

ON THE PROVISION OF UNEMPLOYMENT INSURANCE WHEN WORKERS ARE EX-ANTE HETEROGENEOUS

Ofer Setty

Tel Aviv University

Yaniv Yedid-Levi

Interdisciplinary Center (IDC) Herzliya

Abstract

Labor market outcomes demonstrate considerable variation between and within skill groups. We construct a general equilibrium model with incomplete markets and exogenous differences that matches these facts. We study the role of exogenous heterogeneity in choosing the optimal replacement rate and the maximum benefit for an unemployment insurance (UI) system. The optimal average replacement rate is 27%, compared to 0% in a model without exogenous heterogeneity. The relatively generous choice is due to the redistributive role of UI, which is a manifestation of two elements. First, workers who are unemployed more often receive positive net transfers from the UI system because they draw resources more frequently. Second, the existence of a cap on benefits makes UI progressive. Our main result holds in the presence of a generous progressive taxation system. (JEL: D52, E21, J63, J64, J65, C68)

The editor in charge of this paper was Dirk Krueger.

Acknowledgments: Previously titled: “Who Cares about Unemployment Insurance?”. We thank Dirk Krueger, the editor, and four anonymous referees for numerous useful comments and suggestions. We also thank Paul Beaudry, Tobias Broer, Aspen Gorry, Moshe Hazan, Nir Jaimovich, Sebastian Koehne, Per Krusell, Toshihiko Mukoyama, Itay Saporta-Eksten, Henry Siu, David Weiss, Stephen Zeldes and seminar participants for very helpful comments. Special thanks to Avihai Lifschitz for his contribution and insightful comments during the early stages of this paper. Setty’s research is supported by the Israel Science Foundation (Grant No. 418/11). Yedid-Levi thanks the Social Sciences and Humanities Research Council of Canada for financial support.

E-mail: ofer.setty@gmail.com (Setty); yaniv.yl1@gmail.com (Yedid-Levi)