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Optimal Unemployment Insurance in an Equilibrium Business-Cycle Model[☆]

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Abstract

The optimal cyclical behavior of unemployment insurance is characterized in an equilibrium search model with risk-averse workers. Contrary to the current US policy, the path of optimal unemployment benefits is pro-cyclical - positively correlated with productivity and employment. Furthermore, optimal unemployment benefits react non-monotonically to a productivity shock: in response to a fall in productivity, they rise on impact but then fall significantly below their pre-recession level during the recovery. As compared to the current US unemployment insurance policy, the optimal state-contingent unemployment benefits smooth cyclical fluctuations in unemployment and deliver substantial welfare gains.

Keywords: Unemployment Insurance, Business Cycles, Optimal Policy, Search and Matching

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