Financing Unemployment Insurance Benefits over the Business Cycle

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Abstract

Should unemployment insurance (UI) benefits be countercyclical or procyclical_˜? The answer relies on the ability of the government to finance these benefits. UI benefits are introduced in an infinite-horizon matching model featuring aggregate shocks to labor productivity, employed and unemployed risk-averse workers as well as an intensive margin. They are financed by taxes on labor and possibly by public debt. Under the Ramsey primal approach, optimal allocation is decentralized by an appropriate fiscal policy.
In a recession, optimal UI benefits should be countercyclical because risk-averse workers require insurance, while the incentive issue might be settled by suitable taxes. However, if the government's budget is severely constrained, UI benefits might be sacrificed and appear as procyclical. On the contrary, in the case of perfect access to financial markets, the insurance and incentive motives are independent from each other.

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