Self-fulfilling labor wedge fluctuations and unemployment insurance

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Nikolaos Kokonas[1,2] and Paulo Santos Monteiro[3]

[1]Centre For Macroeconomics, [2]University of Bath, [3]University of York

Unemployment insurance not only provides timely welfare protection and social insurance to the short-term unemployed but is often also regarded as an important macroeconomic stabilizer. In fact, these two roles of unemployment insurance are often intertwined. This is because the stabilizing effect of unemployment insurance is traditionally thought to be most effective in environments featuring incomplete opportunities for private insurance. In this paper we present an additional channel through which unemployment insurance may have both an effective and desirable (welfare improving) stabilization role even in a setting with perfect private insurance markets and, consequently, no motivation for redistribution. Unemployment insurance may help eliminate inefficient self-fulfilling unemployment fluctuations. In calibrated versions of

the model, indeterminacy occurs for replacement rates that are empirically plausible for North America, but not for the replacement rates observed for European countries.