Abstract

The first part of this introductory chapter offers a brief historical survey of job search theory. The goals are to give the reader a sense of how search theory arrived at its current state, to point out some of the roadblocks that search theory has encountered, and to suggest how search theoretic models have evolved so as to overcome those roadblocks. The second part of the chapter offers a brief description of each chapter in the book. Eight chapters follow the introduction, with three devoted to job search theory itself, three to estimating job search models, and two to applying job search theory to public policy.
Unemployment is a persistent and pervasive problem in developed economies. In the last 20 years, every industrialized nation has seen an unemployment rate of 10 percent at least briefly—and in many cases (in Europe and Japan) over a period of years. Industrialized nations spend substantial resources to provide a social safety net for workers who find themselves without a job. Many governments also design and implement programs aimed at either increasing job security (e.g., firing taxes imposed on firms in some European countries) or reducing the time it takes to become reemployed (e.g., government-assisted job search or training programs).

It is remarkable, then, that forty years ago economists had no rigorous explanation of how unemployment could arise and persist in equilibrium. Ad hoc theories existed about “money illusion” and downwardly rigid wages, but it was understood that money illusion could only cause changes in unemployment (it could not explain its existence), and no satisfactory explanation existed of why wages would not fall in the presence of excess supply in the labor market. Economists could not explain unemployment because of the profession’s continued reliance on the pristine model of supply and demand as its workhorse. This model rules out (by assumption) all types of transaction costs that might keep markets from operating efficiently. Uncertainty is ruled out, informational problems are assumed away, and economic agents on opposite sides of the market have no difficulty finding each other. Without the presence of such transaction costs, it is hard to imagine unemployment arising as an equilibrium phenomenon.

In the late 1960s, a revolution began in microeconomics as the supply and demand models of Marshall and Walras began to be replaced by models that took transaction costs seriously and used them to explain a wide variety of economic phenomena. For example, the economics of uncertainty provided an explanation of how insurance markets function while the economics of information explained how identical products could sell for different prices in equilibrium.

Among the most important developments offered by “transaction cost economics” were the new models of equilibrium unemployment. These models began to emerge following publication of George Stigler’s classic 1961 article on “The Economics of Information.” This paper, which many cite as the article that inspired much of the subsequent work on transaction costs, examined the problem faced by a consumer searching for a good that was offered by many firms at different prices. Stigler (1962), J.J. McCall (1965), Dale Mortensen (1970), and others quickly extended the analysis to include the problem faced by an unemployed worker searching for a job across firms that pay different wages. Unemployment would arise if the worker could not find a firm with a vacancy or if it was in the worker’s interest to turn down a wage offer that he or she considered too low.

Other theories of unemployment quickly followed. For example, contract theory explained how optimal contracts between risk-neutral firms and their risk-averse employees in the presence of uncertainty and/or asymmetric information might lead