Abstract for "Endogenous Employment and Incomplete Markets"

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This paper explores the role of effort and human capital as mechanisms to alleviate the idiosyncratic risk faced by individuals in the presence of incomplete markets. I construct a DSGE model where effort and human capital determine the probability of being employed the next period. While effort is a flow variable that has to be exerted every period, human capital is a stock variable chosen when the agent is born. I first show how effort and assets are inverse related, and that only rich enough household invest in education. In the stationary equilibrium individuals diversify between market and non-market mechanisms to reduce risk. As a result, in the long run, the median individual will hold a negative credit balance, which better approximates the real wealth distribution when compared with previous studies. The results shed light on the potential implication of combining policies of unemployment insurance and subsidies to education to improve the wealth distribution.