Equity and efficiency in rationed labor markets

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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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