Unemployment Insurance and Optimal Taxation in Search Models of the Labor Market

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Abstract

In many search models of the labor market, like the Mortensen-Pissarides model, unemployment insurance (henceforth UI) is conveniently interpreted as the value of leisure or home production and is, therefore, treated as an exogenous variable. However, in reality UI has to be funded by taxes that might be (and most of the times are) distortionary. In this paper I consider two models of equilibrium unemployment, random search and directed search, and various ways of raising funds in order to insure the unemployed. I focus on the welfare implications of different taxation systems in these two environments. In the random search model with no taxes, efficiency is not be achieved unless the bargaining power of workers equals the elasticity of the matching function with respect to unemployment. Hence, if the bargaining power is small, a lump sum tax can actually improve welfare. In the directed search model without taxes, constraint efficiency is always achieved. Since firms “direct” workers to apply to them by posting wages, raising funds for UI through a lump sum tax gives an incentive to firms to be aggressive and try to maximize the probability of filing up their vacancies, without fully internalizing the effect of their action. I show two ways through which this externality can be internalized, and constraint efficiency can be re-established.

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