

# Search, wage posting and urban spatial structure

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## Abstract

We develop an urban-search model in which firms post wages. When all workers are identical, there is a unique wage in equilibrium even in the presence of search and spatial frictions. This wage is affected by spatial and labor costs. When workers differ according to the value imputed to leisure, we show that, under some conditions, two wages emerge in equilibrium. The commuting cost not only affects the land market but also the labor market through wages. Workers' productivity also affects housing prices and this impact can be positive or negative depending on the location in the city. We then run some numerical simulations to reproduce some stylized facts about the labor-market outcomes of black and white workers. We find that a reduction in commuting costs for all workers reduces the unemployment rate of white workers and the profit of all firms but increases the wage of all workers (black and white) and raises the fraction of firms posting the high wage.

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## 1. Introduction

It is widely documented that unemployment varies between the regions of a country (Isserman et al., 1986; Gordon, 1987; Blanchflower and Oswald, 1994), between cities of different sizes and functions (Marston, 1985), between the inner and outer areas of cities and between the urban and rural areas. There are also stark spatial differences in incomes. For example, in the United States, the median income of central city residents is 40% lower than that of suburban residents. Despite these features, very few theoretical attempts have been made to better understand the working of the urban labor market and, in particular, urban unemployment and spatial wage dispersion. Indeed, labor economists and macroeconomists traditionally do not incorporate space directly into their studies (see e.g. Layard et al., 1991; Pissarides, 2000; Cahuc and Zylberberg, 2004), even though there are some well-known empirical studies of local labor markets (see e.g. Holzer, 1989; Eberts and Stone, 1992). Similarly, in urban economics, despite numerous empirical studies, the theory of urban labor economics has been relatively neglected. In most advanced urban textbooks (see, in particular, Fujita, 1989; Fujita et al., 1999; Fujita and Thisse, 2002), it is mainly assumed throughout perfect competition in the labor market and the issue of urban unemployment is not even discussed.

It seems, in particular, quite natural to introduce space in a search-matching model (Mortensen and Pissarides, 1999, Pissarides, 2000) because distance interacts with the diffusion of information. In his seminal contribution to search, Stigler (1961) puts geographical dispersion as one of the four immediate determinants of price ignorance. In most search models, say for example Diamond (1982), distance between agents or units implies a fixed cost of making another draw in the distribution. In other words, a spatial dispersion of agents creates more search frictions.

There is by now a small literature on urban search models (Zenou, 2009a,b). In all these models (Simpson, 1992; Coulson et al., 2001, Sato, 2001, 2004; Wasmer and Zenou, 2002, 2006; Smith and Zenou, 2003; Zenou, 2009c), the wage is determined by a bilateral bargaining between the firm and the worker so that all workers are paid the same wage and no spatial wage distribution emerges in equilibrium. There is however an important literature in search (Mortensen, 2003) focusing on wage dispersion where firms post wages instead of bargaining them with workers. The starting point is the Diamond paradox (Diamond, 1971), which says that, when all workers are identical, then, even in the presence of search frictions, the only equilibrium is for all firms to post the reservation wage of workers. In order to obtain a wage dispersion and to avoid the Diamond paradox, researchers have introduced multiple job offers (Burdett and Judd, 1983), workers' heterogeneity (Albrecht and Axell, 1984) and on-the-job search (Burdett and Mortensen, 1998).

The aim of this article is to develop an urban-search model in which firms post wages and derive the implications in the land and labor markets. To the best of our knowledge, this is the first article that does so.

To be more precise, we first consider a model where all workers are homogenous and locate in a monocentric city. We characterize the steady-state equilibrium, which requires solving simultaneously an urban land-use equilibrium and a labor market equilibrium. We show that the Diamond paradox holds. We also show that higher unemployment rate increases the employed workers' utility but decreases the equilibrium housing price in the employment area. We then extend this model by considering two types of workers who differ according to the value imputed to leisure. We show that, under some conditions, there is a spatial wage dispersion so that the Diamond paradox does not hold anymore. We show that the commuting cost affects not only the land market but also the labor market through wages. We also find that workers' productivity affects housing prices and that this impact can be positive or negative depending on the location in the city. We then run some numerical simulations to reproduce some stylized facts about the labor-market outcomes of black and white workers. We find that a reduction in commuting costs for all workers reduces the unemployment rate of white workers and the profit of all firms but increases the wage of all workers (black and white) and raises the fraction of firms posting the high wage.

To summarize, the contribution of our article is 3-fold:

- (i) We propose an alternative model of urban labor markets to the one usually used in the literature. In fact, this is the first article which has a wage-posting mechanism; all other models use a Nash-bargaining wage setting. This has important consequences for the equilibrium since firms has a monopsony power in the former while they share the surplus in the latter.
- (ii) In the heterogenous case (Section 3), we can match some stylized facts from the USA. By reinterpreting the model in terms of black and white workers and

running numerical simulations, we are able to reproduce interesting facts and derive some interesting policy conclusions such as the impact of a transport-cost policy on the labor-market outcomes of black and white workers.

- (iii) We can also analyze the Diamond paradox when space is introduced. Most of the results obtained in the nonspatial case are robust when a land market is considered.

## 2. Ex ante identical workers

There is a continuum of *ex ante* identical workers whose mass is  $N$  and a continuum of *ex ante* identical firms whose mass is 1. Among the  $N$  workers, there are  $L$  employed and  $U$  unemployed so that  $N = L + U$ . The workers are uniformly distributed along a *linear, closed* and *monocentric* city. Their density at each location is taken to be 1. There is no vacant land in the city and all land is owned by absentee landlords. All firms are exogenously located in the Business District (BD hereafter) and consume no space. The BD is a unique employment center located at one end of the linear city. In a centralized city, it corresponds to the Central Business District (CBD), whereas in a completely decentralized city, it represents the Suburban Business District (SBD). Workers are assumed to be infinitely lived, risk neutral and decide their optimal place of residence between the BD and the city fringe. The land market is competitive whereas the labor market is not.

There is no on-the-job search and thus only the unemployed workers search for a job and receive information about job openings. We denote by  $a_U$  the offer arrival rate faced by an unemployed worker.<sup>1</sup> Workers respond to offers as soon as they arrive. There is no recall. Jobs are destroyed at exogenous rate  $\delta$ . It is assumed that there exists a cumulative wage distribution function  $F(w_L)$  that is known by everybody, i.e. workers know  $F(w_L)$  but do not know which firm offers which wage. The support of  $F(w_L)$  is  $[0, \bar{w}_L]$ , where  $\bar{w}_L$  is very large.

A steady-state equilibrium requires solving *simultaneously* an urban land-use equilibrium and a labor market equilibrium. It is convenient to present first the former and then the latter.

### 2.1. Urban land-use equilibrium

Each individual is identified with one unit of labor. Each employed worker goes to the BD to work and incurs a fixed monetary commuting cost  $\tau$  per unit of distance. When living at a distance  $x$  from the BD, he/she also pays a land rent  $R(x)$ , consumes 1 unity of land and earns a wage  $w_L$  (that will be determined at the labor market equilibrium). The *instantaneous* (indirect) utility of an employed worker located at a distance  $x$  from the BD is equal to:

$$W_L(x) = w_L - \tau x - R(x) \tag{2.1}$$

and the bid rent is:<sup>2</sup>

$$\Psi_L(x, W_L) = w_L - \tau x - W_L \tag{2.2}$$

1 The subscripts  $U$  and  $L$  stand for ‘unemployed’ and ‘employed’ respectively.

2 The bid rent is a standard concept in urban economics. It indicates the maximum land rent that a worker located at a distance  $x$  from the BD is ready to pay in order to achieve a utility level (Fujita, 1989).

where  $W_L$  is the common utility level obtained by all employed workers in the city. Concerning the unemployed, they commute less often the BD since they mainly go there to search for jobs. So, we assume that they incur a commuting cost  $s\tau$  per unit of distance, where  $0 < s \leq 1$  is a measure of search intensity or search efficiency;  $s$  is assumed to be exogenous. For example,  $s = 1$  would mean that the unemployed workers go everyday to the BD (as often as the employed workers) to search for jobs. Thus, here, the cost of searching is captured through the increase in commuting costs since higher  $s$  implies higher commuting costs  $s\tau x$ . This is mainly because it is assumed that information about jobs is only gathered in the employment center (BD).<sup>3</sup> Unemployed workers consume 1 unity of land and thus their *instantaneous* (indirect) utility when residing at a distance  $x$  from the BD is given by:

$$W_U(x) = w_U - s\tau x - R(x) \quad (2.3)$$

where  $w_U$  indicates the unemployment insurance payment. The bid rent is thus given by:

$$\Psi_U(x, W_U) = w_U - s\tau x - W_U \quad (2.4)$$

where  $W_U$  is the common utility level obtained by all unemployed workers in the city. Because the bid rent of the employed workers is steeper than that of the unemployed workers, the former live close to jobs while the latter reside farther away. This pattern can capture both the European and American situations. Indeed, if the BD is interpreted as the CBD, then we have the European structure where the rich/employed workers live in the city-center and the poor/unemployed at the outskirts of the city. If the BD is the SBD, then the rich/employed workers live at the periphery while the poor reside in the city center. What is important here is that in both situations the rich live close to jobs, which is the case in Paris and London and in New York or Los Angeles (Brueckner et al., 1999; Glaeser et al., 2008).

**Definition 1:** *An urban - land - use equilibrium with ex ante identical workers is a 3-tuple  $(W_L^*, W_U^*, R^*(x))$  such that:*

$$\Psi_U(N, W_U^*) = R_A = 0 \quad (2.5)$$

$$\Psi_U(L, W_U^*) = \Psi_L(L, W_L^*) \quad (2.6)$$

$$R^*(x) = \max\{\Psi_U(x, W_U^*), \Psi_L(x, W_L^*), 0\} \quad \text{at each } x \in (0, N] \quad (2.7)$$

Equations (2.5–2.7) reflect the equilibrium conditions in the land market. Equation (2.5) says that, at the city fringe  $N$ , the bid rent of the unemployed workers must be equal to the agricultural land rent  $R_A$ , which is normalized to zero without loss of generality. Equation (2.6) states that, at  $L$ , the border between the employed and unemployed workers, the bid rent offered by the employed is equal to the bid rent offered by the unemployed workers. These two equations guarantee that the equilibrium land rent is everywhere continuous in the city. Finally, Equation (2.7) defines the equilibrium land rent as the upper envelope of the equilibrium bid rent curves of all workers and the agricultural rent line. Observe that since all  $N$  workers consume 1 unit of housing each, and since there will be no vacant land inside the city, the distance from

3 We could also have introduced other search costs that are not-distance related. This would have complicated the model without altering any of our results.

the BD to the urban fringe must be given by  $N$  and the border by  $L$ . As a result, the employed reside between 0 and  $L$  whereas the unemployed reside between  $L$  and  $N$ . Solving these equations leads to:

$$W_U^* = w_U - s\tau N \tag{2.8}$$

$$\begin{aligned} W_L^* &= w_L - (1-s)\tau L - s\tau N \\ &= w_L - (1-s)\tau N(1-u) - s\tau N \end{aligned} \tag{2.9}$$

$$R^*(x) = \begin{cases} \tau(sN - x) + (1-s)\tau N(1-u) & \text{for } 0 \leq x \leq L \\ s\tau(N - x) & \text{for } L < x \leq N \\ 0 & \text{for } x > N \end{cases} \tag{2.10}$$

Observe that the labor market affects the land market through both the unemployment rate and the wage. In particular, higher wages increases workers' utility whereas higher unemployment rate increases the employed workers' utility but decreases the equilibrium housing price in the employment area. Indeed, when  $u$  increases,  $L = (1-u)N$ , which is both the size of the employment area and the employment level, decreases. As a result, on average, the employed workers are closer to jobs and thus spend less in commuting costs, which increases their utility. This, in turn, decreases their bid rent [see Equation (2.2)] and thus the housing price within the employment area also decreases at each  $x$ .

## 2.2. Labor-market equilibrium

We can now solve the labor-market equilibrium. We follow here the wage posting literature (Mortensen, 2000, 2003), where the total mass of firms is fixed to 1, so that there is no a free-entry condition and thus no endogenous job creation. Also, the contact rates for both firms and workers are exogenous and not determined using a matching function (as in Pissarides, 2000). Of course, as shown by Mortensen (2000) and Gaumont et al. (2006), including these two aspects in a wage posting model is straightforward and does not generally change the results.

### 2.2.1. Employed workers

The Bellman equation for the employed workers is given by:

$$rI_L(w_L) = w_L - (1-s)\tau N(1-u) - s\tau N - \delta[I_L(w_L) - I_U] \tag{2.11}$$

where  $r$  is the discount factor.

Indeed, employed workers obtain today  $W_L^* = w_L - (1-s)\tau N(1-u) - s\tau N$ , but can lose their job at rate  $\delta$ , and then obtain a negative surplus of  $-[I_L(w_L) - I_U]$ . Equation (2.11) implies that:

$$I_L(w_L) - I_U = \frac{w_L - (1-s)\tau N(1-u) - s\tau N - rI_U}{r + \delta} \tag{2.12}$$

There is thus a reservation wage  $w_L^r$ , i.e. the wage below which unemployed workers refuse to accept a job offer, which is defined as follows:

$$I_L(w_L^r) - I_U = 0 \Leftrightarrow w_L^r = rI_U + (1-s)\tau N(1-u) + s\tau N \tag{2.13}$$

### 2.2.2. Unemployed workers

The Bellman equation for the unemployed workers is given by:

$$rI_U = w_U - s\tau N + sa_U \int_{w_L^r}^{+\infty} [I_L(w_L) - I_U] dF(w_L) \quad (2.14)$$

where  $a_U$  is the exogenous job acquisition rate. Indeed, unemployed workers obtain today  $W_U^* = w_U - s\tau N$ , but can have a contact with a firm at rate  $sa_U$ , and transform this contact into a match if the offer is greater or equal than the reservation wage  $w_L^r$ . In that case, they obtain a positive surplus of  $I_L(w_L) - I_U$ . As stated above, there is a cost of searching  $s$ , which is captured by the total commuting costs  $s\tau N$ , and a reward since higher job search increases the contact rate  $sa_U$  with a firm. Using (2.14), the wage reservation rule (2.13) can be written as:

$$w_L^r = w_U + (1 - s)\tau N(1 - u) + sa_U \int_{w_L^r}^{+\infty} [I_L(w_L) - I_U] dF(w_L)$$

which, using (2.12), is equivalent to:

$$w_L^r = w_U + (1 - s)\tau N(1 - u) + \frac{sa_U}{r + \delta} \int_{w_L^r}^{+\infty} [w_L - (1 - s)\tau N(1 - u) - s\tau N - rI_U] dF(w_L)$$

Using (2.13), we finally obtain:

$$w_L^r = w_U + (1 - s)\tau N(1 - u) + \frac{sa_U}{r + \delta} \int_{w_L^r}^{+\infty} (w_L - w_L^r) dF(w_L) \quad (2.15)$$

### 2.2.3. Unemployment rate

The dynamics of the unemployment level is equal to:

$$\frac{d[u(t)N]}{dt} = \delta[1 - u(t)]N - sa_U u(t)[1 - F(w_L^r)]N$$

where  $u(t)$  is the unemployment rate at time  $t$ . Indeed, at each time  $t$ ,  $[1 - u(t)]N$  employed workers lose their jobs at rate  $\delta$  while  $u(t)N$  unemployed workers find a job at rate  $sa_U u(t)[1 - F(w_L^r)]$ , which is the product of the contact rate  $sa_U u(t)$  and the acceptance rate (workers only accept job offers with wages at least equal to their reservation wage  $w_L^r$ ). In steady state,  $d[u(t)N]/dt = 0$  and thus, the unemployment rate  $u^*$ , is given by:

$$u^* = \frac{\delta}{\delta + sa_U [1 - F(w_L^r)]} \quad (2.16)$$

### 2.2.4 Employment size in a firm

Denote by  $l(w_L)$  the employment level of a firm that offers a wage  $w_L$  to its employees. Denote also by  $G(w_L)$  the proportion of employed workers in the economy receiving a wage no greater than  $w_L$ . The dynamics of  $G(w_L)$  is then given by

$$\frac{d[G(w_L, t)(1 - u(t))N]}{dt} = sa_U [F(w_L) - F(w_L^r)]u(t)N - \delta G(w_L, t)[1 - u(t)]N$$

where  $d[G(w_L,t)(1 - u(t))N]/dt$  is the variation of employed workers receiving a wage no greater than  $w_L$ ,  $sa_U[F(w_L) - F(w_L^r)]u(t)N$  is the flow at time  $t$  of unemployed workers into firms offering a wage no greater than  $w_L$ ,  $\delta G(w_L,t)[1 - u(t)]N$  is the flow at time  $t$  of employed workers out of firms offering a wage no greater than  $w_L$ . In steady state,  $d[G(w_L,t)(1 - u(t))N]/dt = 0$ , and, using (2.16), we easily obtain the following steady state value:

$$G(w_L) = \frac{F(w_L) - F(w_L^r)}{1 - F(w_L^r)} \tag{2.17}$$

We can now determine the employment size in a firm. The employment size  $l(w_L)$  (i.e. the measure of workers) per firm earning a wage  $w_L$  can be expressed as

$$l(w_L) = \lim_{\varepsilon \rightarrow 0} \frac{G(w_L) - G(w_L - \varepsilon)}{F(w_L) - F(w_L - \varepsilon)}(1 - u)N \tag{2.18}$$

where  $[G(w_L) - G(w_L - \varepsilon)](1 - u)N$  represents the steady-state number of workers earning a wage in the interval  $[w_L - \varepsilon, w_L]$  and  $F(w_L) - F(w_L - \varepsilon)$  is the measure of firms offering a wage in the interval  $[w_L - \varepsilon, w_L]$ .

**Leman 1:** Equation (2.18) is equivalent to

$$l(w_L) = \frac{sa_U N}{\delta + sa_U [1 - F(w_L^r)]} \tag{2.19}$$

**Proof:** See the Appendix A. ■

Equation (2.19) specifies the steady-state number of workers available to a firm offering any particular wage, conditional on the wages offered by other firms, represented by the distribution  $F(\cdot)$ , and the workers' reservation wage  $w_L^r$ . Thus, we have shown that, in steady state:

$$l(w_L) = \begin{cases} \frac{sa_U N}{\delta + sa_U [1 - F(w_L^r)]} & \text{iff } w_L \geq w_L^r \\ 0 & \text{iff } w_L < w_L^r \end{cases} \tag{2.20}$$

### 2.2.5. Wage posting

Firms post wages. As in Burdett and Mortensen (1998), firms are interested in maximizing steady-state profit, and will hire as many workers as are willing to accept. The profit of a firm that sets a wage  $w_L$  is given by:

$$\Pi = \max_{w_L} (y - w_L)l(w_L)$$

where  $y$  is the productivity of a worker. We have:

$$\Pi = \begin{cases} \max_{w_L} \left[ \frac{sa_U N(y - w_L)}{\delta + sa_U [1 - F(w_L^r)]} \right] & \text{iff } w_L \geq w_L^r \\ 0 & \text{iff } w_L < w_L^r \end{cases} \tag{2.21}$$

**Proposition 1 (Diamond Paradox):** *At the Nash equilibrium, all firms set the following wage:*

$$w_L^* = w_L^r$$

and thus  $F(w_L)$  is degenerate to one point  $w_L^* = w_L^r$ .

**Proof:** See the Appendix A.

This means that  $w_L^* = w_L^r$  is a mass point and the wage distribution is degenerate to one point  $w_L^* = w_L^r$ . This result is due to the fact that  $l(w_L)$  is independent of  $w_L$ . This is the so-called Diamond paradox (Diamond, 1971).

### 2.3. Steady-state equilibrium

In equilibrium, since all firms set  $w_L^* = w_L^r$ , we have:

$$\int_{w_L^r}^{+\infty} (w_L - w_L^r) dF(w_L) = 0$$

and thus the reservation rule (2.15) is equivalent to:

$$w_L^* = w_L^r = w_U + (1 - s)\tau N(1 - u) \quad (2.22)$$

By using (2.16), we have:

$$w_L^* = w_L^r = w_U + (1 - s)\tau N \left( 1 - \frac{\delta}{\delta + sa_U [1 - F(w_L^r)]} \right)$$

and since  $1 - F(w_L^r) = 1$ , we finally obtain the equilibrium wage of all workers:

$$w_L^* = w_L^r = w_U + (1 - s)\tau N \left( \frac{sa_U}{\delta + sa_U} \right) \quad (2.23)$$

The unemployment benefit  $w_U$ , is the only labor-market part of the wage. The equilibrium wage  $w_L^*$  increases with  $w_U$  because  $rI_U$  increases and thus workers are more demanding and increase their reservation wage. This is what is obtained in the nonspatial search model. The spatial part of the wage,  $(1 - s)\tau N(sa_U/(\delta + sa_U))$ , is what firms must give to workers to compensate for the spatial cost difference between employed and unemployed workers. This spatial compensation is calculated at  $x = L = N(sa_U/(\delta + sa_U))$ , i.e. when the land rent of employed and unemployed workers is the same. In particular, if  $a_U$  increases or  $\delta$  decreases, then wages increase because the spatial cost difference between employed and unemployed workers increases since employed workers are on average further away from jobs. Observe that

$$\frac{\partial w_L^*}{\partial s} \equiv 0 \Leftrightarrow s \equiv \frac{1}{2}$$

Indeed, there are two opposite effects of an increase of  $s$  on the wage  $w_L^*$ . On the one hand, increasing  $s$  reduces the spatial compensation since the spatial cost difference between employed and unemployed workers is smaller. On the other hand, it increases the chance of obtaining a job and thus the employment rate, which, in turn, increases

the distance to jobs for the employed worker located at  $x = L$ . This raises the spatial compensation and thus the wage.

For the model to make sense, we assume that  $y > w_L^*$  so that firms do not make negative profits. This is equivalent to:

$$y - w_U > (1 - s)\tau N \left( \frac{sa_U}{\delta + sa_U} \right) \tag{2.24}$$

**Proposition 2:** Assume (2.24). Then, there is a unique steady-state equilibrium  $(w_L^*, w_L^*, F^*(w_L), \Pi^*, u^*, W_U^*, W_L^*, R^*(x))$ , where  $w_L^{r*} = w_L^*$  is defined by (2.23),  $F^*(w_L)$  is degenerate to one point  $w_L^*$ ,

$$\Pi^* = \frac{sa_U N}{\delta + sa_U} \left[ y - w_U - (1 - s)\tau N \left( \frac{sa_U}{\delta + sa_U} \right) \right] \tag{2.25}$$

$$u^* = \frac{\delta}{\delta + sa_U} \tag{2.26}$$

$$W_U^* = w_U - s\tau N = W_L^* \tag{2.27}$$

and

$$R^*(x) = \begin{cases} \tau(sN - x) + (1 - s)\tau N \left( \frac{sa_U}{\delta + sa_U} \right) & \text{for } 0 \leq x \leq L \\ s\tau(N - x) & \text{for } L < x \leq N \\ 0 & \text{for } x > N \end{cases} \tag{2.28}$$

Observe that all workers participate to the labor market because they all search for a job and all accept it if offered. Also, not surprisingly,  $W_U^* = W_L^*$  and  $I_L^* = I_U^*$ .

### 2.4. Interaction between land and labor markets

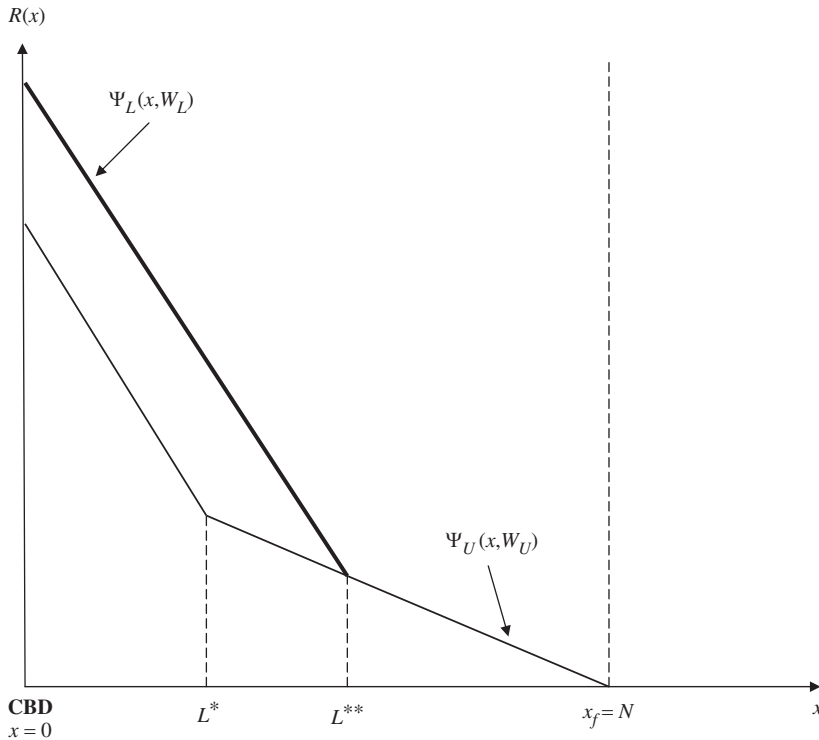
Let us derive some comparative statics results. First, by differentiating (2.25), we have:

$$\Pi^* = \Pi \left( \underset{+}{y}, \underset{-}{w_U}, \underset{+}{a_U}, \underset{-}{\delta}, \underset{?}{s}, \underset{-}{\tau}, \underset{-}{N} \right)$$

Not surprisingly, when  $y$ , the productivity of workers, increases, firms' profits increase. The effects of  $w_U$ ,  $s$ ,  $\tau$  and  $N$  only go through the wage  $w_L^*$  and thus when they increase  $w_L^*$ , firms' profits are reduced. The ambiguity of  $s$  stems from the ambiguity of the effect of  $s$  on  $w_L^*$  mentioned above. On the other hand,  $a_U$  and  $\delta$  affect both the employment in the firm  $l(w_L)$  and the wage  $w_L^*$ . As a result, when  $a_U$  increases or  $\delta$  decreases, then both the employment  $l(w_L)$  and the wage  $w_L^*$  increase, and thus the effect on profits is ambiguous. However, if the productivity  $y$  is high enough, then the first effect dominates the second one, and the net impact is positive.

Second, by differentiating the equilibrium land rent (2.28), for the employed workers, i.e. for  $x \in [0, L]$ , we obtain:

$$R_L^* = R \left( \underset{-}{x}, \underset{+}{a_U}, \underset{-}{\delta}, \underset{+}{s}, \underset{+}{\tau}, \underset{+}{N} \right)$$



**Figure 1.** Impact of an increase in  $a_U$  or a decrease in  $\delta$  on the equilibrium land rent.

These results are mainly due to the competition on the land market. Indeed, when  $a_U$  increases or  $\delta$  decreases, then the employment level  $N(1 - u^*)$  in the economy increases, which means that employed workers are on average further away from jobs. The access to the job center becomes more valuable, which increases the competition in the land market since employed workers bear higher commuting costs than the unemployed workers. As a result, housing prices increase in locations between  $x = 0$  and  $x = L$  but not in the unemployment area, i.e. for  $x \in [L, N]$ . Figure 1 illustrates this effect. Before the shock (i.e. increase in  $a_U$  or decrease in  $\delta$ ), the land rent is given by the ‘normal’ line while after, it is described by the thick line. The equilibrium values with one and two stars correspond, respectively, to before and after the shock. Finally, an increase in  $\tau$ ,  $s$  or  $N$ , increases the competition in the land market because it becomes more costly to travel to the job center and therefore housing prices increase.

### 3. Ex ante heterogeneous workers

Following Albrecht and Axell (1984) and Gaumont et al. (2006), we now assume that there are two types of individuals in the economy who differ according to the value imputed to leisure. This assumption ensures that there can be at most two wages offered in equilibrium. Individuals are denoted by superscript  $i = 0, 1$ . Because the first individual is assumed to value more leisure than the other individual, we have:

$$s^1 > s^0 \tag{3.1}$$

The mass of type 0 individuals is  $N^0$  and the mass of type 1 individuals is  $N^1$ , with

$$N = N^0 + N^1$$

and  $N^i = U^i + L^i$ . Thus,

$$L^i = N^i - U^i = (1 - u^i)N^i \tag{3.2}$$

where  $u^i = U^i/N^i$  is the unemployment rate of type  $i$  workers.

### 3.1. Urban land-use equilibrium

In equilibrium, there will be four types of workers: the unemployed workers of types 0 and 1, with search intensities  $s^0$  and  $s^1$ , and the employed workers earning a wage  $w_L^1$  and  $w_L^0$ , with  $w_L^1 > w_L^0$  (this will be shown below). As we will also see below, in equilibrium, workers of both types 0 and 1 can earn the high wage  $w_L^1$  whereas only workers of type 0 can earn the low wage  $w_L^0$ . As the result, for employed workers, types do not always correspond to wages. We now relax the assumption of housing consumption equal to 1 for all workers and assume on the contrary that

$$h_L^1 > h_L^0 > h_U = 1 \tag{3.3}$$

where  $h_L^i$  is the housing consumption of an employed worker earning a wage  $w_L^i$  and  $h_U$  is the housing consumption of an unemployed worker. Even though it can be confusing to use the same notation  $i$  for workers' types and workers' wages, we keep it to avoid too many notations. Assumption (3.3) reflects the fact that richer workers consume more land, which is a well-documented fact (see e.g. Glaeser et al., 2008). Observe that, because the unemployed have the same revenue  $w_U$ , then they all consume the same amount of land  $h_U$ . As above, we can write the *instantaneous* (indirect) utility functions of an employed worker earning a wage  $w_L^i$  and a type  $i$  unemployed worker located at a distance  $x$  from the BD as:

$$W_L^i(x) = w_L^i - \tau x - h_L^i R(x)$$

$$W_U^i(x) = w_U - s^i \tau x - R(x)$$

Observe that the type  $i = 0, 1$  of a worker plays a role only when they are unemployed since it determines  $s^i$ . The type  $i$  is however irrelevant when they are employed since what matters is only the wage. As a result, in  $W_U^i(x)$ , the superscript  $i$  indicates the type of workers, while in  $W_L^i(x)$ , it represents the type of wage a worker earns. As we will see below, this will not be true for the *intertemporal* utilities since someone employed has to take into account the fact that he/she may be unemployed in the future and thus his/her type will matter even when employed. This is why there are four different instantaneous utilities but five different intertemporal utilities. Let us now determine the bid rents of the employed and unemployed workers. They are, respectively, given by:

$$\Psi_L^i(x, W_L) = \frac{w_L^i - \tau x - W_L^i}{h_L^i}$$

$$\Psi_U^i(x, W_U) = w_U - s^i \tau x - W_U^i$$

Depending on the assumptions we make, different types of urban equilibria can emerge. Because we want to be consistent with the previous section, we would like to focus on an equilibrium where the employed workers reside closer to jobs than the unemployed workers. For that, we assume

$$h_L^1 < \frac{1}{s^1} \quad (3.4)$$

which guarantees that, starting from the BD, we first locate the type 0 employed, then the type 1 employed, then the type 1 unemployed and finally, the type 0 unemployed.<sup>4</sup>

**Definition 2:** Assume (3.3) and (3.4). Then, an urban land-use equilibrium with ex ante heterogenous workers is a 5-tuple  $(W_L^{0*}, W_L^{1*}, W_U^{0*}, W_U^{1*}, R^*(x))$  such that:

$$\Psi_U^0(N, W_U^{0*}) = R_A = 0$$

$$\Psi_U^0(N - U^0, W_U^{0*}) = \Psi_U^1(N - U^0, W_U^{1*})$$

$$\Psi_U^1(L, W_U^{1*}) = \Psi_L^1(L, W_L^{1*})$$

$$\Psi_L^1(L^0, W_L^{1*}) = \Psi_L^0(L^0, W_L^{0*})$$

$$R^*(x) = \max\{\Psi_U^0(x, W_U^{0*}), \Psi_U^1(x, W_U^{1*}), \Psi_L(x, W_L^*), 0\} \quad \text{at each } x \in (0, N]$$

The interpretation of the equilibrium conditions are similar to the ones given in Definition 1, the only difference being that there are now three borders to be considered. Since  $U^0 = u^0 N^0$ ,  $L^0 = (1 - u^0) N^0$  and  $L = N - u^0 N^0 - u^1 N^1$ , solving these equations leads to:

$$W_U^{0*} = w_U - s^0 \tau N \quad (3.5)$$

$$W_U^{1*} = w_U - s^1 \tau N + (s^1 - s^0) \tau u^0 N^0 \quad (3.6)$$

$$W_L^{1*} = w_L^1 - \tau N + (1 - h_L^1 s^0) \tau u^0 N^0 + (1 - h_L^1 s^1) \tau u^1 N^1 \quad (3.7)$$

$$W_L^0 = w_L^0 - \tau \left( N^0 + \frac{h_L^0}{h_L^1} N^1 \right) + \tau u^0 N^0 (1 - s^0 h_L^0) + (1 - h_L^1 s^1) \frac{h_L^0}{h_L^1} \tau u^1 N^1 \quad (3.8)$$

4 If, on the contrary, we had assumed

$$h_L^0 > \frac{1}{s^0}$$

then we would have had an urban configuration where all the unemployed workers reside close to jobs while the employed workers live farther away from the BD.

$$R^*(x) = \begin{cases} \tau \left( \frac{N^1}{h_L^1} + \frac{N^0-x}{h_L^0} \right) - \tau u^0 N^0 \left( \frac{1}{h_L^0} - s^0 \right) \\ - \left( \frac{1}{h_L^1} - s^1 \right) \tau u^1 N^1 & \text{for } 0 \leq x \leq L^0 \\ \tau \left( \frac{N-x}{h_L^1} \right) - \left( \frac{1}{h_L^1} - s^0 \right) \tau u^0 N^0 \\ - \left( \frac{1}{h_L^1} - s^1 \right) \tau u^1 N^1 & \text{for } L^0 < x \leq L \\ s^1 \tau (N-x) - (s^1 - s^0) \tau u^0 N^0 & \text{for } L < x \leq N - U^0 \\ s^0 \tau (N-x) & \text{for } N - U^0 < x \leq N \\ 0 & \text{for } x > N \end{cases} \quad (3.9)$$

The effects are here more complicated than for the homogenous case but the intuition remains the same. Indeed, the interaction between the land and the labor market is done through the wages  $w_L^0$  and  $w_L^1$  and the unemployment rates  $u^0$  and  $u^1$ . Here also, an increase in  $u^0$  and/or  $u^1$  increase the workers' utility but decrease the equilibrium land rent.

### 3.2. Labor-market equilibrium

Firms post wages. Let  $\theta \in [0,1]$  be the fraction of firms posting the high wage  $w_L^1$  and thus  $1-\theta$  the fraction posting the low wage  $w_L^0$ . As in the previous section, given any distribution of posted wages  $F(w_L)$ , each worker of type  $i$  will have a reservation wage  $w_L^{r,i}$  such that he/she accepts a job if  $w_L \geq w_L^{r,i}$  and rejects it if  $w_L < w_L^{r,i}$ , with  $w_L^{r,1} > w_L^{r,0}$ . It should also be clear that, in equilibrium, no firm will post anything other than the reservation wage of workers, as a firm posting  $w_L \in (w_L^{r,0}, w_L^{r,1})$  could reduce  $w_L$  down to  $w_L^{r,0}$  and make more profit per worker without changing the set of workers who accept. This was the same argument made in the proof of Proposition.

#### 3.2.1. Unemployed workers

Since we already know that the only two posted wages are  $w_L^{r,1}$  and  $w_L^{r,0}$ , the relevant steady-state Bellman equations for the unemployed workers are given by:

$$\begin{aligned} rI_U^0 &= W_U^{0*} + s^0 a_U (1 - \theta) (I_L^{0,0} - I_U^0) + s^0 a_U \theta (I_L^{0,1} - I_U^0) \\ rI_U^1 &= W_U^{1*} + s^1 a_U \theta (I_L^{1,1} - I_U^1) \end{aligned}$$

where  $I_U^i$  is the value function of an unemployed worker of type  $i = 0,1$ , while  $I_L^{i,j}$  is the value function of an employed worker of type  $i = 0,1$  and earning a wage  $j = 0,1$ , where the superscript  $j$  corresponds to a wage  $w_L^{r,j}$ .

We will now proceed as follows. We assume that  $w_L^{r,1} > w_L^{r,0}$  and we will then find a condition that validates this assumption (see Proposition 3). As a result, a value function  $I_L^{1,0}$  cannot exist since a type 1 worker will always refuse a job offer with a wage  $w_L^{r,0}$ . Indeed, type 1 workers accept the high wage  $w_L^{r,1}$  but not the low wage  $w_L^{r,0}$ , while type 0 workers accept both wage offers. Since the reservation rule property implies that

$$I_L^{0,0} = I_U^0 \quad (3.10)$$

and

$$I_L^{1,1} = I_U^1 \quad (3.11)$$

the Bellman equations can be written as

$$rI_U^0 = W_U^{0*} + s^0 a_U \theta (I_L^{0,1} - I_U^0) \quad (3.12)$$

$$rI_U^1 = W_U^{1*} \quad (3.13)$$

### 3.2.2. Employed workers

Similarly, the relevant steady-state Bellman equations for the employed workers are equal to:

$$rI_L^{0,0} = W_L^{0*} - \delta(I_L^{0,0} - I_U^0)$$

$$rI_L^{0,1} = W_L^{1*} - \delta(I_L^{0,1} - I_U^0)$$

$$rI_L^{1,1} = W_L^{1*} - \delta(I_L^{1,1} - I_U^1)$$

Using the reservation rules (3.10) and (3.11), these equations simplify to:

$$rI_L^{0,0} = W_L^{0*} \quad (3.14)$$

$$rI_L^{0,1} = W_L^{1*} - \delta(I_L^{0,1} - I_U^0) \quad (3.15)$$

$$rI_L^{1,1} = W_L^{1*} \quad (3.16)$$

### 3.2.3. Unemployment rate

At the steady state, the unemployment rates  $u^i = U^i/N^i$  are equal to:

$$u^0 = \frac{\delta}{\delta + s^0 a_U} \quad (3.17)$$

$$u^1 = \frac{\delta}{\delta + s^1 a_U \theta} \quad (3.18)$$

Indeed, workers of type 0 accept any job offer ( $w_L^{r0*}$  or  $w_L^{r1*}$ ), while workers of type 1 only accept high-wage jobs, which arrive at rate  $s^1 a_U \theta$ . As a result, the higher the fraction of firms posting the high wage, the lower the unemployment rate for type 1 workers.

### 3.2.4. Wages

We have the following result

**Proposition 3:** *The firms post the following wages:*

$$w_L^{r1*} = w_U + (1 - s^1) \tau N + [s^1 - s^0 - (1 - h_L^1 s^0)] \tau u^0 N^0 - (1 - h_L^1 s^1) \tau u^1 N^1 \quad (3.19)$$

$$w_L^{r0*} = w_U + \tau \left( N^0 + \frac{h_L^0}{h_L^1} N^1 \right) - \left( \frac{r + \delta + s^1 a_U \theta}{r + \delta + s^0 a_U \theta} \right) s^0 \tau N - (1 - h_L^1 s^1) \frac{h_L^0}{h_L^1} \tau u^1 N^1 \quad (3.20)$$

$$+ \left[ \frac{s^0 a_U \theta (s^1 - s^0 - (1 - s^0 h_L^0)) - (1 - s^0 h_L^0) (r + \delta)}{r + \delta + s^0 a_U \theta} \right] \tau u^0 N^0$$

Moreover, if

$$1 + \frac{s^0(h_L^1 - h_L^0)}{(s^1 - s^0)} > \frac{N}{N^0} \frac{(\delta + s^0 a_U)}{\delta} \tag{3.21}$$

holds, then  $w_L^{r1*} > w_L^{r0*}$ .

**Proof:** See the Appendix A.

This proposition confirms that  $w_L^{r1*} > w_L^{r0*}$ , which is not always true since there is a short-run *cost* (higher commuting costs) and a long-run *gain* (higher contact rate with firms) of providing search effort. Inequality (3.21) is a sufficient condition that involves only parameters and guarantees that  $w_L^{r1*} > w_L^{r0*}$ . As can be seen in the Appendix A, the high wage  $w_L^{r1*}$  is determined by (A.1), i.e.  $W_L^{1*} = W_U^{1*}$  while the low wage  $w_L^{r0*}$  by (A.2), i.e.

$$W_L^{0*} = \frac{(r + \delta)W_U^{0*} + s^0 a_U \theta W_L^{1*}}{r + \delta + s^0 a_U \theta}$$

These two conditions are roughly equivalent to the ones obtained in the nonspatial case where wages and unemployment benefits are involved instead of utilities (see Gaumont et al., 2006, p. 834). What is crucial here is the fact that the competition in the land market (through, e.g. the commuting costs) affect the wage determination. Furthermore, we have:

$$\frac{\partial w_L^{r1*}}{\partial \theta} = -(1 - h_L^1 s^1) \tau N^1 \frac{\partial u^1}{\partial \theta} > 0$$

Contrary to the nonspatial model, the high wage  $w_L^{r1*}$  depends on  $\theta$  because an increase in  $\theta$  affects negatively  $u^1$ , which affects the location of workers in city (the employed are closer to jobs), thus the competition in the land market and ultimately the wage. Furthermore, we have:

$$\frac{\partial w_L^{r0*}}{\partial \theta} = -\frac{(r + \delta)(s^1 - s^0)s^0 a_U \tau}{(r + \delta + s^0 a_U \theta)^2} (N - u^0 N^0) - (1 - h_L^1 s^1) \tau N^1 \frac{h_L^0}{h_L^1} \frac{\partial u^1}{\partial \theta} \cong 0$$

since  $\partial u^1 / \partial \theta < 0$ . A similar effect was present in the nonspatial model, but it was always positive. Here, the mechanism is quite different since it goes through  $u^1$  and thus the competition in the land market, while in the nonspatial model, it was through the job contact rate  $s^0 a_U \theta$ .

### 3.2.5. Firms

Instead of following the approach of Albrecht and Axell (1984) as we did in the previous section, we now follow that of Gaumont et al. (2006) because it is simpler. Of course the two approaches are equivalent. Firms maximize steady-state profits. There are two types of firms  $i = 0, 1$ ; those offering the high wage  $w_L^{r1*}$  (type 1 firms) and those offering the low wage  $w_L^{r0*}$  (type 0 firms). The profit of a firm of type  $i$  is given by:

$$\Pi^i = \frac{a_F \rho^i}{r + \delta} (y - w_L^{ri*}) \tag{3.22}$$

where  $\rho^i$  is the probability that a random unemployed worker accepts a job offer at wage  $w_L^{r_i^*}$  and  $a_F$  is the exogenous rate at which a firm meets a worker. A job match is when these two events are realized, which occurs at rate  $a_F \rho^i$ .

For a type 1 firm posting the high wage  $w_L^{r_1^*}$ ,  $\rho^1 = 1$  since a job offer is never turned down. On the contrary, for a type 0 firm posting the high wage  $w_L^{r_0^*}$ ,

$$\rho^0 = \frac{u^0 N^0}{u^0 N^0 + u^1 N^1}$$

since a job offer is only accepted by unemployed workers of type 0. Using (3.17) and (3.18), this can be written as:

$$\rho^0 = \frac{(\delta + s^1 a_U \theta) N^0}{(\delta + s^1 a_U \theta) N^0 + (\delta + s^0 a_U) N^1} \tag{3.23}$$

In order to avoid the Diamond paradox (Proposition 1), i.e. only the lowest wage is posted in equilibrium, one needs to write a condition that guarantees that both wages  $w_L^{r_0^*}$  and  $w_L^{r_1^*}$  coexist in equilibrium. For that, it has to be that, in equilibrium, firms are indifferent between posting  $w_L^{r_0^*}$  and  $w_L^{r_1^*}$ , otherwise the two wages cannot coexist together. This is an iso-profit condition. Let us thus calculate the profits  $\Pi^0$  and  $\Pi^1$ .

Plugging  $\rho^1 = 1$  and (3.23) into (3.22), we obtain:

$$\Pi^0 = \frac{a_F}{r + \delta} \frac{(\delta + s^1 a_U \theta) N^0}{(\delta + s^1 a_U \theta) N^0 + (\delta + s^0 a_U) N^1} (y - w_L^{r_0^*}) \tag{3.24}$$

$$\Pi^1 = \frac{a_F}{r + \delta} (y - w_L^{r_1^*}) \tag{3.25}$$

where the wages  $w_L^{r_1^*}$  and  $w_L^{r_0^*}$  are given by (3.19) and (3.20), respectively. The iso-profit condition is thus  $\Pi^1 = \Pi^0$ , which is equivalent to:

$$\theta^* = \left( \frac{\delta + s^0 a_U}{s^1 a_U} \right) \frac{N^1}{N^0} \left( \frac{y - w_L^{r_1^*}}{w_L^{r_1^*} - w_L^{r_0^*}} \right) - \frac{\delta}{s^1 a_U} \tag{3.26}$$

Observe that  $\theta$  enters in  $w_L^{r_0^*}$  and  $w_L^{r_1^*}$  through  $u^1$ . We have the following result:

**Proposition 4:** *The sufficient conditions for a nondegenerate labor-market equilibrium (i.e.  $0 < \theta^* < 1$ ) to exist and to be unique are  $\underline{y} < y < \bar{y}$ , where  $\underline{y}$  and  $\bar{y}$  are, respectively, defined by (A.6) and (A.7) in the Appendix A.*

**Proof:** See the Appendix A.

Even if the conditions are much more complicated than for the nonspatial model, the intuition remains the same. The productivity  $y$  has to be large enough to prevent that all firms pay the lowest wage  $w_L^{r_0^*}$  and low enough to prevent that all firms pay the highest wage  $w_L^{r_1^*}$ . In other words, to obtain wage dispersion, the productivity  $y$  has to have intermediate values that belong to  $(\underline{y}, \bar{y})$ .

The steady-state general equilibrium is then easy to calculate. We assume (3.1), (3.3), (3.4), (3.21), and  $\underline{y} < y < \bar{y}$ . The value of  $\theta^*$  is given by (A.4) in the Appendix A. Then, plugging this value in (3.23) and (3.18), we obtain, respectively  $\rho^{0*}$ , the equilibrium probability a random unemployed worker accepts a job offer at wage  $w_L^{r_0^*}$  and the

equilibrium unemployment rate  $u^{1*}$  [the other unemployment rate  $u^{0*}$  is only function of parameters and determined by (3.17)]. By plugging these values of unemployment rates  $u^{0*}$  and  $u^{1*}$  and the value of  $\theta^*$  in (3.20) and (3.19), we obtain the wages  $w_L^{r0*}$  and  $w_L^{r1*}$ . Furthermore, by plugging these values of the wages  $w_L^{r0*}$  and  $w_L^{r1*}$  and the value of  $\theta^*$  in (3.24) and (3.25), we obtain firms' equilibrium profits  $\Pi^{0*}$  and  $\Pi^{1*}$ . Finally, using the values of the wages and the unemployment rates in (3.5–3.9), we obtain the equilibrium utilities  $W_U^{0*}$ ,  $W_U^{1*}$ ,  $W_L^{0*}$ ,  $W_L^{1*}$  and the equilibrium land rent  $R^*(x)$ .

### 3.3. Numerical simulations

We would now like to run some numerical simulations of the model. It seems quite natural to interpret types 0 and 1 workers as black and white workers, respectively. Indeed, it is assumed that all workers are *ex ante* identical (same productivity, same unemployment benefit, etc.) with one difference: search intensities are higher for whites than for blacks, i.e.  $s^1 > s^0$ . This is a well-documented fact [see, e.g. Patacchini and Zenou (2005) for the UK, and Holzer et al. (1994), and Johnson, (2006), for the USA]. In our model, search intensities also capture commuting cost differences since unemployed workers mainly search by commuting to the BD. In this interpretation, when there are unemployed, whites have higher pecuniary commuting costs per unit of distance than blacks since  $s^1\tau > s^0\tau$ . Observe that we have considered an equilibrium where type 0 unemployed workers are very far away from jobs. In most American cities, it is indeed the case that poor (unemployed) black workers reside in inner cities located far away from jobs.

The unit time is one-quarter of a year. The interest rate is set at  $r=0.01$ , which reflects the US historical annual rate of 4%. The job destruction rate is set at  $\delta=0.055$  (implying an average duration of employment of 4 years and 2 months) to match with the sample average for the quarterly job destruction rate of 5.5% (Davis and Haltiwanger, 1992). We set the job-contact rate at  $a_U=4.75$ , implying on average a contact with a firm every 19 days. As in the 1990 US census, the fraction of black workers is set at 13%, i.e.  $N^0/N=0.13$  (see e.g. McCall, 2001). The firms' contact rate  $a_F=1.5$ , which is a consistent with an average vacancy duration of 60 days reported in Van Ours and Ridder (1992).

We would like to match the 1990 census unemployment rates for blacks and whites, which are equal to  $u^{0*}=12.6\%$  (Black or African American) and  $u^{1*}=5.3\%$  (White), respectively. To match these unemployment rates, we have seven parameters: the unemployment benefit  $w_U$ , productivity  $y$ , commuting costs  $\tau$ , search efforts of black and white workers, i.e.  $s^0$  and  $s^1$  and housing consumption of black and white workers, i.e.  $h_L^0$  and  $h_L^1$ . These parameters have to respect the conditions imposed by the model that is (3.1), (3.3) and (3.4). Table 1 summarizes the different values given to the variables.

#### 3.3.1. Steady-state equilibrium

Let us calculate the steady-state equilibrium for these parameters values. The numerical results of the equilibrium are displayed in Table 2.

As can be seen in Table 2, we obtain values of unemployment rates of white and black workers (i.e. 5.3% and 12.6%, respectively) that match the 1990 US census. Concerning wages, there is no much difference between blacks and whites

**Table 1.** Parameter values

$y = 1.05044$ Productivity	$\tau = 0.01$ Pure discount rate
$w_U = 0.32$ Unemployment benefit	$\delta = 0.055$ Job-destruction rate
$a_F = 1.5$ Firms' job contact rate	$a_U = 4.75$ Workers' job contact rate
$N^0/N = 13\%$ Percentage of blacks (type 0)	$N^1/N = 87\%$ Percentage of whites (type 1)
$\tau = 0.1$ Pecuniary commuting cost	
$s^0 = 0.08$ Search effort of blacks (type 0)	$s^1 = 0.24$ Search effort of whites (type 1)
$h_L^0 = 1.1$ Housing consumption of blacks (type 0)	$h_L^1 = 1.2$ Housing consumption of whites (type 1)

**Table 2.** Steady-state equilibrium

$\theta^*$ (%)	86.00
$u^{0*}$ (%)	12.64
$u^{1*}$ (%)	5.31
$w_L^{0r*}$	0.99
$w_L^{1r*}$	1.03
$\rho^{0*}$ (%)	26.24
$W_U^{0*}(I_U^{0*})$	0.24 (10.87)
$W_U^{1*}(I_U^{1*})$	0.083 (8.26)
$W_L^{0*}(I_L^{0,0*}, I_L^{0,1*})$	0.109 (10.87; 10.47)
$W_L^{1*}(I_L^{1,1*})$	0.083 (8.26)
$\Pi^* = \Pi^0 = \Pi^1$	0.36

( $w^{r1*}/w^{r0*} = 1.04$ ), which is roughly what is observed for low-skilled workers in the USA (Jaynes, 1990; Grodsky and Pager, 2001). Furthermore, in equilibrium, 86% of firms post the high wage  $w_L^{1r*}$ , which is again consistent with the data since it implies that there are 86% of firms employing white workers in this economy.

Moreover, the arrival rates for type 0 (black) and type 1 (white) workers are, respectively, given by  $s^0 a_U = 0.38$  and  $s^1 a_U \theta = 0.98$ , which imply that the average duration of unemployment is  $7\frac{1}{2}$  months for blacks and 3 months for whites. Furthermore,  $\rho^{0*}$ , the probability that a random unemployed worker accepts a job offer at wage  $w_L^{r0*}$ , is equal to 26.24%. This means that the firms that post the high wage will transform a contact into a match with probability 1 while this will be true only in 26.24% of the time for firms posting the low wage since type 1 workers will always refuse such an offer. Since each firm has a contact with a worker every 20 days (i.e.  $a_F = 1.5$ ), this also means that, on average, a match occurs every month for firms posting the low wage. Table 2 also gives the different utilities (both instantaneous and intertemporal) and one can see that, because of a fiercer competition in the land market for employed workers, their utilities are not always higher than that of the unemployed workers. Finally, Figure 2 illustrates Proposition 4 by showing that, for low values of the productivity  $y$  (i.e.  $\underline{y} \simeq 0.6$ ),  $\theta^* \approx 0$  while for high values of  $y$  (i.e.  $\bar{y} \simeq 1$ ),  $\theta^* \geq 1$ .

### 3.3.2. Interaction between land and labor markets

We would like to pursue our analysis by investigating the interaction between land and labor markets. For that, let us study the impact of a key labor-market variable,  $y$ ,

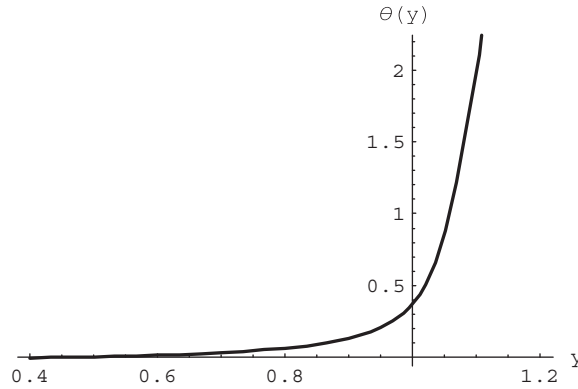


Figure 2. Impact of the productivity  $y$  on  $\theta$ .

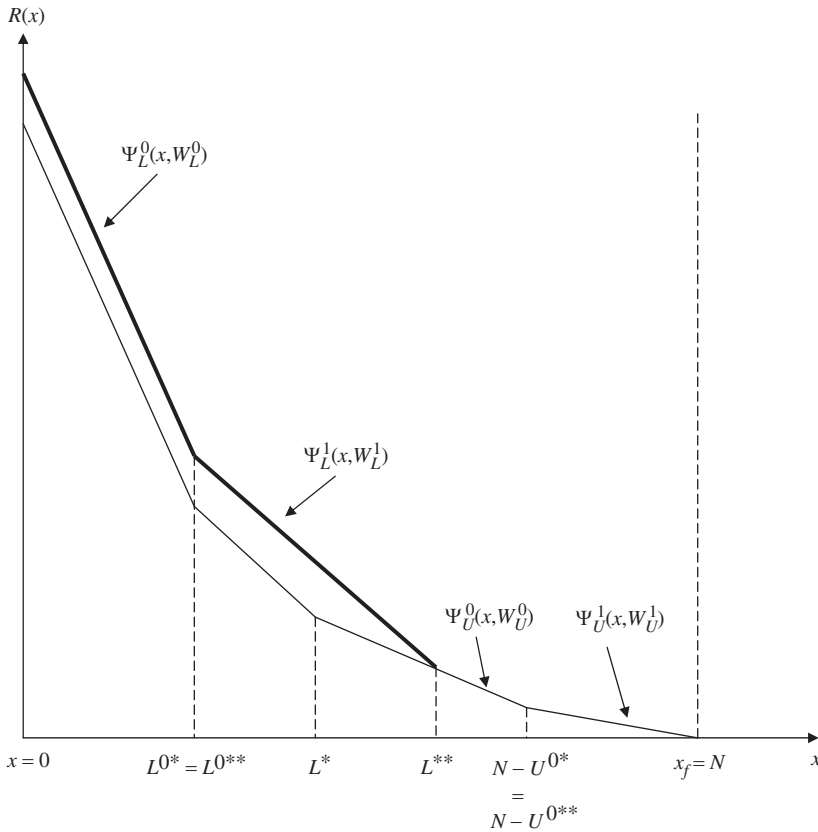


Figure 3. Impact of an increase in the productivity  $y$  on the equilibrium land rent.

on the equilibrium land price  $R^*(x)$ . Figure 3 displays the result (the variables with one and two stars are, respectively, the equilibrium values before and after a change in  $y$ ; the normal and thick lines correspond, respectively, to before and after the increase of  $y$ ). Remember that  $L^i$  is the area in the city where the employed workers earning  $w_L^{ir*}$  reside

while  $U^i$  is the area in the city where type  $i$  unemployed workers live. Looking at (3.9), an increase in  $y$  affects the bid rents and thus the competition in the land market only through  $u^1$ . In particular,  $y$  affects negatively  $u^1$  since the latter is a negative function of  $\theta$ , which is itself a positive function of  $y$ . So when  $y$  increases, the areas  $L^0 = (1 - u^0)N^0$  and  $U^0 = u^0N^0$  are not affected while  $L^1 = (1 - u^1)N^1$  expands and  $U^1 = u^1N^1$  shrinks (Figure 3). This is due to the fact that only the bid rents of the employed workers are affected by a change in  $y$ , and this effect is positive. Indeed, by differentiating (3.9), at a given  $x$ , one obtain:

$$\frac{\partial R_{L^0}^*(x)}{\partial y} = \frac{\partial R_{L^1}^*(x)}{\partial y} = -\left(\frac{1}{h_L^1} - s^1\right) \tau N^1 \frac{\partial u^1}{\partial \theta} \frac{\partial \theta}{\partial y} > 0$$

and

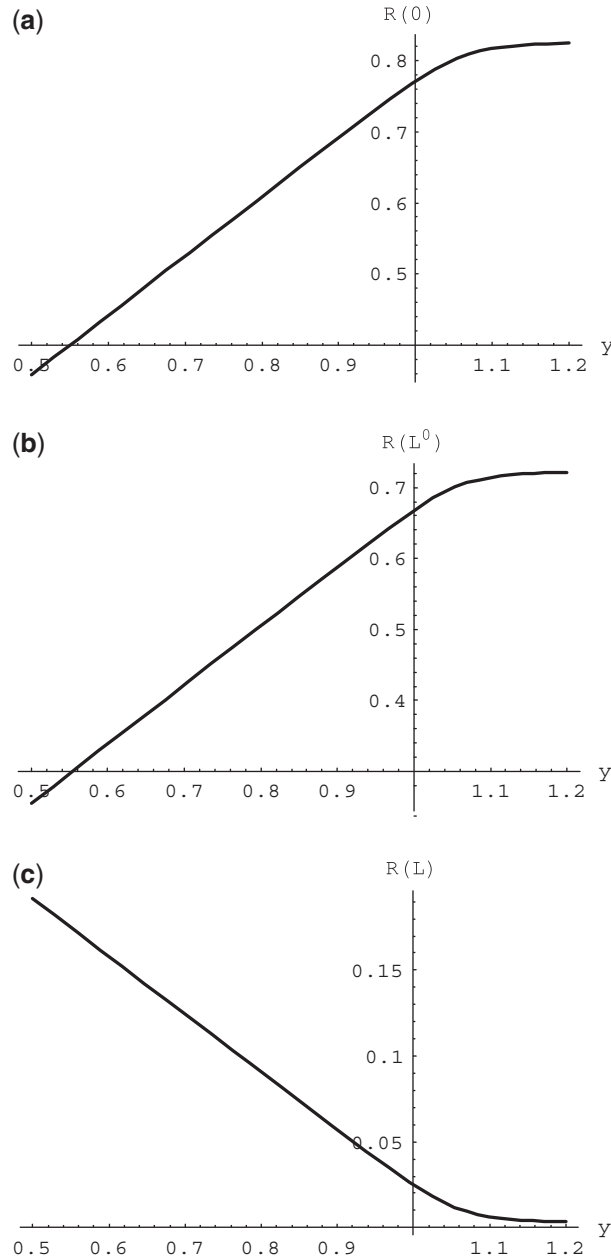
$$\frac{\partial R_{U^0}^*(x)}{\partial y} = \frac{\partial R_{U^1}^*(x)}{\partial y} = 0$$

where  $R_{L^i}^*(x)$  and  $R_{U^i}^*(x)$  are the equilibrium land rents at a distance  $x$  for the employed workers earning  $w_L^{ir*}$  and type  $i$  unemployed workers, respectively.

To better understand this result, Figures 4(a–c) display the impact of  $y$  on the land rent at  $x=0$ ,  $x=L^0$  and  $x=L$ , respectively. In these figures, one can see that the relationship is positive for  $R^*(0)$  and  $R^*(L^0)$  but negative for  $R^*(L)$ . Indeed, as stated above, when  $y$  increases, the employee's bid rents increase because the competition in the land market is fiercer due to the fact that the unemployment rate  $u^1$  decreases. So at  $x=0$  and at  $x=L^0$  land rents increase because the bid rents of workers earning both  $w_L^{0r*}$  and  $w_L^{1r*}$  increase and these locations are not affected by a change in  $y$  (Figure 3). Now, when  $y$  increases,  $\Psi_L^1(x, W_L)$ , the bid rent of workers with high wages, increases, while  $\Psi_L^0(x, W_L)$ , the bid rent of type 0 unemployed workers, is not affected. As a result, the location  $x=L$  shifts rightward (from  $L^*$  to  $L^{**}$ ), which makes the competition in the land market less fierce and thus the land price decreases. This is an interesting effect of workers' productivity on housing prices. Similar results can be obtained with other labor-market variables such as, for example, the job-destruction rate  $\delta$ , which affects the equilibrium land rent only indirectly through  $u^1$ .

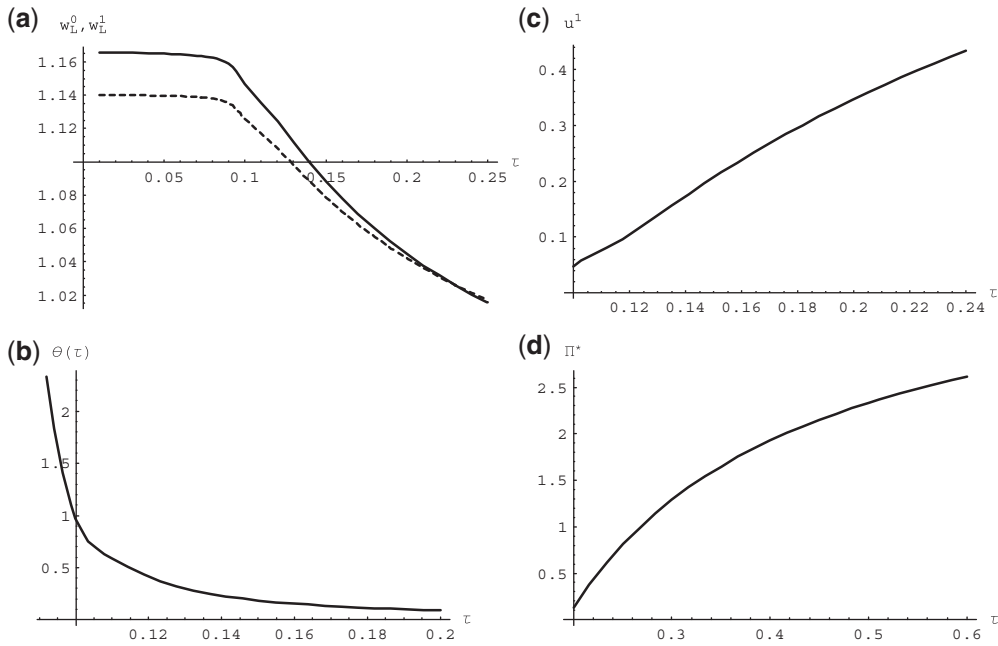
### 3.3.3. Policy implications

Let us analyze some policy implications of the model. It has often been advocated that reducing commuting costs could be an efficient tool to improve the labor-market outcomes of black workers in the USA (see, in particular, Pugh, 1998). In the context of our model, we examine the impact of a reduction of the commuting cost  $\tau$  on the equilibrium labor market variables,  $w_L^{0r*}$ ,  $w_L^{1r*}$ ,  $\theta^*$ ,  $u^{1*}$  and  $\Pi^*$ . The effects are complex since  $\tau$  not only directly affects the land market through the land rent and the instantaneous utilities but also indirectly affects the labor market through the wages. Let us better understand these effects. By differentiating Equations (3.5–3.8), one can see that an increase in  $\tau$ , decreases the utilities of the unemployed workers of both types (i.e.  $W_U^0$  and  $W_U^1$ ) but has an ambiguous effect on the utilities of the employed workers. Indeed, when  $\tau$  increases, the competition in the land market increases, so all workers pay higher housing prices and thus their utilities decrease. This is the direct effect. There is, however, an indirect effect that goes through  $u^1$ , since the latter is



**Figure 4.** Impact of the productivity  $y$  on the land rent at (a)  $x=0$ , (b)  $x=L^0$  and (c)  $x=L$ .

negatively affected by  $\theta$ , which itself is affected by  $\tau$ . So when  $\tau$  increases,  $u^1$  changes, which affects the location workers in the city, which, in turn, affects the competition in the land market and thus the utilities. The latter indirect effect is only true for the employed workers as can be seen in Equations (3.7) and (3.8).



**Figure 5.** Impact of the commuting cost  $\tau$  on (a) wages (solid line  $w_L^1$ , dash line  $w_L^0$ ) (b)  $\theta$ , (c) the unemployment rate  $u^1$  and (d) the profit  $\Pi^*$ .

Figure 5a displays the relationship between commuting costs and wages. Decreasing commuting costs increase the wage for both black and white workers. Take, for example,  $w_L^1 = w_L^{1r*}$ . By differentiating (3.19) with respect to  $\tau$ , one can see that, holding  $u^1$  constant, the relationship is positive. Indeed, as stated above, when  $\tau$  increases, at a given  $u^1$ , the competition in the land market becomes fiercer so that bid rents increase and thus all utilities decrease. Since  $w_L^{1r*}$  is determined by  $W_L^{1*} = W_U^{1*}$ , then because these two utilities decrease and only the first one is a function of  $w_L^{1r*}$ , then, following a raise in  $\tau$ , this wage has to increase for this equality to be true. Now, when we also take into account the fact that  $u^1$  is a positive function of  $\tau$  (this effect is indirect and goes through  $\theta$ ), the net effect is ambiguous. In the numerical example, the indirect negative effect is greater than the positive direct effect and thus the net effect is negative. The same intuition runs for the low wage  $w_L^0 = w_L^{0r*}$ .

Figure 5b–d displays the other comparative statics results. Not surprisingly, a reduction in the commuting cost  $\tau$  decreases  $\theta^*$ , the fraction of firms offering the high wage, but increases  $u^{1*}$ , the unemployment rate of white workers, and  $\Pi^*$ , firms' profit. The intuition of these results is similar to that of the wages since the effect goes through the land market. The crucial aspect here is the fact that the land market amplifies the effect of the labor market. Observe that, in our model, commuting costs do not affect blacks' unemployment rate because they accept any job offer ( $w_L^0$  or  $w_L^1$ ). As a result,  $\theta$  (the fraction of firms posting the high wage  $w_L^1$ ), which is a function of commuting costs, does not affect blacks' unemployment rate.

#### 4. Extension: different commuting costs

In the previous section, workers were supposed to have heterogeneous utilities from leisure time, which was only reflected in their labor market search behavior but not in their commuting costs. It is well-documented that a large part of the cost of commuting is time cost. It seems therefore reasonable to now extend the model so that the commuting cost per unit of distance  $\tau$  is *not* constant across workers with differing time costs (opportunity costs to leisure). As a result, we now assume

$$s^1 > s^0 \text{ and } \tau^0 > \tau^1 \tag{4.1}$$

Let us start with the urban land-use equilibrium. As before, there will be four types of workers: the unemployed workers of types 0 and 1, with search intensities and commuting costs  $s^0, \tau^0$  and  $s^1, \tau^1$ , and the employed workers earning a wage  $w_L^1$  and  $w_L^0$ , with  $w_L^1 > w_L^0$ . As before, we assume (3.3). The ‘bid rents’ of the employed and unemployed workers can now be written as:

$$\Psi_L^i(x, W_L) = \frac{w_L^i - \tau^i x - W_L^i}{h_L^i}$$

$$\Psi_U^i(x, W_U) = w_U - s^i \tau^i x - W_U^i$$

Because we would like to focus on the same equilibrium as in the previous section, we assume

$$\frac{s^0 \tau^0}{\tau^1} < s^1 < \frac{1}{h_L^1} \tag{4.2}$$

which guarantees that, starting from the BD, we first locate the type 0 employed, then the type 1 employed, then the type 1 unemployed, and finally, the type 0 unemployed. Using Definition 2, we can solve this equilibrium and obtain the following equilibrium values for the different utility functions:

$$W_U^{0*} = w_U - s^0 \tau^0 N \tag{4.3}$$

$$W_U^{1*} = w_U - s^1 \tau^1 N + (s^1 \tau^1 - s^0 \tau^0) u^0 N^0 \tag{4.4}$$

$$W_L^1 = w_L^1 - \tau^1 N + (\tau^1 - \tau^0 h_L^1 s^0) u^0 N^0 + (1 - h_L^1 s^1) \tau^1 u^1 N^1 \tag{4.5}$$

$$W_L^0 = w_L^0 - \tau^0 L^0 - \tau^1 (N - L^0) \frac{h_L^0}{h_L^1} + \left( \frac{h_L^0}{h_L^1} \tau^1 - h_L^0 s^0 \tau^0 \right) u^0 N^0 + \left( \frac{h_L^0}{h_L^1} - h_L^0 s^1 \right) \tau^1 u^1 N^1 \tag{4.6}$$

Let us now focus on the labor-market equilibrium. Solving the model exactly as before, we obtain the following result:

**Proposition 5:** *The firms post the following wages:*

$$w_L^{r1*} = w_U + (1 - s^1) \tau^1 N - [(1 - s^1) \tau^1 + s^0 \tau^0 (1 - h_L^1)] u^0 N^0 - (1 - h_L^1 s^1) \tau^1 u^1 N^1$$

$$w_L^{r0*} = w_U + \tau^0 L^0 + \tau^1 (N - L^0) \frac{h_L^0}{h_L^1} - \frac{s^0 N [(r + \delta)\tau^0 + s^1 \tau^1 a_U \theta]}{r + \delta + s^0 a_U \theta} - (1 - h_L^1 s^1) \frac{h_L^0}{h_L^1} \tau^1 u^1 N^1$$

$$+ \left[ \frac{s^0 a_U \theta (s^0 \tau^0 + s^1 \tau^1) - (\tau^1 - h_L^1 s^0 \tau^0) (r + \delta + s^0 a_U \theta) \frac{h_L^0}{h_L^1}}{r + \delta + s^0 a_U \theta} \right] u^0 N^0$$

Moreover, if

$$\tau^1 N \left( \frac{h_L^1 - h_L^0}{h_L^1} \right) + \tau^1 L^0 \frac{h_L^0}{h_L^1} > \tau^0 L^0 + s^1 N$$

holds, then  $w_L^{r1*} > w_L^{r0*}$ .

Thus, even if the model becomes more complicated, all the results of the previous section are preserved.

## 5. Concluding remarks

In this article, we propose a search-urban model where firms post wages. We first develop a model where all workers are identical and show that there is a unique equilibrium wage even in the presence of search frictions. We investigate the interaction between land and labor markets and show, in particular, that higher unemployment rate increases the employed workers' utility but decreases the equilibrium housing price in the employment area. We then develop a model where there are two types of workers who differ according to the value imputed to leisure. We show that, under some conditions, two wages will emerge in equilibrium so that the Diamond paradox does not hold anymore. One interesting aspect of the results is to analyze how the two markets (land and labor) interact with each other. We show that the commuting cost  $\tau$  not only directly affects the land market through the land rent and the instantaneous utilities but also indirectly affects the labor market through the wages. Another interesting and testable result is the impact of workers' productivity on housing prices. The impact can be positive or negative depending on the location in the city.

This model can easily be generalized to  $K > 2$  types of workers where there will be  $K$  reservation wages  $w_L^{1*}, \dots, w_L^{K*}$ , and in equilibrium these are posted with probabilities  $\theta_1, \dots, \theta_K$  with  $\sum_{i=1}^K \theta_i$  (Gaumont et al., 2006). In our spatial model, this model will be very cumbersome to analyze since we will have to locate  $K$  types of workers in the city, but it is clearly possible. However, this will not add very much in terms of intuition of the results compared with the case when  $K = 2$ .

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## Appendix A

**Proof of Lemma 1:** Plugging (2.16) and (2.17) into (2.18) leads to

$$l(w_L) = \lim_{\varepsilon \rightarrow 0} \frac{\frac{F(w_L) - F(w_L^r)}{1 - F(w_L^r)} - \frac{F(w_L - \varepsilon) - F(w_L^r)}{1 - F(w_L^r)}}{F(w_L) - F(w_L - \varepsilon)} \frac{sa_U [1 - F(w_L^r)]}{\delta + sa_U [1 - F(w_L^r)]} N$$

Denote  $\lim_{\varepsilon \rightarrow 0} F(w_L - \varepsilon) = F(w_L^-)$ , then we have

$$\begin{aligned} l(w_L) &= \frac{\frac{F(w_L) - F(w_L^r)}{1 - F(w_L^r)} - \frac{F(w_L^-) - F(w_L^r)}{1 - F(w_L^r)}}{F(w_L) - F(w_L^-)} \frac{sa_U [1 - F(w_L^r)]}{\delta + sa_U [1 - F(w_L^r)]} N \\ &= \frac{\frac{F(w_L) - F(w_L^-)}{1 - F(w_L^r)}}{F(w_L) - F(w_L^-)} \frac{sa_U [1 - F(w_L^r)]}{\delta + sa_U [1 - F(w_L^r)]} N \\ &= \frac{sa_U N}{\delta + sa_U [1 - F(w_L^r)]} \end{aligned}$$

which is (2.19). ■

**Proof of Proposition 1:** The first order condition of (2.21) is:

$$\frac{\partial \Pi}{\partial w_L} = \frac{-sa_U N}{\delta + sa_U [1 - F(w_L^r)]} < 0$$

Thus, since the profit is decreasing in wages when  $w_L \geq w_L^r$ , firms will set the lowest possible wage, which is  $w_L^* = w_L^r$ . No deviation is profitable since a lower wage than  $w_L^r$  leads to a zero profit and a higher wage does not increase neither productivity nor  $l(w_L)$  but increase the cost of labor and thus leads to a lower profit. ■

**Proof of Proposition 3:** We will proceed as follows. We assume that  $w_L^1 > w_L^0$  and then will find a condition that validates this assumption. First, we calculate the wages  $w_L^1$  and  $w_L^0$ .

Solving (3.11) using (3.13) and (3.16) yields:

$$W_L^{1*} = W_U^{1*} \tag{A.1}$$

which using (3.6) and (3.7) leads to (3.19).

Observe now that using (3.15), we have:

$$I_U^{0,1} = \frac{W_L^{1*} + \delta I_U^0}{r + \delta}$$

Thus (3.12) can be written as:

$$\begin{aligned} rI_U^0 &= W_U^{0*} + s^0 a_U \theta [I_U^{0,1} - I_U^0] \\ &= W_U^{0*} + s^0 a_U \theta \left[ \frac{W_L^{1*} - rI_U^0}{r + \delta} \right] \end{aligned}$$

By solving this last equation in  $I_U^0$ , we obtain:

$$rI_U^0 = \frac{(r + \delta)W_U^{0*} + s^0 a_U \theta W_L^{1*}}{r + \delta + s^0 a_U \theta}$$

Using this last value, it is easy to verify that the reservation rule (3.10) is now given by:

$$W_L^{0*} = \frac{(r + \delta)W_U^{0*} + s^0 a_U \theta W_L^{1*}}{r + \delta + s^0 a_U \theta} \tag{A.2}$$

By solving (A.2) using (3.5), (3.7), (3.8) and (3.19), we obtain (3.20).

Let us now show that  $w_L^{1*} > w_L^{0*}$ . Using (3.19) and (3.20), this is equivalent to:

$$\begin{aligned} &(1 - s^1)\tau N + \left( \frac{r + \delta + s^1 a_U \theta}{r + \delta + s^0 a_U \theta} \right) s^0 \tau N - \tau \left( N^0 + \frac{h_L^0}{h_L^1} N^1 \right) \\ &+ \left[ s^0 (h_L^1 - h_L^0) + \frac{(s^1 - s^0)(r + \delta)}{r + \delta + s^0 a_U \theta} \right] \tau u^0 N^0 \\ &- \left( \frac{h_L^1 - h_L^0}{h_L^1} \right) (1 - h_L^1 s^1) \tau u^1 N^1 > 0 \end{aligned}$$

which can be written as

$$\begin{aligned} \tau N^1 \left( \frac{h_L^1 - h_L^0}{h_L^1} \right) - \tau N \frac{(r + \delta)(s^1 - s^0)}{r + \delta + s^0 a_U \theta} + \left[ s^0 (h_L^1 - h_L^0) + \frac{(s^1 - s^0)(r + \delta)}{r + \delta + s^0 a_U \theta} \right] \tau u^0 N^0 \\ - \left( \frac{h_L^1 - h_L^0}{h_L^1} \right) (1 - h_L^1 s^1) \tau u^1 N^1 > 0 \end{aligned}$$

After some rearrangements, we obtain:

$$\frac{N^1 \left( \frac{h_L^1 - h_L^0}{h_L^1} \right) [1 - (1 - h_L^1 s^1) u^1] (r + \delta + s^0 a_U \theta)}{(r + \delta)(s^1 - s^0)} + \frac{s^0 (h_L^1 - h_L^0) u^0 N^0 s^0 a_U \theta}{(r + \delta)(s^1 - s^0)} + \frac{s^0 (h_L^1 - h_L^0) u^0 N^0}{(s^1 - s^0)} + u^0 N^0 > N$$

Because  $1 - (1 - h_L^1 s^1) u^1 > 0$  (since the unemployment rate  $u^1 < 1$ ), a sufficient condition (that involves only parameters and thus no endogenous variables) for this inequality to be true is:

$$u^0 N^0 \left[ 1 + \frac{s^0 (h_L^1 - h_L^0)}{(s^1 - s^0)} \right] > N$$

Using (3.17), this can be written as:

$$\frac{\delta}{\delta + s^0 a_U} \left[ 1 + \frac{s^0 (h_L^1 - h_L^0)}{(s^1 - s^0)} \right] > \frac{N}{N^0}$$

which is equivalent to (3.21). ■

**Proof of Proposition 4:** Using the wages  $w_L^{r1*}$  and  $w_L^{r0*}$  defined by (3.19) and (3.20), respectively, and the unemployment rate  $u^1$ , defined by (3.18), we have:

$$\frac{y - w_L^{r1*}}{w_L^{r1*} - w_L^{r0*}} = \frac{X + y + \frac{(1 - h_L^1 s^1) \tau N^1 \delta}{\delta + s^1 a_U \theta}}{Z - \frac{\delta(1 - h_L^1 s^1)(h_L^1 - h_L^0) \tau N^1}{h_L^1 (\delta + s^1 a_U \theta)}} \tag{A.3}$$

where

$$\begin{aligned} X &\equiv [s^0(1 - h_L^1) + (1 - s^1)] \tau u^0 N^0 - (1 - s^1) \tau N - w_U \\ Z &\equiv \left[ (s^1 - s^0) \left( \frac{r + \delta}{r + \delta + s^0 a_U \theta} \right) + \left( 1 - \frac{h_L^0}{h_L^1} \right) (s^0 h_L^1 - 1) \right] \tau u^0 N^0 \\ &+ \left[ \frac{r + \delta + a_U s^1 \theta}{r + \delta + a_U s^0 \theta} s^0 - \left( 1 - s^1 + \frac{h_L^0}{h_L^1} \right) \right] \tau N - \left( 1 - \frac{h_L^0}{h_L^1} \right) (1 - u^0) \tau N^0 \end{aligned}$$

Plugging this value (A.3) into (3.26), we obtain:

$$\theta^* = \left( \frac{\delta + s^0 a_U}{s^1 a_U} \right) \frac{N^1}{N^0} \left( \frac{X + y + \frac{(1 - h_L^1 s^1) \tau N^1 \delta}{\delta + s^1 a_U \theta^*}}{Z - \frac{\delta(1 - h_L^1 s^1)(h_L^1 - h_L^0) \tau N^1}{h_L^1 (\delta + s^1 a_U \theta^*)}} \right) - \frac{\delta}{s^1 a_U} \tag{A.4}$$

which is equivalent to:

$$\frac{\delta N^0}{(\delta + s^0 a_U) h_L^1 N^1} + \frac{s^1 a_U N^0}{(\delta + s^0 a_U) h_L^1 N^1} \theta^* = \frac{(X + y)(\delta + s^1 a_U \theta^*) + (1 - h_L^1 s^1) \tau N^1 \delta}{Z h_L^1 (\delta + s^1 a_U \theta^*) - \delta(1 - h_L^1 s^1)(h_L^1 - h_L^0) \tau N^1}$$

Let us define the following functions:

$$f(\theta) = \frac{\delta N^0}{(\delta + s^0 a_U) h_L^1 N^1} + \frac{s^1 a_U N^0}{(\delta + s^0 a_U) h_L^1 N^1} \theta$$

$$g(\theta) = \frac{(X + y)(\delta + s^1 a_U \theta^*) + (1 - h_L^1 s^1) \tau N^1 \delta}{Z h_L^1 (\delta + s^1 a_U \theta^*) - \delta (1 - h_L^1 s^1) (h_L^1 - h_L^0) \tau N^1}$$

Then  $\theta^*$  is defined by  $f(\theta) = g(\theta)$ . Observe that

$$f(0) = \frac{\delta N^0}{(\delta + s^0 a_U) h_L^1 N^1} > 0$$

$$f'(\theta) = \frac{s^1 a_U N^0}{(\delta + s^0 a_U) h_L^1 N^1} > 0$$

$$g(0) = \frac{X + y + (1 - h_L^1 s^1) \tau N^1}{Z h_L^1 - (1 - h_L^1 s^1) (h_L^1 - h_L^0) \tau N^1} > 0$$

$$g'(\theta) = (1 - h_L^1 s^1) \tau N^1 \delta Z h_L^1 s^1 a_U - \delta (1 - h_L^1 s^1) (h_L^1 - h_L^0) \tau N^1 (X + y) s^1 a_U$$

First, we want that:  $f(0) < g(0)$ . This is equivalent to:

$$\frac{\delta N^0}{(\delta + s^0 a_U) h_L^1 N^1} < \frac{X + y + (1 - h_L^1 s^1) \tau N^1}{Z h_L^1 - (1 - h_L^1 s^1) (h_L^1 - h_L^0) \tau N^1}$$

which is equivalent to:

$$y > \underline{y}$$

where

$$\underline{y} \equiv \frac{\delta N^0 [Z h_L^1 - (1 - h_L^1 s^1) (h_L^1 - h_L^0) \tau N^1]}{(\delta + s^0 a_U) h_L^1 N^1} - X - (1 - h_L^1 s^1) \tau N^1 \tag{A.5}$$

Second, we want that:  $g'(\theta) < 0$ , which is equivalent to

$$y > \underline{y}$$

where

$$\underline{y} \equiv \frac{h_L^1}{h_L^1 - h_L^0} Z - X \tag{A.6}$$

It is easy to verify that  $\underline{y} > \underline{y}$  so the two conditions  $y > \underline{y}$  and  $y > \underline{y}$  reduces to  $y > \underline{y}$ .

So far we have shown that  $f(0) < g(0)$ ,  $f'(\theta) > 0$  and  $g'(\theta) < 0$ . This guarantees that there exists a unique and strictly positive  $\theta^*$ . Let us now show that  $\theta^* < 1$ . We have:

$$f(1) = \frac{\delta + s^1 a_U}{\delta + s^0 a_U} \frac{N^0}{h_L^1 N^1}$$

$$g(1) = \frac{X(\delta + s^1 a_U) + (1 - h_L^1 s^1) \tau N^1 \delta}{Y h_L^1 (\delta + s^1 a_U) - \delta (1 - h_L^1 s^1) (h_L^1 - h_L^0) \tau N^1}$$

So, if when  $\theta^* = 1$ ,  $f(1) > g(1)$ , then we are certain that  $\theta^* < 1$  since the intersection between  $f(\theta)$  and  $g(\theta)$  occurs before  $f(\theta) > g(\theta)$ . The condition  $f(1) > g(1)$  is equivalent to:

$$\frac{(\delta + s^1 a_U) N^0}{(\delta + s^0 a_U) h_L^1 N^1} > \frac{X(\delta + s^1 a_U) + (1 - h_L^1 s^1) \tau N^1 \delta}{Y h_L^1 (\delta + s^1 a_U) - \delta (1 - h_L^1 s^1) (h_L^1 - h_L^0) \tau N^1}$$

which after some calculations leads to

$$y < \bar{y}$$

where

$$\bar{y} \equiv \frac{N^0 [Z h_L^1 (\delta + s^1 a_U) - \delta (1 - h_L^1 s^1) (h_L^1 - h_L^0) \tau N^1]}{(\delta + s^0 a_U) h_L^1 N^1} - \frac{\delta (1 - h_L^1 s^1) \tau N^1}{\delta + s^1 a_U} - X \quad (\text{A.7})$$

The results then follow. ■