Abstract

How is the optimal level of unemployment insurance affected when accounting for skill differences? We analyze this question using a general equilibrium model that has a number of key elements: (i) a search and matching friction in the labor market; (ii) workers who have the ability to save and cannot perfectly insure idiosyncratic risks; and (iii) ex-ante heterogeneity in unemployment risk and labor income. Considering a proportional tax and replacement rate UI system, our model suggests an optimal replacement rate of 32%, while a model without ex-ante heterogeneity calls for a much lower replacement rate (12%). We show that both dimensions of heterogeneity are responsible for these results. Specifically, we argue that income differences induce an incentive to redistribute consumption across skill groups. However, given the UI system, such redistribution is feasible only when there are differences in unemployment risk.