Geys (2016) question whether family ties generally have a negative effect on economic outcomes and show that this relation only holds for advanced economies. Ljunge (2015) provides evidence that stronger family ties are associated with stronger civic virtues that might in turn lead to better functioning institutions and improved economic outcomes.

component, labor market regulation that increases the income of the old generation can be welfare improving and these potential gains are larger in countries characterized by a larger family size. Neugart (2008) analyzes how the size of intra-household transfers affects preferences for employment protection legislation of those voters who are out-of-the labor force but have an employed spouse. He finds that in countries where this voter group is relatively large, labor regulation is comparatively strict. These papers differ from our work in one crucial aspect. They analyze the relation between family ties and the level of labor market regulation, independent of a country's state of the economy. We, however, focus on the question how the interaction of intra-family altruism and the economic situation affects support for changes in labor market regulation. Reher (1998) emphasizes the divide between central/northern Europe and the Mediterranean region regarding the intensity of family ties. Bentolila and Ichino (2008) build on this finding to show that intra-family transfers work as unemployment insurance in southern Europe whereas northern European countries rely on state provided insurance systems.

While our paper is mainly a contribution to the political economy of reform, it is also related to labor economics as it builds on insider-outsider theory (Lindbeck and Snower, 1984, 1986, 2002). Bentolila et al. (2012) provide a detailed analysis of labor market dualism in Spain which is the real-world labor market that motivates our model. Di Cintio and Grassi (2015) show in an efficiency wage framework where market dualism arises endogenously that hiring and firing restrictions increase the use of flexible contracts and raise the wage differential. Grüner (2013) analyzes the sustainability of structural reforms in Spain and Italy within a political economy framework and highlights the politically pivotal role of insider employees. Finally, our paper is related to the literature that tries to explain cross-country differences in employment protection. Saint-Paul (2002) and Brügemann (2012) analyze models in which employment protection creates its own support. These models give rise

to multiple equilibria and can thus rationalize the cross country differences in labor market policies.

The paper is organized as follows. Section II provides the empirical observations that motivate our work. The model setup is developed in Section III. We then derive the effect of altruism on reform support in Section IV and analyze the impact of wealth in Section V. In Section VI, we discuss policy implications. Section VII concludes. Online Appendix A provides a detailed sensitivity analysis and discussion of assumptions, while Online Appendix B and C report details about mathematical derivations and data sources, respectively.

II MOTIVATING EVIDENCE

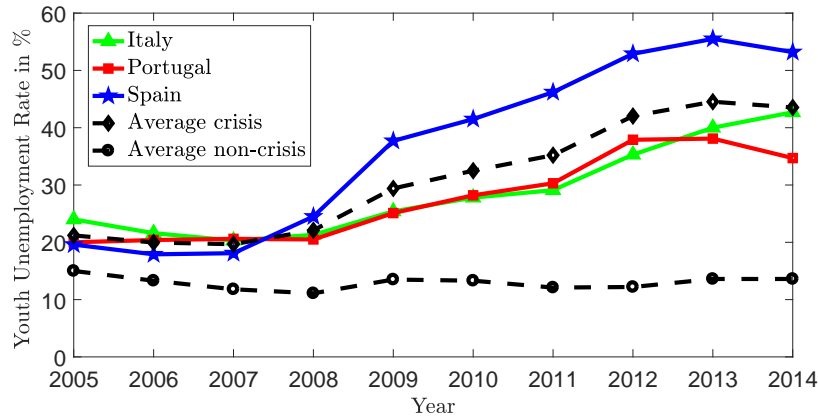
This section presents the empirical evidence that motivates our paper. We first describe the employment situation in the crisis countries since 2005 and then present data showing that efforts to reform have been weak. Finally, we provide evidence from the World Values Survey confirming that family ties in the affected countries are strong.

The severe impact of the economic downturn since 2008 is most evident in labor market data, especially for the age cohort 15–24. As shown in Figure 1, youth unemployment has increased dramatically reaching rates around 40 percent in Italy and Portugal and a staggering 56 percent in Spain, whereas it remained almost stable in other euro area countries. The overall unemployment rates are critical, too. The figures for 2014 are 12.7 percent, 14.1 percent, and 24.5 percent in Italy, Portugal, and Spain, respectively.⁶ Besides this substantial rise in unemployment, also the other outsider groups have significantly grown during the crisis. In Spain, for instance,

⁶Data are taken from Eurostat: <http://ec.europa.eu/eurostat>; accessed on 30 May 2015.

FIGURE 1

Youth unemployment in crisis countries 2005–2014



Note: The lines ‘Average crisis’ and ‘Average non-crisis’ depict average youth unemployment rates of the crisis countries and of selected non-crisis countries (Finland, Germany and the Netherlands), respectively.

Source: Eurostat.

the share of involuntary part-time work in total employment rose from 4.3 percent in 2008 to 10.3 percent in 2014. The incidence of discouraged workers increased from 1.0 percent in 2008 to 2.2 percent in 2013. Moreover, the share of temporary employment rose among the youngest cohort (15-24 years) from 59.2 percent in 2008 to 69.1 percent in 2014. Similar developments can be observed in Italy and Portugal.⁷ According to the crisis hypothesis, these dramatic figures should have triggered comprehensive policy changes. However, reform efforts have been rather limited. This lack of reform is reflected in the Heritage Foundation’s Index of Labor Freedom for the crisis countries. The index is mainly based on World Bank data and measures

⁷Data are taken from the OECD: <https://stats.oecd.org>; accessed on 5 November 2015.

labor market flexibility by considering various aspects of a country's legal and regulatory framework. It is measured on a scale between 0 and 100 where higher values indicate more flexibility (for a detailed description of the index see Online Appendix C). To measure the change of labor market regulation over the crisis years, we compare the index values for the pre-crisis year 2007 with the data for 2014 (see Table 1). Contrary to the prediction of the crisis hypothesis, values for Portugal have remained almost unaffected over this period while the index value for Italy has decreased, implying an even stronger regulation of labor markets. The Spanish index value has slightly increased during the crisis, but Spain's relative position within the comprehensive set of countries captured by the index has decreased from rank 115 in 2007 to 127 in 2014. Moreover, in a detailed evaluation of Spanish labor market policy during the crisis, Bentolila et al. (2012) argue that 'the extraordinary rise in unemployment in Spain since 2007 was insufficient to trigger labor market reform.' Overall, the sharp increase in youth unemployment in the crisis countries has not led to substantial labor market reforms.

Why have these extremely high rates of youth unemployment not induced more pressure to reform? Do these countries have a common characteristic which makes the crisis hypothesis fail? Interestingly, one cultural attribute shared by southern European countries is strong family ties. The important role of the family in these countries has long been highlighted in the sociological literature (see Reher, 1998). Alesina and Giuliano (2011) develop a quantitative measure of family ties based on data from the World Values Survey. The crisis countries are all characterized by strong family ties, especially compared to northern European countries (see Table 1 for an overview of the index values and Online Appendix C for a detailed description of the World Values Survey and the composition of the index).

Recent work suggests that family ties indeed have a significant impact on politico-economic outcomes, for instance on political participation and economic growth

TABLE 1

Family ties and labor market freedom in selected euro area countries

	Family ties	Labor market freedom (in 2007 and 2014)
Crisis countries:		
Italy	0.2	75; 55
Portugal	0.0	43; 43
Spain	0.1	50; 53
Non-crisis countries:		
Finland	-0.6	46; 55
Germany	-0.7	46; 51
Netherlands	-0.8	66; 66

Note: Strength of family ties is measured on a scale from -1 (weak) to 1 (strong); labor market freedom is measured on a scale from 0 (strongly regulated) to 100 (mostly free).

Source: Alesina and Giuliano (2011) for family ties and Heritage Foundation (2015) for labor market freedom.

(Alesina and Giuliano, 2011, 2014). Moreover, and closely related to our work, Bentolila and Ichino (2008) show that financial transfers within families are more frequent in countries with strong family ties, especially when a household is hit by unemployment. Hence, the role of the family as a mechanism for insuring against unemployment appears to be particularly important in southern European countries. Moreover, higher indirect transfers are also a result of family ties. A survey by the ‘European Foundation for the Improvement of Living and Working Conditions’ (Eu-

rofound, 2014) shows that, as a response to the poor employment situation, in 2011 more young people lived with their parents than did in 2007, with a more pronounced increase of co-residence in countries with strong family ties.

This evidence suggests that family ties and the resulting transfers might play a role in determining support for reform. In the next section, we set up a simple political economy model that investigates how family ties affect public support for deregulatory labor market reforms in times of economic crisis. The model implies that in the presence of strong family ties the median voter might not be in favor of reforming a status quo characterized by strict labor market regulation and very high (youth) unemployment — as witnessed in the crisis countries in the years 2010 to 2014.

III THE MODEL

The economy is populated by a unit measure of agents who differ in their state of employment: they are either insiders (i) or outsiders (o). Agents form families. A family is composed of two agents who are linked via altruism. Hence, an agent can be represented by a pair (j, \tilde{j}) where $j \in \{i, o\}$ refers to the agent's state of employment and $\tilde{j} \in \{i, o\}$ to that of the other family member. This yields three family types: insider families, outsider families, and mixed families. We denote the fraction of insiders in the population by η and assume that the employment states of two members of the same family are independent. We discuss this assumption in Online Appendix A.5.

Preferences

The preferences of agents are represented by the following utility function:

$$u(c_{j,\tilde{j}}) - 1_{\{j=i\}}d + \alpha \left(u(c_{\tilde{j},j}) - 1_{\{\tilde{j}=i\}}d \right),$$

where (j, \tilde{j}) represents the agent's type, $c_{j, \tilde{j}}$ his consumption and $c_{\tilde{j}, j}$ denotes the other family member's consumption. Parameter α measures an agent's altruistic link to his or her family member, where $0 \leq \alpha \leq 1$. Moreover, $u(c_{j, \tilde{j}})$ is of the constant relative risk aversion (CRRA) type with risk-aversion parameter γ :

$$u(c_{j, \tilde{j}}) = (c_{j, \tilde{j}}^{1-\gamma}) / (1 - \gamma).$$

We assume that being an insider is associated with effort that causes disutility d . As we normalize the disutility of being an outsider to zero, the parameter d effectively reflects the difference in effort between insiders and outsiders.⁸ For the main part of our analysis we do not need to assume a lower bound on d .⁹ In contrast, note that we have to impose an upper bound \bar{d} on d to ensure that agents always prefer to be insiders rather than outsiders.

Each agent's budget constraint comprises the following elements. Insiders earn e_i , which is normalized to one: $e_i = 1$. Outsiders receive e_o satisfying $0 < e_o < e_i$. Besides income, agents can also finance consumption through wealth w . To simplify the analysis, we assume that there is no heterogeneity among agents with respect to wealth. Agents can transfer resources to their family member where $t_{j, \tilde{j}}$ represents the net transfer agent j receives from his or her family member. These three income sources are disposable to the agents, so the budget constraint of agent (j, \tilde{j}) reads

$$e_j + w + t_{j, \tilde{j}} = c_{j, \tilde{j}}.$$

⁸To simplify the analysis, we assume a 'representative' outsider with constant e_o and $d = 0$. In reality, income and work effort are not constant among outsiders since these comprise a heterogeneous group of agents composed of the unemployed, the underemployed and workers in the low-wage sector. The working outsiders dispose of higher income than the unemployed but have less leisure and vice versa. Still, on average, insiders are likely to work more and enjoy less leisure than outsiders which speaks in favor of assuming $d > 0$.

⁹Assuming $d < 0$ could be interpreted as an additional utility gap (beyond the wage gap) between insiders and outsiders arising from, for example, social stigma.

Labor market and reform

The effects of deregulating labor market reforms have been extensively studied (see, among others, Blanchard and Giavazzi, 2003, Saint-Paul, 1993, 1995, 2004, Bentolila et al., 2012 and Aguirregabiria and Alonso-Borrego, 2014). A prime example of such a reform is a reduction of employment protection, for instance, a lowering of firing costs. Such a reform makes hirings more attractive for two reasons: First, via the direct channel of lowering the expected cost of future firings. Second, via the indirect effect of reducing workers' bargaining power and thereby putting downward pressure on wages. Thus, the reform tends to increase employment, yet at the cost of lower wages and/or greater risk of job loss for the established insiders. This nexus leads to a conflict between insiders and outsiders over reform: improved access to the labor market for outsiders comes at the price of reduced wages and/or lower job security for insiders.

To focus on the interaction of altruism and voting behavior, we do not model the labor market explicitly but rather take the above mentioned effects of labor market reform as given. We denote the share of insiders before voting on reform by the parameter η and the change in the insider share following reform by $\Delta\eta > 0$. The change of insider wages through reform is given by $\Delta e_i \leq 0$, where $e_o \leq e_i + \Delta e_i$ ensures that insider wages are never below outsider wages. Labor market flexibility is represented by the parameter f , with $0 \leq f \leq 1$, that captures the likelihood of job turnover in the absence of reform. At the extremes, agents either remain in their state of employment for sure in case of a completely rigid labor market ($f = 0$). Or, for $f = 1$, the probability of becoming an insider in the next period is independent of an agent's employment status ex ante. In general terms, the probability of remaining an insider if reform is not implemented is $p_i^n = 1 - f(1 - \eta)$. As a consequence, the probability for an outsider to become an insider in the absence of reform is now given by $p_o^n = f\eta$ — as the two probabilities have to satisfy $p_i^n\eta + p_o^n(1 - \eta) = \eta$. Here,

and in the following, the probability of becoming an insider is denoted by p , where the subscript indicates the agent's employment status ex ante and the superscript denotes whether reform is implemented (r) or the status quo is preserved (n).

The change of labor market flexibility through reform is captured by the parameter Δf , where $0 \leq \Delta f \leq 1 - f$. If $\Delta f = 0$, reform has no impact on labor turnover. Conversely, $\Delta f = 1 - f$ implies that all agents have the same probability of becoming an insider ex post irrespective of their employment status ex ante. In general, if reform is implemented, the probability of remaining an insider is $p_i^r = 1 - (f + \Delta f)(1 - (\eta + \Delta\eta))$. The probability of an outsider to become an insider is given by $p_o^r = ((f + \Delta f)(1 - \eta - \Delta\eta)\eta + \Delta\eta)/(1 - \eta)$. Formally, the implementation of reform has the following effects. First, the labor market becomes more flexible ($\Delta f \geq 0$), insider wages decrease ($\Delta e_i \leq 0$) and the insider share in the economy increases ($\Delta\eta > 0$). The share of insiders after reform hence becomes $\eta + \Delta\eta$. The reduction of insider wages and a higher risk of job loss are the sources of the insiders' opposition to reform.

In the following, we only focus on the effect of a decreased insider wage ($\Delta e_i < 0$) and assume that job security remains unaffected ($\Delta f = 0$). In Online Appendix A we consider several cases with $\Delta f > 0$ (some with $\Delta e_i < 0$ and others with $\Delta e_i = 0$). For all these parameterizations, we obtain the same qualitative results as in our baseline scenario where reform only reduces insider wages but does not decrease job security for insiders. Thus, focusing on only one of these effects simplifies the analysis without affecting the qualitative results of the analysis.

To focus on the role of family ties, we make a further strong assumption: We set $f = 0$, that is agents remain in their state of employment for sure in the absence of reform. In combination with $\Delta f = 0$, we obtain $f + \Delta f = 0$, which implies that all insiders keep their jobs for sure after reform ($p_i^r = 1$). The additional insider jobs generated by the reform are distributed among the former outsiders

which implies that the probability for an outsider to become an insider after reform is $p_o^r = \Delta\eta/(1-\eta)$. In Online Appendix A.1-A.4, we show in a comprehensive sensitivity analysis that relaxing these strong assumptions made on the labor market characteristics does not change our results qualitatively. Table 2 summarizes all parameters of the model. We have to set the above mentioned upper bound $\bar{d} = u(e_i + \Delta e_i + w) - u(e_o + w)$ to ensure that, in the absence of altruism ($\alpha = 0$, and thus $t_{j,\tilde{j}} = 0$), agents always (also after reform) prefer to be insiders rather than outsiders, which requires $u(e_i + \Delta e_i + w) - d > u(e_o + w)$.

Voting on reform

Agents are in favor of reform whenever the expected utility of reform exceeds the utility in the absence of reform:

$$\begin{aligned}
U_{(j,\tilde{j})}^r &= (1 - p_j^r)(1 - p_{\tilde{j}}^r)(1 + \alpha)u(c_{o,o}) + (1 - p_j^r)p_{\tilde{j}}^r(u(c_{o,i}) + \alpha(u(c_{i,o}) - d)) \\
&\quad + p_j^r(1 - p_{\tilde{j}}^r)(u(c_{i,o}) - d + \alpha u(c_{o,i})) + p_j^r p_{\tilde{j}}^r(1 + \alpha)(u(c_{i,i}) - d) \\
&\geq \\
U_{(j,\tilde{j})}^n &= u(c_{j,\tilde{j}}) - 1_{\{j=i\}}d + \alpha(u(c_{\tilde{j},j}) - 1_{\{\tilde{j}=i\}}d).
\end{aligned} \tag{III.1}$$

where $U_{(j,\tilde{j})}^r$ represents the expected utility from reform and $U_{(j,\tilde{j})}^n$ denotes the utility in case of no reform for an agent who is of type (j, \tilde{j}) . Under the assumptions made above the respective probabilities become $p_i^r = 1$ and $p_o^r = \Delta\eta/(1-\eta)$. The decision whether reform is implemented or rejected depends on the political process. We apply majority vote: reform is implemented if and only if

$$\sum_{j \in \{i,o\}} \sum_{\tilde{j} \in \{i,o\}} 1\{U_{(j,\tilde{j})}^r \geq U_{(j,\tilde{j})}^n\} \mu(j, \tilde{j}) \geq 0.5,$$

where $\mu(j, \tilde{j})$ represents the share of agents with characteristics (j, \tilde{j}) . The description of the voting scheme completes the model's politico-economic environment.

TABLE 2
Overview of the model's parameters

Description	Parameter	Range	Section IV
Agent characteristics:			
Altruism	α	$[0, 1]$	0 and 1
Risk aversion	γ	$[0, \infty)$	0
Disutility of an insider job	d	$(-\infty, \bar{d})$	$(-\infty, \bar{d})$
Wealth	w	$(-e_o, \infty)$	$(-e_o, \infty)$
Labor market characteristics:			
Insider share ex ante	η	$[0, 1)$	$[0, 1)$
Insider income ex ante	e_i	1	1
Outsider income	e_o	$(0, 1)$	$(0, 1)$
Labor market flexibility ex ante	f	$[0, 1]$	0
Reform characteristics:			
Change of insider share	$\Delta\eta$	$(0, 1 - \eta]$	$(0, 1 - \eta]$
Change of insider income	Δe_i	$[e_o - e_i, 0]$	$(e_o + d - 1, 0)$
Change of labor market flexibility	Δf	$[0, 1 - f]$	0

The last column provides the parameter values assumed in Section IV. More general cases are considered in Section V and Online Appendix A.

The median voter framework is the natural modeling choice in our setup, as we consider voting on a single reform with given characteristics. Faced with such a binary choice, even the multiple parties in a political system of proportional representation — as in the southern European countries that motivate our analysis — would just

split into two blocks: supporters and opponents to reform.

IV FAMILY TIES AND ECONOMIC REFORM

We now turn to the analysis of the model. In order to carve out the interaction between altruism, state of employment, and voting behavior as clearly as possible, we first consider risk neutral agents ($\gamma = 0$). Risk neutrality rules out any effects of wealth so we can set $w = 0$.

We begin the analysis by looking at the two extreme values of the altruism parameter: on the one hand, a complete absence of altruism ($\alpha = 0$), which we call the ‘individualistic case’, on the other hand the ‘completely altruistic case’ ($\alpha = 1$). Then, we explore voting behavior under ‘incomplete altruism’ ($0 < \alpha < 1$).

Individualistic case: $\alpha = 0$

First, note that the individualistic scenario of course implies that there are no transfers between family members, $t_{j,\bar{j}} = 0$. Agents are exclusively concerned with their own expected state of employment when it comes to the decision whether to vote in favor of or against reform. The outsider votes in favor of reform if and only if

$$U_o^r = p_o^r(u(e_i + \Delta e_i) - d) + (1 - p_o^r)u(e_o) \geq u(e_o) = U_o^n.$$

From the assumption that $d < \bar{d} = u(e_i + \Delta e_i) - u(e_o)$ it follows directly that $U_o^r > U_o^n$. Hence, an outsider always prefers reform. Conversely, as $\Delta e_i < 0$, an insider is always in favor of the status quo:

$$U_i^n = u(e_i) - d > u(e_i + \Delta e_i) - d = U_i^r.$$

Thus, all outsiders vote in favor of reform and all insiders vote against reform. Since we assume majority vote, the implementation of reform only depends on whether the median voter is an insider or an outsider. This yields the following result.

Lemma 1 *Suppose $\alpha = 0$. Then reform is implemented if and only if there are more outsiders than insiders (i.e. iff $\eta < 0.5$).*

To interpret this result recall that the outsider share $1 - \eta$ is not the unemployment rate but also includes the underemployed, workers in the low-wage sector and employees with jobs characterized by low levels of protection. Hence, the outsider share can be much larger than the unemployment rate and can even exceed 50 percent in times of economic downturn (see Dolado et al., 2002 and Bentolila et al., 2012). The simple finding stated in Lemma 1 is in line with the rationale of the crisis hypothesis: reform will only be implemented if a sufficiently large share of the population suffers from the institutional rigidities of the labor market. We now turn to the question of how voting behavior changes in the presence of altruism. First, we analyze the case of complete altruism ($\alpha = 1$).

Completely altruistic case: $\alpha = 1$

In the case of complete altruism, the individual optimization problem becomes a ‘family problem’ since each agent weighs the well-being of both family members equally. Therefore, the altruistic family ‘speaks with one voice’ — that is to say, there is never disagreement and both members vote either in favor of or against reform. Importantly, this is also true when family members are in different states of employment — in contrast to the individualistic case in which members of the same family cast opposing votes on reform if their job status differs.

We first analyze the voting decision of families in which both members are in the same state of employment. Since members of these families are identical, their decision follows the same reasoning as that of their individualistic counterparts.

Lemma 2 *Families in which both members are outsiders (insiders) vote in favor of (against) reform.*

We can now derive the levels of the insider share η at which these families are median voters. Recall that the employment states of two members of the same family are assumed to be independent. Therefore, the share of insider families among all families is η^2 . Consequently, if $\eta^2 > 1/2$, i.e. $\eta > 1/\sqrt{2}$, the median voter is the insider family, and reform is blocked. Symmetrically, if $\eta < 1 - 1/\sqrt{2}$ the median voter is the outsider family and reform is implemented. These results imply that at the extremes of the employment spectrum the majority vote in the completely altruistic case is similar to the individualistic case.

The interesting interval is the one between these regions. In this interval the median voter is the mixed family which votes in favor of reform if and only if

$$\begin{aligned} (1 - p_o^r)[2u(\frac{e_i + \Delta e_i + e_o}{2}) - d] + p_o^r 2[u(e_i + \Delta e_i) - d] \\ \geq \\ 2u(\frac{e_i + e_o}{2}) - d. \end{aligned} \tag{IV.1}$$

In the risk neutral case, this simplifies to

$$p_o^r(e_i + \Delta e_i - e_o - d) \geq -\Delta e_i,$$

where the expression on the left-hand side of the equation represents the mixed family's expected gain from reform and the term on the right-hand side captures the loss due to lower wage of the insider family member. Since $p_o^r = \Delta\eta/(1 - \eta)$, this is equivalent to $\eta \geq 1 + (\Delta\eta/\Delta e_i)(e_i + \Delta e_i - e_o - d)$.

The voting decision of the mixed family hence depends on η . It votes in favor of reform only if the probability of becoming an insider for the outsider family member is sufficiently high. We denote the value of η that stipulates this probability reform threshold τ (recall that $p_o^r = \Delta\eta/(1 - \eta)$).

Lemma 3 *If $\alpha = 1$ and $\gamma = 0$, the mixed family votes in favor of reform if and only if $\eta \geq \tau = 1 + (\Delta\eta/\Delta e_i)(e_i + \Delta e_i - e_o - d)$.*

Hence, in contrast to the individualistic case, it is possible that the outsider member of the mixed family votes against reform. Only if $\eta \geq \tau$, the mixed family is willing to accept the wage loss in exchange for improved job perspectives for the outsider family member. Otherwise the mixed family prefers to maintain the status quo. From Lemma 2 and Lemma 3, Proposition 1 directly follows.

Proposition 1 *If $\alpha = 1$ and $\gamma = 0$, reform is implemented if and only if $\eta \in [0, 1 - 1/\sqrt{2}] \cup [\tau, 1/\sqrt{2}]$, where $\tau = 1 + (\Delta\eta/\Delta e_i)(e_i + \Delta e_i - e_o - d)$.*

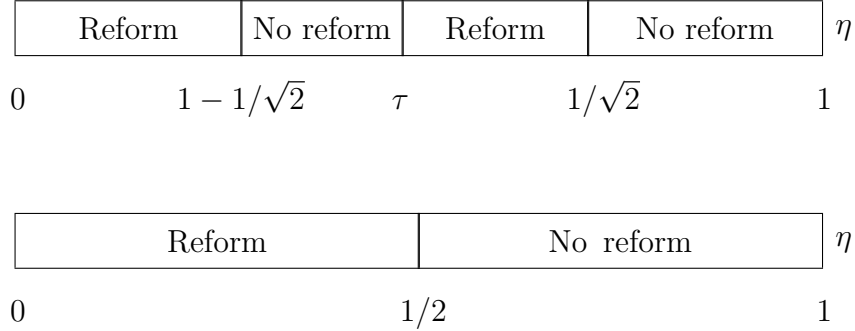
Thus, Proposition 1 entails that there is a non-monotone relation between η and the majority vote on reform if and only if $\tau \in (1 - 1/\sqrt{2}, 1/\sqrt{2})$, which implies the following Proposition.

Proposition 2 *If $\alpha = 1$ and $\gamma = 0$, there is a non-monotone relation between the insider share η and the majority vote on reform if and only if $\Delta\eta(e_i + \Delta e_i - e_o - d) \in (\Delta e_i \cdot (1 - 1/\sqrt{2}), \Delta e_i \cdot 1/\sqrt{2})$.*

The term $\Delta\eta(e_i + \Delta e_i - e_o - d)$ is the aggregate gain of outsiders through reform, while the terms $\Delta e_i \cdot (1 - 1/\sqrt{2})$ and $\Delta e_i \cdot 1/\sqrt{2}$ are equal to the aggregate loss of insiders through reform at the bounds of the region where mixed families are the median voters. Thus, Proposition 2 implies that the non-monotonicity result holds if and only if the gain of outsiders through reform is bigger than the insiders' loss when there are very few insiders and smaller than the insiders' loss when there are many insiders. If this is not the case, non-monotonicity simply breaks down because the characteristics of the reform are either extremely positive or extremely negative implying that mixed families are always in favor of or against reform, respectively, no matter how large the share of insiders. A reform that satisfies the condition in Proposition 2 can nevertheless improve welfare substantially. For values of η close to $1 - 1/\sqrt{2}$ the gain for outsiders can be more than twice as large as the loss for

FIGURE 2

Reform decision as a function of the insider share η



Comparison of the individualistic case (lower graph) and the completely altruistic case (upper graph).

insiders. Moreover, the welfare implications of reform would be even more positive if the effects on employers/capitalists were included. Figure 2 graphically compares the results of the individualistic and the completely altruistic cases.

The main conclusion is that altruistic links can have a significant impact on voting behavior. On the one hand, a relatively bad employment situation does not induce, but rather prevents reform (for $\eta \in [1 - 1/\sqrt{2}, \tau]$). On the other hand, a majority of the population is in favor of reform when the employment situation is relatively good (for $\eta \in [\tau, 1/\sqrt{2}]$).

When relating our model to the motivating example of the southern European crisis countries, the most interesting case is clearly $\eta \in [1 - 1/\sqrt{2}, \tau]$, when reform is blocked at low insider shares. If one takes into account that the group of outsiders, besides the unemployed, also comprises temporary employed and underemployed workers, the insider share in these countries easily goes below τ -values of around 50 percent (see Bentolila et al., 2012). Moreover, as we show in the Online Appendix, the reform

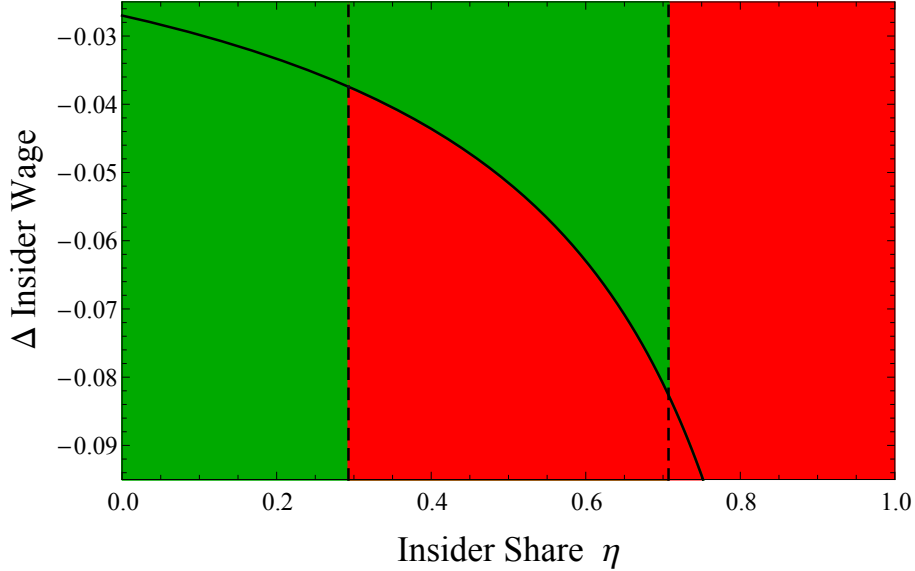
threshold τ can, depending on parameter values, be well above 0.5, which means that reform blockage (by altruistic mixed families) can occur at outsider shares far below 50 percent.

The reform threshold τ depends on various parameters. For illustration purposes, we now stipulate concrete values for the relevant parameters. We set $e_o = 1/3$, $d = 0.1$ and $\Delta\eta = 0.05$ and let the crucial parameter Δe_i vary.¹⁰ Figure 3 shows how τ , and thus the majority vote on reform, changes in reaction to the variation in Δe_i . In the red/dark regions reform is rejected, while it is accepted in the green/light regions. Dashed lines indicate a change in the family types that are the median voters: from left to right the median voters are first the outsider families (o,o), then the (completely altruistic) mixed families, and finally insider families. The solid line is the mixed family's indifference curve. Figure 3 illustrates that the larger is the decrease of the insider wage following reform, the higher must be η to compensate the mixed family for the income reduction (i.e. the better must be the chance $\Delta\eta/(1 - \eta)$ for the outsider to become an insider after reform). This is intuitive: As the reform becomes less attractive, the region where it is supported shrinks.

¹⁰We assume in the baseline scenario that an outsider disposes of one third of insiders' income. As the group of outsiders is very heterogeneous, this parameter is difficult to match to the data. One reasonable proxy might be the ratio of minimum relative to average wages of full-time workers, which is very close to one third in Spain and Portugal (according to OECD: <https://stats.oecd.org>, accessed on 5 November 2015). Moreover, unemployment benefits are comparably low in the crisis countries and hence are unlikely to substantially increase the average outsider wage. The preference parameter d , which measures the disutility arising from the workload of an insider job, is also hard to pin down. We consider a value corresponding to 10 percent of the insider wage to be a sensible assumption. This might appear low at a first glance, however, it also reflects that insider jobs are associated with prestige whereas outsiders are often socially disadvantaged. Finally, the parameters $\Delta\eta$ and Δe_i depend on how comprehensive the reform is. In the baseline scenario, we set $\Delta\eta = 0.05$ and let Δe_i vary to analyze how this affects the support for reform by the mixed family.

FIGURE 3

Majority vote as a function of the change of insider wage and of the insider share



Parameter values are $e_o = 1/3$, $d = 0.1$ and $\Delta\eta = 0.05$. Green/light regions indicate majority support for reform, while red/dark regions indicate rejection.

We have derived the above findings within a very stylized model to make the basic mechanism that reverses the crisis hypothesis as clear as possible. In the following, we show that our result still holds if some strong assumptions are relaxed. First, we consider the case of incomplete altruism ($0 < \alpha < 1$). Then, in Section V, we show that in the presence of risk aversion and wealth the results also hold and can become even stronger. Online Appendix A demonstrates that relaxing our assumptions made on the labor market and the considered reform does not qualitatively change our results. Higher f and $\Delta\eta$ decrease the reform threshold, while a higher Δf increases the reform threshold. Finally, note that by assuming the benefit of reform to be an increase in insider jobs $\Delta\eta$ and the cost to be a reduction Δe_i in wages for η insiders,

we stipulate that the net social benefit of reform $\Delta\eta(e_i + \Delta e_i - e_o - d) - \eta\Delta e_i$ is increasing in the outsider share $1 - \eta$. Thus, by assumption, there is an element in the model that works in favor of the crisis hypothesis. However, we have shown that the crisis hypothesis nevertheless breaks down due to the impact of family ties. In Online Appendix A.4 we show that this is still true if the net social benefit of reform is increasing even faster in the outsider share, in particular when reform creates more jobs in case the outsider share is high (i.e. when $\Delta\eta$ is a decreasing function of η).

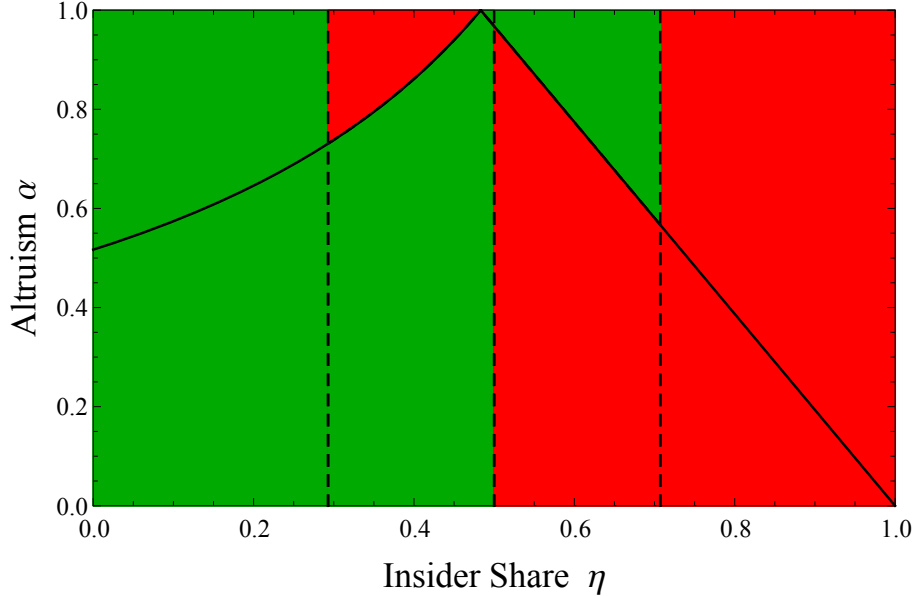
Incomplete altruism: $0 < \alpha < 1$

So far, we have looked only at the two extreme cases of the altruism parameter α . The median voter's choice strongly differs between the two cases. Naturally, the question arises how this choice changes when we move from one extreme to the other.¹¹ Online Appendix B derives the answer to this question analytically. Figure 4 graphically illustrates the results for the following parameter values: $e_o = 1/3$, $d = 0.1$, $\Delta e_i = -0.05$ and $\Delta\eta = 0.05$. Again, dashed lines indicate a change in the family types that are the median voters: from left to right the median voters are first the outsider families (o,o), then outsiders within mixed families (o,i), then insiders in such families (i,o), and finally insider families (i,i). Solid lines indicate the indifference lines of (o,i) and (i,o) members of mixed families. Going from the bottom to the top of Figure 4, we can see how the reform decision changes as the altruism parameter increases from zero to one. For low values of altruism, the decision is exactly as in the individualistic case. However, at a certain level of altruism ($\alpha \approx 0.55$) the insiders within mixed families start to favor reform even for η -values where they are

¹¹Another alternative to relax our assumption is to consider one-sided altruism only. Suppose insider parents are altruistic towards their outsider children, but not vice versa. In this situation the mechanism we describe is weakened as the children are not interested in their parents' consumption anymore, but still present, because children still receive transfers from their parents.

FIGURE 4

Majority vote as a function of altruism and insider share for $\Delta\eta = 0.05$.



Green/light regions indicate majority support for reform, while red/dark regions indicate rejection.

the median voters ($\eta \leq 1/\sqrt{2}$). Similarly, there is a point ($\alpha \approx 0.73$) at which the outsiders of mixed families start to oppose reform even for η -values where they are the median voters ($\eta \geq 1 - 1/\sqrt{2}$). In this case the small chance for the outsider to obtain an insider job is not worth incurring the wage reduction for the insider family member. Both these regions become bigger as altruistic links become stronger, until the case of complete altruism is reached.

The upshot of this sensitivity analysis is as follows. First, moderately reducing the altruism parameter below one does not alter the qualitative findings: the crisis hypothesis still fails. Secondly, however, with low but positive levels of altruism,

the majority vote does not differ at all from the individualistic case. Combined, these two findings suggest that two countries, even if they do not strongly differ with respect to the intensity of family ties, might qualitatively differ in their aptitude to embrace reform. For instance, in a country with altruism parameter 0.8 reform is blocked for a certain range of low insider shares, while in a country with altruism parameter 0.7 reform is implemented for all insider shares below fifty percent.

V THE ROLE OF WEALTH

In this section we analyze how wealth as an additional source of intra-family transfers affects support for reform. This aspect is relevant for the crisis countries since these have a relatively high level of median net wealth. The ECB's (2013) Eurosystem Household Finance and Consumption Survey reports median net household wealth in Italy, Portugal, and Spain of €173.5k, €75.2k, and €182.7k respectively, compared to €85.8k, €51.4k, and €103.6k respectively in Finland, Germany, and the Netherlands.¹²

Therefore, we now allow for risk-averse agents ($\gamma > 0$) to study wealth effects. Additionally, we set $\alpha = 1$ to explore the relation between altruism and risk aversion as clearly as possible and to keep the analysis simple. How does risk aversion affect the voting decisions of agents within the pivotal mixed family? To answer this question, we have to consider Equation III.1, and solve for the reform threshold τ which represents the level of η at which the mixed family is indifferent between voting in favor of or against reform. If risk aversion is a small natural number, we can obtain an analytical solution for τ (see Online Appendix B). Table 3 summarizes how the reform threshold τ changes as a reaction to an increase in risk aversion.

¹²Controlling for household size reduces the difference between southern and northern European countries, yet only marginally (see ECB, 2013).

Higher risk aversion leads to an increase of the threshold τ which implies a reduced support for reform. The more risk averse agents are, the better must be the post-reform job perspectives to make the mixed family accept a reduction of the insider member's income. This result is intuitive as we would expect risk averse agents to oppose reform more strongly than risk neutral ones.

We now turn to the role of wealth. Under risk neutrality, wealth w has no effect. In the following, we show that this is not the case under risk aversion, which we set equal to $\gamma = 2$. The effect of wealth is ambiguous. On the one hand, wealth provides insurance against the worst case outcome of reform, namely that the outsider family member remains an outsider while the insider's wage is reduced. In this case, a wealthy family can still maintain a decent level of consumption. *Ceteris paribus*, this insurance effect decreases the reform threshold τ . On the other hand, wealth decreases the marginal utility of consumption and thus changes the trade-off between

TABLE 3

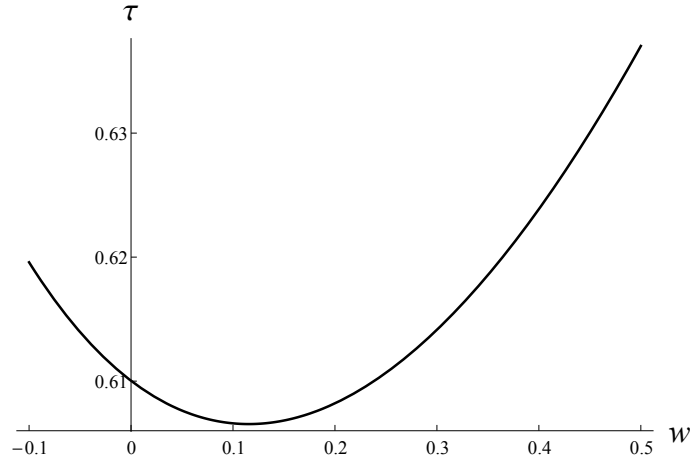
Reform threshold as a function of the degree of risk aversion

Risk aversion γ	Reform threshold τ
0	48.3
1	55.2
2	61.0
3	65.9
4	69.9

Parameter values are $e_o = 1/3$, $w = 0$, $d = 0.1$, $\Delta\eta = 0.05$ and $\Delta e_i = -0.05$. A higher reform threshold implies a larger region of η -values for which reform is blocked.

FIGURE 5

Reform threshold as a function of wealth w



Parameter values are $\gamma = 2$, $e_o = 1/3$, $d = 0.1$, $\Delta e_i = -0.05$ and $\Delta \eta = 0.05$.

a higher income from an insider job and the associated higher disutility of work. While we only consider parameter choices where agents prefer to be insiders rather than outsiders, the utility margin by which they prefer to be insiders decreases with their wealth. This effect puts upward pressure on the reform threshold when wealth increases.

In Figure 5, we plot the overall effect of wealth on the reform threshold for $d = 0.1$, $e_o = 1/3$, $\Delta e_i = -0.05$ and $\Delta \eta = 0.05$. The first effect initially shifts the reform threshold of the mixed family slightly down indicating an increasing support for reform. Once the second effect dominates, the reform threshold is shifted up illustrating a reduced willingness of the mixed family to support reform.

In conclusion, we find that high levels of wealth can reinforce our core mechanism: if outsider members of a mixed family can increase their consumption not only due to transfers from the wage income of insider family members but also from dissaving

family assets, then the parameter region in which reform is blocked becomes even bigger. In light of this theoretical finding one might conjecture that the high median household wealth in the crisis countries has contributed to the observed reform fatigue. However, the strength of this effect could only be properly assessed in a dynamic setup, in which the length of unemployment spells and the process of dis-saving wealth are both explicitly modeled.

Throughout this section, we have assumed an equal distribution of wealth among agents. An interesting effect can occur when we allow for wealth inequality. First, suppose a situation in which all agents' wealth equals the value where the reform threshold reaches its minimum in Figure 5. Now consider a case with the same total wealth, but unequally distributed: there would be poorer families to the left and wealthier families to the right of the minimum. Both are less supportive of reform than without inequality. As a consequence, overall support for reform decreases.

VI POLICY IMPLICATIONS

In this section we discuss policy implications of our main results from Sections IV and V, respectively.

Austerity and reform

The main conclusion from Section IV is that, in the presence of intra-family altruism, crisis might hinder rather than facilitate economic reform — a finding that casts doubt on the crisis hypothesis. This finding yields an interesting policy implication regarding the effect of austerity in countries with strong family ties. According to the crisis hypothesis, austerity measures that aggravate an economic downturn could have a positive employment effect via the indirect channel of facilitating labor market reforms. Along these lines, Drazen and Grilli (1993) argue that ‘crises may raise

welfare if they are the only way to induce necessary policy changes.’ In contrast, our model shows that the consequences of austerity can be quite different when family ties are taken into account. In the presence of intra-family altruism an economic slump does not lead to employment-promoting reforms, but rather causes reform blockage and redistribution of resources from insider family members to outsider members. As can be seen in Figure 2, a crisis reduces the willingness to reform in a range of the insider share where the individualistic case predicts reform. In contrast, stimulating the economy might encourage reform where the benchmark predicts blockage. Note, however, that this effect depends on the characteristics of the economy and the reform: Proposition 2 states that for reforms that are less attractive for the mixed family (namely, $\tau > 1/\sqrt{2}$), family ties simply expand the region where reform is rejected, but do not imply support for reform in case of relatively good economic circumstances. Our finding suggests that countries with different degrees of family ties might require diverging policy prescriptions to successfully induce economic reforms in times of crisis.

Wealth, inequality, and reform

The core result of Section V is that wealth matters for the mixed family’s voting decision on reform. As wealth increases, becoming an insider is less attractive since the utility gain of consuming the additional income is decreasing, while the utility loss of having less leisure remains the same. Hence, a high level of wealth can lead to reform fatigue, an aspect that might be relevant for the crisis countries where median net wealth is comparatively high (see, for instance, ECB, 2013).

Furthermore, we argue in Section V that resistance to reform might be even stronger if wealth is unequally distributed. On the one hand, poor mixed families oppose reform more strongly because they lack a wealth buffer that alleviates the worst case outcome of reform (a wage cut for the insider and no transition to insider status

for the outsider). On the other hand, for the wealthy mixed families the perspective of both members becoming insiders is less attractive as their marginal utility of additional income is relatively low. Therefore, in the presence of strong family ties, substantial wealth inequality can reinforce resistance to reform — redistributive policies, in contrast, have the potential to diminish reform blockage.

VII CONCLUSION

This paper analyzes how family ties affect support for economic reform in times of crisis. We make a theoretical contribution to the literature on the political economy of reform by casting doubt on the crisis hypothesis, which states an inverse relation between the state of an economy and support for reform. Taking intra-family altruism into account can reduce support for reform in an economic crisis. Furthermore, our theoretical findings hint at a potentially important policy implication: austerity measures might block rather than foster economic reforms if applied to countries where family ties are strong. Our model provides an explanation for the limited reform progress in several southern European countries during and following the Great Recession.¹³ Of course, other mechanisms also play a role in creating opposition to labor market reform in the crisis countries. For instance, as older workers are both more likely to have a permanent contract and to be unionized, labor unions might oppose reform despite high youth unemployment (see Blanchflower, 2006, and Boeri and Jimeno, 2015). Another reason for reform blockage in the crisis coun-

¹³Note, however, that some reform efforts have been made in the crisis countries, in particular in Spain in 2012 and Italy in 2014 (see OECD, 2013 and OECD, 2015, respectively). To the extent that labor market reforms have been implemented in the crisis countries, the mechanism described in our model suggests an explanation why these reforms have not been more comprehensive and why they have been significantly delayed despite massive pressure by the EU and the IMF (see, for instance, Bentolila et al., 2012).

tries might be that their political systems are mainly characterized by proportional representation, which requires cross-party compromises that might impede reform implementation (see, for instance, Persson and Tabellini, 2000).

Although we focus on labor market reform, the underlying mechanism of our model might also be relevant for other policy fields. For instance, the reform of a pay-as-you-go social security system that aims to ease the financial burden on the young might be opposed by the latter if they receive transfers from their parents. Tabellini (2000) and Hansson and Stuart (1989) have considered a similar idea by arguing that intergenerational altruism leads to a willingness of the young to pay for the old. Our mechanism gives this story a new twist as the young prefer maintaining the system, in particular in times of crisis, because they expect transfers from the old. Another example is public sector reform. Many societies maintain inefficiently large and costly public sectors which is puzzling from a theoretical point of view (see the discussion in Acemoglu et al., 2011). According to our argument, it is especially difficult to reform such a public sector during an economic downturn if many voters are altruistically linked to state employees. Voters who would demand a reform that reduces an inflated public bureaucracy in the absence of altruism might oppose it if they can expect transfers from public sector employees.

In this paper, we have chosen a static approach to present the mechanism relating family ties and reform support as clearly as possible. However, considering a dynamic setup would allow to address further important aspects like intergenerational conflicts, short-run versus long-run effects, and sustainability of reform.

This work is a first step toward understanding how family ties affect a country's tendency to reform. Further work — both theoretical and empirical — is needed to develop a more detailed understanding of this relation.

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