The Job Ladder, Unemployment Risk, and Incomplete Markets

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Abstract :
We study a general equilibrium search model with jobs differing in productivity and unemployment risk. Risk-averse workers, searching off and on the job, self-insure against labor income risk via a non-state-contingent bond. On-the-job search mitigates, undoes, or even reverses the risk-aversion-induced inefficiency of search out of unemployment. The interplay of imperfect insurance and unemployment risk heterogeneity creates a new distortion: employed workers climb the job ladder over-cautiously. More generous unemployment insurance can increase job creation by kick-starting the job ladder. Quantitatively, these forces improve the equity-efficiency trade-off and we find the welfare-maximizing replacement rate to be high, in line with current US policy.