Equity and efficiency in rationed labor markets

Aart Gerritsen*

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The social welfare implications of income tax policy are shown to critically depend on whether or not labor markets are rationed — i.e., on the existence of involuntary unemployment. With rationed labor markets, raising taxes on the employed and transfers to the unemployed might improve both equity and efficiency. It improves equity by redistributing income from the employed to the unemployed; it improves efficiency as it encourages people with a small utility surplus of employment to exit the labor market, leaving their jobs for people with a higher utility surplus. I derive conditions under which this result continues to hold when only part of the labor market is rationed, when there is both frictional and rationing unemployment, and when rationing endogenously follows from trade unions’ monopoly power.

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*Erasmus School of Economics, Erasmus University Rotterdam, P.O. Box 1738, 3000DR Rotterdam, The Netherlands. E-mail: agerritsen@ese.eur.nl; Internet: https://sites.google.com/site/aartgerritsen/. Part of the research was conducted at the Max Planck Institute for Tax Law and Public Finance. I am grateful to the Editor (Claus Kreiner) and two anonymous referees for their insightful and constructive remarks. I also thank Robin Boadway, Kai Brückerhoff, Bas Jacobs, Kai Konrad, Jenny Ligthart, Frederick van der Ploeg, Marit Rehavi, Hendrik Vrijburg, Floris Zoutman, and participants of numerous seminars and conferences for many helpful comments and discussions. Financial support from The Netherlands Organization for Scientific Research (NWO Vidi Grant No. 452-07-013) is gratefully acknowledged.
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