

A Positive Theory of Unemployment Insurance in Frictional Labor Market

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Abstract

This paper presents a tractable frictional labor-market model in which the unemployment insurance level is endogenously determined. We incorporate the policy determination through probabilistic voting into the competitive search model with risk aversion. Search frictions induce unemployment, leading to the political conflict between employed and unemployed workers. Conversely, the political outcome affects labor-market conditions, e.g., the market tightness, because both the expected utility of workers and the expected profit of firms depend on public policy. The interaction between market conditions and political decisions enables us to explain various labor-market phenomena, which are not explainable in terms of an exogenous-policy model.

JEL classification: D72; J64; J65

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