Hungerbühler, Mathias; Lehmann, Etienne

Working Paper
On the optimality of a minimum wage: new insights from optimal tax theory

IZA Discussion Papers, No. 2957

Provided in Cooperation with:
IZA – Institute of Labor Economics

Suggested Citation: Hungerbühler, Mathias; Lehmann, Etienne (2007) : On the optimality of a minimum wage: new insights from optimal tax theory, IZA Discussion Papers, No. 2957, Institute for the Study of Labor (IZA), Bonn

This Version is available at:
http://hdl.handle.net/10419/34638

Terms of use:
Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.
On the Optimality of a Minimum Wage: New Insights from Optimal Tax Theory

Mathias Hungerbühler
Etienne Lehmann

July 2007
On the Optimality of a Minimum Wage: New Insights from Optimal Tax Theory

Mathias Hungerbühler  
*University of Namur*

Etienne Lehmann  
*CREST and IZA*

Discussion Paper No. 2957  
July 2007

IZA  
P.O. Box 7240  
53072 Bonn  
Germany  
Phone: +49-228-3894-0  
Fax: +49-228-3894-180  
E-mail: iza@iza.org

Any opinions expressed here are those of the author(s) and not those of the institute. Research disseminated by IZA may include views on policy, but the institute itself takes no institutional policy positions.

The Institute for the Study of Labor (IZA) in Bonn is a local and virtual international research center and a place of communication between science, politics and business. IZA is an independent nonprofit company supported by Deutsche Post World Net. The center is associated with the University of Bonn and offers a stimulating research environment through its research networks, research support, and visitors and doctoral programs. IZA engages in (i) original and internationally competitive research in all fields of labor economics, (ii) development of policy concepts, and (iii) dissemination of research results and concepts to the interested public.

IZA Discussion Papers often represent preliminary work and are circulated to encourage discussion. Citation of such a paper should account for its provisional character. A revised version may be available directly from the author.
ABSTRACT

On the Optimality of a Minimum Wage: New Insights from Optimal Tax Theory*

We build a theoretical model to study whether a minimum wage can be welfare-improving if it is implemented in conjunction with an optimized nonlinear income tax. We consider this issue in a framework where search frictions on the labor market generate unemployment. Workers differ in productivity. The government does not observe workers’ productivity but only their wages. Hence, the redistributive policy solves an adverse selection problem. We show that a minimum wage is optimal if the bargaining power of the workers is relatively low. However, if the government controls the bargaining power, then it is preferable to set a sufficiently high bargaining power.

JEL Classification: D86, H21, H23, J64, J68

Keywords: optimal taxation, minimum wage, search-matching unemployment, bunching, wage bargaining

Corresponding author:

Etienne Lehmann
CREST-INSEE
Laboratoire de Macroeconomie
Timbre J360
15 Boulevard Gabriel Péri
92 245 Malakoff Cedex
France
E-mail: etienne.lehmann@ensae.fr

* We thank participants of seminars in ERMES - Paris 2, CREST and CORE and at the PET 2007 meeting in Nashville. In particular, we thank Pierre Cahuc and Guy Laroque for fruitful comments. A part of this research was realized while Hungerbühler was visiting ERMES-Paris 2 and another part while Lehmann was visiting the Department of Economics of the Université Catholique de Louvain.
I Introduction

The minimum wage is one of the most controversial economic policies. On the ground of equity considerations, a minimum wage aims to play a redistributive role by increasing income for the least skilled workers. One might however counter-argue that redistributive taxation can achieve this goal in a more efficient way. On the ground of efficiency considerations, the minimum wage is often blamed for its adverse effects on labor demand. This is true as long as labor markets are perfectly competitive. However, the minimum wage can be helpful to correct for noncompetitive wage setting (see e.g. Robinson 1933 or Stigler 1946). In our opinion, it is therefore necessary to include optimal taxation and labor market imperfections when one considers the normative issue of the minimum wage.

In this paper, we propose a theoretical model to study whether a minimum wage can be welfare-improving if it is implemented in conjunction with an optimized nonlinear income tax à la Mirrlees (1971). To integrate explicitly the unemployment effects of a minimum wage, we consider this issue in a framework where search frictions on the labor market à la Mortensen and Pissarides (1999) generate endogenous “involuntary” unemployment (i.e. some workers are willing to work at the equilibrium wage, but fail to find a job).

In our model, workers differ with respect to productivity. They decide whether to search for a job, while firms search for workers to fill their job vacancies. If a worker and a firm are paired, they Nash-bargain the wage. The government observes wages, but not productivity. Hence, it faces an adverse selection problem. Since the productivity of a match is revealed through the wage, and since the negotiated wage is the one that maximizes the Nash Product, incentive constraints depend only on Nash Products. However, and contrary to the standard model in contract theory, workers’ participation constraints depend on a different variable than incentive constraints. In our case, the participation depends on the workers’ expected incomes while searching. We show that in such a context, bunching at the bottom of the wage distribution appears at the (second-best) optimum if the workers’ bargaining power is relatively low. In our model where wages are negotiated, we interpret such a bunching as an argument in favor of a binding minimum wage.

This first result holds under the assumption that the government cannot influence the workers’ bargaining power. We further show that, if the government can control the bargaining power, then it is desirable to increase a relatively low bargaining power, in which case our previous argument for the minimum wage disappears.

The impact of a minimum wage in the case of a monopsony in the labor market has been studied among others by Robinson (1933) and Stigler (1946). Firms do not face competition on the labor market and thus distort wages downwards, thereby reducing labor supply and eventually employment. Therefore, a binding minimum wage can restore efficiency and increase employment (along the labor supply), provided its level is not above
the equilibrium wage in a perfectly competitive labor market. Our contribution differs in several ways from Stigler’s. First, we integrate taxation into the framework. As already noted by Stigler, tax measures might achieve the same result as the minimum wage, and possibly even in a more efficient way. We however show that a minimum wage is — under certain conditions — even optimal when tax measures are available. Second, while Stigler only analyses the efficiency problem, we analyze the impact of the minimum wage in a framework where the government wants to redistribute from low-income to high-income individuals, and thus faces an efficiency-equity trade-off. Third, we introduce “involuntary” unemployment. In Stigler’s simple monopsony model, every individual who is willing to work at the (monopsony) market wage is able to find a job. We assume search and matching frictions, which imply that not every individual who is willing to work at the equilibrium wage can find a job. Some people fail to find one and become “involuntarily” unemployed.

Many papers have already investigated whether the minimum wage can be useful in combination with an optimized redistributive tax (see Franklin Allen 1982, Stephen Allen 1987, Guesnerie and Roberts 1987, Drèze and Gollier 1993, Marceau and Boadway 1994, Boadway and Cuff 2001, among others). In particular, Stephen Allen (1987) considers a model with two types of imperfectly substitutable workers and endogenous hours of work à la Stiglitz (1982). He shows that a minimum wage is never optimal in conjunction with the optimized nonlinear income tax, because a rise in the minimum wage strengthens the relevant incentive constraint. We abandon this framework of two types of imperfect-substitute labors and we instead base our labor demand margin on matching frictions. In our model, search frictions drive a wedge between (marginal) productivity and the wage, while productivity and hours of work are exogenous. Furthermore, we consider a model with a continuum of productivity which is — as we will show — more relevant for considering the issue of the form of the optimal redistributive allocation.

Finally, we extend the model of optimal redistributive taxation in a search equilibrium framework developed by Hungerbühler, Lehmann, Parmentier and Van der Linden (2006, henceforth HLPV). Contrary to HLPV, we allow the bargaining power to be lower than the one prescribed by the so-called Hosios (1990) condition. In such a case, a rise in wage for a given level of the Nash Product increases workers’ expected income. As we show, this effect opens the room for a welfare-improving role of the minimum wage.

The paper is organized as follows. In Section II, we present the basic model, including incentive and participation constraints. Next, in Section III, we solve the model for a given bargaining power. We show that a minimum wage is optimal if the bargaining power is sufficiently low. Section IV considers the case when the government can control...
the bargaining power. Finally, we conclude in Section V.

II The model

Our model follows the framework built in HLPV to deal with the optimal tax problem of Mirrlees (1971) within the equilibrium unemployment theory of Mortensen and Pissarides (1999) and Pissarides (2000). To keep things as simple as possible, we consider a static setting which has become standard in the models of search equilibrium with taxation (see also Boone and Bovenberg, 2002). There is a mass $1$ of risk-neutral individuals. They can be either employed, unemployed or out of the labor force. Their preferences on consumption and leisure are assumed quasi-linear in consumption. Individuals differ with respect to their productivity $a \in [a_0, a_1]$ with $0 \leq a_0 < a_1 < \infty$ according to the continuous density function $f(a)$ and the cumulative density function $F(a)$. These functions are common knowledge, while the productivity is private information to the worker. The timing of the model is as follows:

1. First, the government commits to its policy. The policy consists in a tax schedule $T(\cdot)$, a welfare benefit $b$ and a minimum wage $w$. Since the government cannot observe the individuals’ productivities but only their wages, this tax schedule is conditional on the gross wage $w$ only. The government cannot observe whether a non-employed individual has searched for a job but not found one (hence, she is unemployed) or simply not searched for a job at all (hence, she is out of the labor force). Consequently, all non-employed individuals get the same welfare benefit $b$ (whatever their productivity and their participation decision). In section IV only, we assume that the government has an additional policy instrument: It can control the workers’ bargaining power $\beta$.

2. In a second step, individuals and firms decide to participate in the labor market. The individuals have the binary choice to invest all their leisure time in search for a job or to stay out of the labor force and enjoy utility from leisure, $d > 0$, and the welfare benefit $b$. They do decide to participate in the market if their expected income is above the utility of staying out of the labor force. Firms can decide to open job vacancies. To do so, they first have to invest capital to build up the workstation. This capital investment is assumed irreversible and productivity-specific, i.e. to be able to hire a worker of ability $a$, the firm has to buy $\kappa_a$ units of capital. Conversely,

\footnote{Our results still hold if $a_1 \to \infty$ as long as $\int_{a_0}^{a_1} aF(a)$ is finite.}

\footnote{A firm might consist of a large number of different jobs. The government observes in a firm’s account only the sum of the total investment costs $\kappa_{a}$ and total profits $a - w$, but cannot disentangle the costs and profits of each job. For this reason, we assume that no tax schemes based on investment costs $\kappa_{a}$ or profits $a - w_{a}$ are available to the government.}
an individual of ability $a$ can only work at a firm that has made the appropriate investment in equipment, i.e. that has invested the exact amount $\kappa_a$ of capital. We assume that

$$\frac{\kappa_a}{\kappa_a} \leq \frac{1}{a} \quad (1)$$

Firms decide to enter into the labor market as long as their expected profit is positive.

3. Next, individuals and firms match on their skill-specific labor markets. To model the search frictions, we use a standard matching function. The number of matches is a function of the number of individuals searching for a job and of firms searching for a worker. Capital investment and labor markets are productivity-specific. In this sense, we assume directed search\(^5\). The outcome of this matching process determines the unemployment rate in our model. During this matching process, the firm observes the productivity of the worker. Unmatched firms loose their invested capital.

4. The worker and the firm bargain the gross wage that is paid to the worker.

5. Production and transfers occur.

II.1 The matching process, participation decisions and employment

The matching function $H(U_a, V_a)$ in labor market $a$ gives the number (density) $H_a$ of employed individuals of type $a$ as a function of the number $U_a$ of workers searching for a job, and the number $V_a$ of job vacancies. This matching function is assumed to represent heterogeneities and frictions that we do not model explicitly. It is usually assumed that the matching function $H(\cdot, \cdot)$ is increasing in both its arguments, concave and homogeneous of degree 1. Empirical studies have found that a Cobb-Douglas approximation of the matching function fits the data well (Petrongolo and Pissarides, 2001). We therefore assume that the matching function is given by

$$H(U_a, V_a) = A \left( U_a \right)^\gamma \left( V_a \right)^{1-\gamma} \quad \text{with} \quad \gamma \in (0, 1) \quad (2)$$

where $A > 0$ is a scale parameter of the matching function. If individuals of type $a$ search for a job, then $U_a = f(a)$, otherwise $U_a = 0$. The probability for a firm to hire a

\(^4\)This assumption ensures that in an economy without government intervention, the unemployment rate among the high-skilled individuals is not higher than the unemployment among the low-skilled individuals.

\(^5\)While the government does not observe a worker’s productivity, we assume that firms observe it after a match. Hence, if a type-$a$ worker searches on a type-$t \neq a$ labor market and finds a job, the match becomes unproductive and the worker is fired. Since search is costly for workers, a type-$a$ worker has no incentive to search on another labor market.
worker $H_a/V_a$ is a decreasing function of the number of vacancies, while the probability $L_a = H_a/U_a$ for a searching worker to find a job increases in the number of vacancies.

A firm has to invest $\kappa_a$ units of capital to open a type-$a$ vacancy. When the firm finds a suitable worker for this vacancy, this match produces $a$ units of goods. Note that the investment takes place before the matching to the worker. Since there are matching frictions on the labor market, some firms do not find a worker. In that case, the loss of the firm is equal to the investment cost $\kappa_a$. If the firm finds a worker for its vacancy, then they have to bargain on the gross wage $w_a$ and the firm’s profit writes $a - w_a - \kappa_a$. Since the probability that a firm finds a worker of type $a$ is equal to $H_a/V_a$, the expected profit from posting a vacancy can be written as $(H_a/V_a)(a - w_a) - \kappa_a$. Firms enter the market as long as these expected profits are positive. Hence, this expected profit is nil at equilibrium, and therefore

$$\frac{H_a}{V_a}(a - w_a) = \kappa_a \quad (3)$$

Given (2), one has $H_a/V_a = A \cdot (V_a/U_a)^{-\gamma}$. The free-entry condition (3) therefore determines the ratio $V_a/U_a$, and thereby the probability $L_a = H_a/U_a = A \cdot (V_a/U_a)^{1-\gamma}$ for a type-$a$ searching worker to find a job, which is given by:

$$L_a = A^{\frac{1}{\gamma}} \left( \frac{a - w_a}{\kappa_a} \right)^{\frac{1-\gamma}{\gamma}} \quad (4)$$

If the wage $w_a$ decreases, then the firm’s surplus $a - w_a$ increases relative to the vacancy cost $\kappa_a$, and hence, firms create more vacancies and the probability of finding a job increases for type-$a$ searching workers. An additional firm that enters the market increases employment and therefore gross output. But it also increases the resources spent for capital investments. The impact of an additional vacancy on net output (net of investment costs) is then ambiguous and depends on the number or vacant jobs that are already on the labor market. If the wage is sufficiently low, the firm has incentives to enter the market, even though this might not be optimal from a social point of view, because too many resources might then be spent for capital investments. The gross output generated by workers of type $a$ is equal to $aH_a = aL_a f(a)$. Let

$$Y_a \equiv aL_a - \frac{V_a \kappa_a}{f(a)}$$

Output net of investment costs on the type-$a$ labor market can then be written as $aH_a - V_a \kappa_a = Y_a f(a)$. Multiplying Equation (3) by $V_a$, one gets

$$Y_a (w_a) \equiv w_a L_a = A^{\frac{1}{\gamma}} \left( \frac{a - w_a}{\kappa_a} \right)^{\frac{1-\gamma}{\gamma}} w_a \quad (5)$$

Because of free entry, firms’ expected profits equal 0, so their total surplus $(a - w_a) L_a f(a)$ equals total investment costs $V_a \kappa_a$. As a consequence, net output consists only in the total
gross wages of workers, \( w_a L_a f (a) \). Net output is an inverse-U shaped function of gross wage.

A type-\( a \) participating worker finds a job with probability \( L_a \). In this case, she gets the wage \( w_a \) and has to pay income taxes \( T (w_a) \). If she doesn’t find a job, her income consists of the welfare benefit \( b \). The (ex-ante) expected income of a searching individual equals \( L_a [w_a - T (w_a)] + (1 - L_a) b \). If the individual decides to stay out of the labor force, then she gets the welfare benefit \( b \) and enjoys her leisure time which gives her utility \( d \). Hence, the individual participates in the labor market as long as

\[
\Sigma_a = L_a [w_a - T (w_a)] + (1 - L_a) b ≥ b + d. \tag{6}
\]

Then, the participation constraint for type-\( a \) workers simplifies to

\[
\Sigma_a ≥ d \tag{7}
\]

### II.2 The wage bargain

At this stage of the game, the entry costs are sunk. If there is an agreement between the firm and the worker on the wage \( w \), the output is produced and the firm pays the worker the negotiated wage. In the absence of an agreement, nothing is produced, and the worker only gets the welfare benefit \( b \). The ex-post surplus of the worker is therefore equal to \( x = w - T (w) - b \), whereas the surplus of the firm equals \( a - w \). As it is standard in the literature, we assume that the wage negotiation amounts to maximize the Nash Product defined by

\[
\mathcal{N} (w, x, a) ≡ (a - w)^{1 - \beta} x \tag{8}
\]

where \( \beta ∈ (0, \gamma] \) denotes the worker’s relative bargaining power. In this paper, we are only interested by the case where workers’ bargaining power \( \beta \) is lower than the elasticity of the matching function \( \eta \), that is

\[
\beta ≤ \gamma \tag{9}
\]

As we will show later, the minimum wage appears at the optimum as soon as \( \beta < \gamma \). If the wage that maximizes the Nash product \( \mathcal{N} (w, x, a) \), lies below the minimum wage \( w \), then the minimum wage must be paid to the worker. This leads to:

\[
w_a ≡ \arg \max_{w ≥ w} \mathcal{N} (w, x, a) = \max \left[ w, \frac{\beta [1 - T' (w_a)] a + (1 - \beta) (T (w_a) + b)}{1 - \beta \cdot T' (w_a)} \right] \tag{10}
\]

The second equality holds only for values of \( w_a \) where the function \( w → T (.) \) admits a derivative. To simplify notations in what follows, we define the maximized Nash product
$N_a$ as:

$$N_a = (a - w_a)^{1-\beta} (w_a - T(w_a) - b)$$

so $N_a = \mathcal{N}(w_a, x_a, a)$. Given this definition, we can rewrite the worker’s expected surplus from participation as

$$\Sigma_a = A^{\frac{1}{\gamma}} (\kappa_a)^{\frac{1}{\gamma}} N_a (a - w_a)^{1-\frac{1-\beta}{\gamma}}$$

### II.3 The government’s problem

#### II.3.1 Incentive constraints

Since the government only observes the income $w$ of employed individuals but not their productivity $a$, it faces an adverse selection problem. Therefore, the government has to choose a menu of bundles $(w_a, x_a)$ that leads agents to reveal their ability. By determining the wage $w_a$, agents send a “message” about their productivity. The particularity of this problem in our context is that the message is here jointly determined by the worker and the firm of a match. However, since the wage maximizes the Nash product $\mathcal{N}(w, x, a)$, we$^6$ treat this problem as if a single agent chooses the wage that maximizes $\mathcal{N}(w, x, a)$. Therefore we can apply standard techniques (see e.g. Salanié 2002) and express incentive constraints in terms of Nash products. Using the taxation principle, it is equivalent to design a tax function $T(w)$ or to let the firm-worker pair choose among the menu of proposed bundles $(w_a, x_a)$. To be optimal, the allocations must induce the individual matches to truthfully reveal their type, which is the case for a firm-worker pair of type $a$ if and only if

$$\text{for all } a' \neq a \quad \mathcal{N}(w_a, x_a, a) \geq \mathcal{N}(w_{a'}, x_{a'}, a)$$

In other words, a worker-firm pair of type $a$ prefers the wage $w_a$ designed for it (which induces the workers’ ex-post surplus to be $x_a = w_a - T(w_a) - b$), instead of wage $w_{a'}$ designed for any other type $a'$ (which induces the workers’ ex-post surplus to be equal to $x_{a'} = w_{a'} - T(w_{a'}) - b$). Since at a constant value for the Nash product, we have that the marginal rate of substitution between the wage $w$ and the worker’s ex-post surplus $x$

$$\left. \frac{\partial x}{\partial w} \right|_{\mathcal{N}(\cdot, a)} = \frac{1 - \beta}{\beta} \frac{x}{a - w}$$

is decreasing in $a$, the single-crossing property is fulfilled. This allows a full description of incentive compatible allocations.

$^6$For further discussions, see HLPV. In particular, since the government observes only wages, and since we rule out side-payments or tax evasion, the firm and the worker of a match cannot send separate messages.
Lemma 1 If an allocation \( \alpha \mapsto (w_\alpha, x_\alpha, \Sigma_\alpha, N_\alpha) \) is incentive compatible then, \( \alpha \mapsto w_\alpha \) is a nondecreasing function, \( \alpha \mapsto \Sigma_\alpha \) is an increasing function, there exists a single type \( \alpha_d \) such that \( \Sigma_{\alpha_d} = d \), all types with \( \alpha \geq \alpha_d \) do participate and

\[
N_\alpha = N_{\alpha_d} \cdot \exp \left[ \frac{1 - \beta}{\beta} \int_{\alpha_d}^{\alpha} \frac{dt}{t - w_t} \right] \tag{15}
\]

\[
\Sigma_\alpha = d \cdot \left( \frac{a - w_\alpha}{a_d - w_{a_d}} \right)^{\frac{1 - \beta}{\gamma} - \frac{1}{\gamma}} \cdot \left( \frac{\kappa_\alpha}{\kappa_{a_d}} \right)^{\frac{\gamma - 1}{\gamma}} \cdot \exp \left[ \frac{1 - \beta}{\beta} \int_{\alpha_d}^{\alpha} \frac{dt}{t - w_t} \right] \tag{16}
\]

\[
x_\alpha = A^{-\frac{\beta}{\gamma}} \cdot \left( \frac{a - w_\alpha}{\kappa_\alpha} \right)^{\frac{1 - \beta}{\gamma}} \cdot \Sigma_\alpha = N_\alpha \cdot (a - w_\alpha)^{-\frac{1 - \beta}{\gamma}} \tag{17}
\]

Conversely, for any real \( \alpha_d \in [a_0, a_1] \) and any nondecreasing function \( \alpha \mapsto w_\alpha \), the allocation \( \alpha \mapsto (w_\alpha, x_\alpha, \Sigma_\alpha, N_\alpha) \) defined by Equations (15), (16) and (17) is incentive compatible and workers of type \( \alpha \) participate if and only if \( \alpha \geq \alpha_d \).

Here is a brief sketch of the Proof. Applying the envelope theorem to the wage bargaining program (11) gives the derivative of \( \log N_\alpha \). Integrating this derivative between \( \alpha_d \) and \( \alpha \) gives (15). To obtain (16), we first use Equation (12) at \( \alpha = \alpha_d \) together with the participation constraint \( \Sigma_{\alpha_d} = d \) to obtain \( N_{\alpha_d} \). We then use (15) to get \( N_\alpha \) and finally, we use (12) to obtain \( \Sigma_\alpha \). Equation (17) is obtained directly thanks to (6). The proof in Appendix A in particular takes care that \( N_\alpha \) may not admit a derivative everywhere. We call equations (15) and (16) the first-order incentive constraints. We call the second-order incentive constraint the requirement that:

\[
\alpha \mapsto w_\alpha \text{ is a non-decreasing function} \tag{18}
\]

If this constraint is binding at the bottom of the wage distribution, we interpret this result as a minimum wage\(^7\).

\[\text{II.3.2 The government’s objective and budget constraint}\]

As in HLPV, we assume that the government cares only about the distribution of expected utilities, i.e. \( \Sigma_\alpha + b \) for the participating types and \( b + d \) for the non participating ones.

We assume the following objective to the government:

\[
\Omega = F (a_d) \Phi (b + d) + \int_{a_d}^{a_1} \Phi [L_a (w_a - T (w_a)) + (1 - L_a) b] f (a) \, da
\]

\(^7\)The minimum wage as a legally binding instrument might not be necessary to implement an optimum with bunching at the bottom of the wage distribution (See Cahuc and Laroque 2007 for a discussion). The tax system might be sufficient. In particular, one way to implement the bunching at the bottom is to set \( T (w) \) at a very high level for \( w < w_\text{m} \). This is obviously equivalent to imposing a high fine for all matches that choose a wage below the minimum wage.
where $\Phi(.)$ is a twice continuously differentiable, increasing and concave function. This formulation implies that the government compensates individuals for their innate productivity $a$, but not for their labor market status. It admits as a limiting case the maximin criterion. Using the definition of the worker’s expected surplus (6), one can rewrite this objective as

$$\Omega = F(a_d)\Phi(b + d) + \int_{a_d}^{a_1} \Phi(b + \Sigma_a)f(a)\,da$$  \hspace{1cm} (19)

The budget constraint can be written as

$$\int_{a_d}^{a_1} T(w_a)\,L_a\,f(a)\,da = \left[F(a_d) + \int_{a_d}^{a_1} (1 - L_a)\,f(a)\,da\right]b + E$$

where $E \geq 0$ denotes exogenous public expenditures. Since firms’ profits net of vacancy costs are nil and only labor incomes are taxed, the Walras’s law implies that the government’s budget constraint can be replaced by the resource constraint

$$\int_{a_d}^{a_1} Y_a(w_a)\,f(a)\,da = \int_{a_d}^{a_1} \Sigma_a f(a)\,da + E + b$$  \hspace{1cm} (20)

The left-hand side of (20) denotes total production net of vacancy costs and the right-hand side the distribution of these available resources to all individuals.

Hence, the government maximizes its objective (19), subject to the budget constraint (20), the first-order incentive constraint (16), the second-order incentive constraint (18) and the participation constraint (7). Therefore, the government’s problem is reduced to choosing a threshold value $a_d$ and a nondecreasing function $a \mapsto w_a$. Given this choice, the participation constraint $\Sigma_a = d$ and Equation (12) give $N_a$. The first-order incentive constraint (15) gives $N_a$ for all $a > a_d$. For all $a \geq a_d$, we get $\Sigma_a$ either from $N_a$ and equation (12) or directly through (16). The budget constraint (20) yields the value of the welfare benefit $b$. Finally we get the workers’ ex-post surplus $x_a = w_a - T(w_a) - b$, thereby the level of tax from (6).

III The optimal policy for a given bargaining power

This section describes the consequences of policy changes on welfare when the government cannot influence the workers’ bargaining power. To understand the underlying economic mechanisms at work, we need to describe the optimality conditions for all variables. We

Adding this latter motive leads to an objective function of the form

$$F(a_d)\Phi(b + d) + \int_{a_d}^{a_1} [L_a\Phi(w_a - T(w_a)) + (1 - L_a)\Phi(b)]\,f(a)\,da$$

This alternative formulation does not change the mechanisms that lead to our main results, but makes the model less tractable.
first compute the shadow cost of public funds (III.1), and then the optimality condition for the wage in the absence of bunching (III.2). After this preliminary, we derive the main Proposition of this paper (III.3), that is the optimality condition for the minimum wage level. We finally turn to the condition with respect to the participation threshold (III.4). The mathematical derivations of the optimality conditions are in Appendix B.

### III.1 The shadow cost of public funds

Consider a rise in the level of public expenditures $E$, holding the threshold $a_d$ and the wage distribution $a \mapsto w_a$ constant. Then, neither $Y_a (w_a)$ nor $\Sigma_a$ is affected by this change. Therefore, the only change in Equation (20) is that $b$ decreases one-to-one when $E$ rises. The social utility of non-participating individuals decreases by $\Phi_0 (b + d)$ while the social expected utility of participating individuals of type $t$ decreases by $\Phi_0 (b + \Sigma_t)$. Let $\lambda$ be the shadow cost of public funds. We hence get that:

$$\lambda = \Phi' (b + d) F (a_d) + \int_{a_d}^{a_1} \Phi' (\Sigma_t + b) f (t) \, dt$$

(21)

### III.2 Optimal negotiated wages $w_a$

We now describe the optimality condition for the wage $w_a$ at a point of the skill distribution where there is no bunching (and at a point where $a \mapsto w_a$ is continuous). We consider a marginal translation $\delta w$ of the function $a \mapsto w_a$ on an infinitesimal interval $[a, a + \delta a]$. We get from Appendix B.1:

$$0 = \lambda \left. \frac{\partial Y_a}{\partial w_a} (w_a) f (a) \right|_{E = \text{efficiency effect}} - \frac{1 - \beta}{\beta (a - w_a)^2} Z_a \left|_{E = \text{informational rents effect}} + \left( \frac{1 - \beta}{\beta} - \frac{1 - \gamma}{\gamma} \right) \frac{1}{a - w_a} [\Phi' (\Sigma_a + b) - \lambda] \Sigma_a f (a) \right|_{E = \text{bargaining power effect}}$$

(22)

where

$$Z_a = \int_a^{a_1} (\lambda - \Phi' (\Sigma_t + b)) \Sigma_t f (t) \, dt$$

(23)

Consider the optimization problem for agents of type $a$. Given the participation constraint (7), Equation (12) and the first-order incentive constraint (15), the Nash product for type $a$ is predetermined and not affected by the change in the wage $w_a$.

---

9Since we are considering the optimal wage $w_a$ at at point where there is no bunching, this optimal wage has also to solve a “locally relaxed problem” that is identical to the government’s problem, except that the second-order incentive constraint (18) is not imposed in a neighborhood of $a$. It is the necessary condition of this locally relaxed problem that we are actually deriving.
The first term in equation (22) stands for the efficiency part of the trade-off. An increase in the wage rate $w_a$ implies that less vacancies are created, which has two consequences. First, it decreases employment and therefore gross output. But it also decreases the resources used for investments in capital to build workstations. The effect on output net of investment costs equals $\partial Y_a/\partial w_a$ and is therefore ambiguous (see equation (5)). Multiplying this by the shadow cost $\lambda$ of public funds and the density $f(a)$ of type-$a$ workers gives the efficiency term in (22).

The second term in equation (22) represents the impact on informational rents of a higher gross wage for type-$a$ workers. When firm-worker matches endowed with productivity $a$ have a higher gross wages (while keeping the Nash product $N_a$ fixed), more productive firm-worker matches find it more attractive to mimic them. In other words, a type- $t>a$ worker-firm pair finds it profitable (in terms of Nash Product 8) to choose the wage $w_a$ designed for type-$a$ jobs instead of the wage $w_t$ designed for them.

![Figure 1: The informational rent effect](image)

Figure 1 illustrates this point. It displays the iso-Nash curves for types $a$ and $t$ with $t>a$. Because productivity is higher, the elasticity of the firm’s surplus with respect to the gross wage is smaller for worker-firm pairs of type $t$ than for pairs of type $a$. Consequently, the iso-Nash curves corresponding to type $a$ are steeper than iso-Nash curves corresponding to type $t$ (see Equation 14). For a given level of Nash product accruing to type $a$, the government can propose different bundles, for instance a low wage combined with a low ex-post surplus $(w_a, x_a)$ or a higher wage combined with a higher ex-post surplus $(w_a', x_a')$. If the government proposes $(w_a, x_a)$, it has to give a Nash product at least equal to $N_t$ to prevent type-$t$ worker-firm pairs to mimic type-$a$ pairs. If the government however proposes the allocation $(w_a', x_a')$, then, it has to give a Nash product $N_t'$, which is strictly higher than $N_t$. Hence, the higher the wage $w_a$, the higher the Nash
product for types $t$ above $a$, which means that a higher wage increases informational rents. In the “informational rent” term of equation (22), the term in front of $Z_a$ measures the rate at which the growth rate of the worker’s maximized Nash product has to increase to prevent more productive matches from mimicking the type $a$ match.

From the first-order incentive constraint (15), the Nash product designed for all types $t$ above $a + da$ has to increase by the same proportion to prevent mimicking. Since wages designed for all these types above $a + da$ are not changed, we get that the expected surplus for these types increases in the same proportion, so $\Delta \Sigma_t/\Sigma_t = \Delta N_t/N_t = \Delta N_{a+da}/N_{a+da}$. The increase in the expected surplus obtained by type-$t$ worker-firm pairs increases the social welfare by $\Phi_0(\Sigma_t)$, but implies a budgetary cost equal to $\lambda$. Integrating these two terms over all types $t$ above $a + da$ gives the shadow cost $Z_a$ of a relative increase of the type-$a$ Nash product (see equation (23))\footnote{Formally $-Z_a$ is the welfare effect of a relative unit change in the Nash product $N_a$, keeping the function $t \mapsto w_t$ unchanged for $t \in [a,a_1]$.}. Taking the limit when $da$ tends to 0 leads to the informational rent effect in (22). We get the following Lemma, which is proved in Appendix B.2:

**Lemma 2** The shadow cost $Z_a$ of a relative increase in the Nash product is positive for all $a < a_1$.

In other words, the government desires to avoid informational rents.

A third effect appears in the present model due to the fact that workers’ bargaining power $\beta$ is below the elasticity of the matching function, $\gamma$. In our model, the expected surplus $\Sigma_a$ that the government focuses on does not coincide with the Nash product $N_a$ that the firm and the worker maximize when they negotiate the wage. For a given maximized Nash product $N_a$ (that is predetermined by the incentive constraints), a change in the wage $w_a$ has also an impact on the expected surplus $\Sigma_a$ as described in equation (12).

The intuition is depicted in Figure 2. Both Nash product $N_a$ and workers’ expected surplus $\Sigma_a$ are increasing functions of workers’ ex-post surplus $x_a$ and of firms’ surplus $a - w_a$ (thereby a decreasing function of the gross wage $w_a$). However, if the Hosios condition $\beta = \gamma$ is not fulfilled, they put different relative weights on these two components. Hence, the marginal rate of substitution between gross wages $w_a$ and workers’ ex-post surplus $x_a$ that keep workers’ expected surplus $\Sigma_a$ unchanged differ from the one that keep Nash product $N_a$ unchanged. Since $\beta < \gamma$, the Nash product criterion puts a higher relative weight on gross wages $w$. Hence, increasing the wage $w_a$ for a given Nash product $N_a$ increases workers’ expected surplus $\Sigma_a$, while increasing the wage $w_a$ for a given workers’ expected surplus $\Sigma_a$ decreases the Nash product $N_a$. This implies that the iso-Nash curves are steeper than the corresponding iso-expected-surplus curves. When the employment
level decreases by an increase in gross wages from $w_1$ to $w_2$, the net income has to rise from $x_1$ to $x_2$ to give the same Nash product as before to this firm-worker match. In terms of expected surplus, this increase in net income more than compensates for the employment loss due to the relatively small increase in gross wages. The expected surplus therefore increases.

The increase in $\Sigma$ is valued at the marginal social utility of type $a$, namely $\Phi'_a$. Since the government thus gives more resources to agents of type $a$, less resources can be affected to redistribution toward other individuals. This decrease in budgetary funds is valued at the marginal cost of public funds $\lambda$. An increase in the wage rate is therefore desirable if type $a$ is a low-productivity type that gets a lower expected surplus than the high-productivity type because of the first-order incentive constraint. Giving resources to this low-productivity type is socially valuable because it increases equity. The contrary is true if type $a$ is a high-productivity type from whom the government wants take resources in order to redistribute.

The sum of these three terms gives (22).

III.3 Optimal minimum wage $w$

We are now in the position to derive the main result of this section. We interpret the minimum wage as a bunching of wages over an interval at the bottom of the skill distribution. Let $a_m$ denote the upper bond of this interval (see Figure 3). We now consider the welfare effect of an increase in the minimum wage $w$, that is of an increase of wages over $[a_d, a_m]$ up to $w_m$. In this policy change, we keep $a_d$ unchanged. The tax function $T(\cdot)$ is adjusted so that participation decisions remain unchanged.
We show in Appendix B.3 that:

\[
\frac{\partial \Omega}{\partial w} = \lambda \int_{a_d}^{a_m} \frac{\partial Y_a}{\partial w} (w) f(a) da + \int_{a_d}^{a_m} (\Phi' (\Sigma_a + b) - \lambda) \Sigma_a \frac{1 - \gamma}{\gamma} \left( \frac{1}{a_d - w} - \frac{1}{a - w} \right) f(a) da + \left( \frac{1 - \beta}{\beta} \frac{1}{a_m - w} - \frac{1 - \gamma}{\gamma} \frac{1}{a_d - w} \right) Z_{a_m}
\]

An increase in the minimum wage has three effects. The first term captures the efficiency effect. In accordance with common wisdom, a higher minimum wage decreases employment (and hence increases unemployment). Even though this leads to a lower gross output, the higher wage also implies that less resources are spent by firms investing in new workstations. Therefore, the effect on net output \( \partial Y_a / \partial w_a (w) \) is ambiguous.

The second term captures the effect on the expected surplus of the workers of types \( a \) in \([a_d, a_m]\) whose wages are given by the minimum wage. The effect of a marginal increase \( \Delta w \) of the minimum wage on the expected surplus of these workers is twofold. First, the rise in the minimum wage reduces the labor demand. Equation (4) implies that a rise \( \Delta w \) of the minimum wage decreases the probability for a type-\( a \) searching worker to find a job by

\[
\frac{\Delta L_a}{L_a} = \frac{1 - \gamma}{\gamma} \frac{\Delta w}{a - w}
\]

Second, the government has to increase \( w - T(w) \) to keep type-\( a_d \) workers in the labor force. Hence, one has

\[
\frac{\Delta (w - T(w) - b)}{w - T(w) - b} = \frac{\Delta L_{a_d}}{L_{a_d}} = \frac{1 - \gamma}{\gamma} \frac{\Delta w}{a_d - w}
\]
to keep type \( a_d \) workers indifferent between participating or not. The net effect on workers’ expected surplus \( \Sigma_a \) is therefore

\[
\frac{\Delta \Sigma_a}{\Sigma_a} = \frac{\Delta L_a}{L_a} + \frac{\Delta (w - T(w) - b)}{w - T(w) - b} = \frac{1 - \gamma}{\gamma} \left( \frac{\Delta w}{a_d - w} - \frac{\Delta w}{a - w} \right)
\]

At a given wage level, the probability of finding a job is relatively less sensitive to wage for workers of a higher productivity. Hence, for \( a > a_d \), the net effect of a rise in minimum wage on workers’ expected surplus is positive. The induced increase in \( \Sigma_a \) has a direct consequence on the government’s objective that is valued at a rate \( \Phi' (\Sigma_a) \), and a negative effect on public funds that is valued at rate \( \lambda \). Summing this effect for all types between \( a_d \) and \( a_m \) gives the second term in the right-hand side of (24).

Finally, a rise in the minimum wage changes the level of the Nash product for the workers of the limiting type \( a_m \). Firms’ ex-post surplus \( a_m - w_{a_m} \) decreases by \( \Delta w \) while workers’ ex-post surplus increases by \( \Delta (w - T(w) - b) \), so the net effect equals to

\[
\frac{\Delta N_{a_m}}{N_{a_m}} = \frac{1 - \beta \Delta (a_m - w_{a_m})}{\beta (a_m - w_{a_m})} + \frac{\Delta (w - T(w) - b)}{w - T(w) - b} \left( \frac{1}{\gamma} \frac{1}{a_d - w} - \frac{1 - \beta}{\beta} \frac{1}{a_m - w} \right) \Delta w
\]

However, this relative change in the Nash product of these workers spills over the whole distribution of productivity to prevent the mimicking off worker-firm pairs of all type \( t \) above \( a_m \) (see 15). Since \( Z_a \) is the shadow cost of a relative increase in the Nash product, the last term of equation (24) represents the effect of the minimum wage on the individuals whose wage is not constraint by the minimum wage.

From this optimality condition on the minimum wage, we can derive the following proposition:

**Proposition 1** If \( \beta < \gamma \), a binding minimum wage is optimal.

**Proof.** Assume by contradiction that bunching at the bottom is not optimal. For this, we consider a threshold \( a_d \) and a function \( a \mapsto w_a \), such that this function is increasing in the neighborhood of \( a = a_d \). Hence we get \( a_m = a_d \). So, Equation (24) simplifies to

\[
\frac{\partial \Omega}{\partial w} = \left( \frac{1 - \beta}{\beta} - \frac{1 - \gamma}{\gamma} \right) \frac{Z_{a_d}}{a_d - w_{a_d}}
\]

Since \( \beta < \gamma \), the terms in the bracket is positive. Furthermore, \( Z_{a_d} \) is positive too from Lemma 2. Therefore, one finds that, starting from any situation with no minimum wage, there exists a binding level of minimum wage that is welfare-improving. ■

To recommend a minimum wage even though it increases unemployment might seem slightly counterintuitive at first sight. To explain the mechanisms that lie behind this
result, start from the case where there is no binding minimum wage (hence $a_m = a_d$).

Now, consider an increase in the wage of type $a_d$ above the wage $w_{a_d}$ that solves equation \((22)\). Given that the participation constraint for $a_d$ has still to hold with equality, equation \((12)\) implies that this increase in the wage decreases the maximized Nash product $N_{a_d}$.

This initial level of the maximized Nash product is however important: Through the first-order incentive constraint \((15)\), it determines the evolution of the Nash product for all types. These Nash products then again determine the surplus given to individuals by \((12)\).

Hence, decreasing the initial maximized Nash product $N_{a_d}$ by an increase in $w_{a_d}$ implies that the rents for all types $a > a_d$ decrease. This mechanism thus allows the government to extract more resources from the high-productivity individuals ($a > a_d$). These resources are then available for redistributive purposes of the government. However, since all wages for higher-productivity types solve equation \((22)\), the increase in $w_{a_d}$ implies that there is a downward jump in wages right above $a_d$. This clearly violates the second-order incentive constraint \((18)\). As a consequence, the optimal solution exhibits bunching at the bottom of the wage distribution. Such a bunching can be interpreted as a binding minimum wage.

Technically speaking, the new feature of our model is that while the worker and the firm maximize the Nash product, the participation constraint depends on another variable, the expected surplus. In the traditional adverse selection model in contract theory, the variables concerning the agent’s maximization problem and the participation constraint are the same. By the participation constraint, the maximized utility of the lowest participating type has to equal the (exogenous) outside option of the individual. Therefore, the principal cannot affect the maximized utility of the lowest participating type. From this utility of the lowest participating type, the incentive constraints then determine the evolution of the maximized utility for all other types, and hence the informational rent given to these types. In our model, things are different. Even though the expected surplus of the lowest participating type must equal the outside option (i.e. the utility of leisure in our case), the government can decrease the level of the maximized Nash product by imposing a very high wage on the lowest participating individual (see equation \((12)\)). This implies through the incentive constraints that the Nash products of all types decrease, and, again by equation \((12)\), expected surplus of all individuals above the lowest type decreases (See the effect of $w_{a_d}$ in Equation \((16)\)). Hence, this allows the government to decrease informational rents of the agents and use these resources for redistributive purposes, which in turn increases social welfare. However, choosing a very high wage for the lowest participating individual inevitably violates the second-order incentive constraint. As a consequence, there is bunching at the bottom of the wage distribution in the second-order approach, and since this constraint is on the wage, we can interpret this bunching as a minimum wage.
III.4 Optimal participation $a_d$

For completeness, we finally consider a marginal change in the threshold $a_d$, keeping the function $a \mapsto w_a$ unchanged. The optimal participation decision sets the optimal value of the threshold type $a_d$ and writes (see Appendix B.4)

$$
\lambda \left( Y_{a_d} (w_{a_d}) - d \right) f(a_d) = \frac{1 - \gamma}{\gamma} \left( \frac{1}{a_d - \bar{w}} - \frac{k_{a_d}}{\kappa_{a_d}} \right) Z_{a_d}
$$

The left-hand side of (27) corresponds to the efficiency part of the trade-off. When $a_d$ decreases, participation increases by an amount that is proportional to the density $f(a_d)$. The participation of these workers increases total net output by $Y_{a_d}$ but requires that they receive an expected surplus at least equal to $d$ to participate. This net budgetary gain is socially valued at the shadow cost of public funds, $\lambda$. The right-hand side of (27) is the equity part of the trade-off. When $a_d$ decreases, worker-firm pairs with productivity $a_d$ have the possibility to mimic the additional participants. To avoid this mimicking, the government has to give an additional informational rent to type-$a_d$ matches. The term in front of $Z_{a_d}$ is equal to the relative increase in the Nash product that should be given to type-$a_d$ matches to prevent them from mimicking the new entrants. The equity cost multiplies this increase by the shadow cost $Z_{a_d}$ of a relative increase in the Nash product $N_{a_d}$.

IV Varying bargaining power

The previous section considered the optimal policy if the bargaining power is exogenous. This section has a look at what happens when the government can also influence the worker’s bargaining power $\beta$. There might be different ways how the government can affect the bargaining power. The law can change the bargaining procedures, or the way unions are financed, etc. Explaining in more details how bargaining power is changed is beyond the scope of the paper. We simply assume that the government has some degree of latitude about the bargaining power through institutional settings.

The envelope theorem implies that $\frac{d\Omega}{d\beta} = \frac{\partial \Omega}{\partial \beta}$. Analyzing this last expression, we can derive the following proposition, which is proved in Appendix C:

Proposition 2 A worker’s bargaining power $\beta$ that is below the elasticity of the matching function, $\gamma$, is never optimal.

To understand this result, one might identify the distortions that are present in the (second-best) optimum. In the absence of redistribution and under the Hosios condition (i.e. $\beta = \gamma$), negotiated wages maximize net output. Since the government wants to redistribute from high- to low-income individuals, it wants to install a high marginal
tax rate. According to equation (10), this distorts the wage downwards. However, the bargaining power also distorts the wage levels. A higher bargaining power increases the wage, again according to equation (10). Therefore, a rise in the bargaining power induces a distortion on the wage that (partly) offsets the one induced by the redistributive taxation. The equity-efficiency trade-off becomes less severe the higher the worker’s bargaining power $\beta$. An increase in $\beta$ is thus always desirable, at least up to the point where $\gamma = \beta$.

We are not able to find analytical results for the case where $\beta > \gamma$. In fact, Appendix C shows that increasing the workers’s bargaining power is welfare-improving as long as $\Sigma_a$ is increasing in $a$, that is, as long as the desired redistribution goes from high- to low-productive workers. Lemma 1 only proves that this is the case when $\beta \leq \gamma$. If $\beta > \gamma$, then the worker’s expected surplus at the optimal solution might not be monotonically increasing in $a$ anymore.

To understand why we need workers’ expected surplus $\Sigma_a$ to be increasing in types to obtain our result that a rise in workers’ bargaining power is welfare-improving, we have to analyze whether a rise in the bargaining power $\beta$ relaxes or strengthens the relevant incentive constraints. When workers’ expected utility $\Sigma_a$ increases with their productivity $a$, the relevant incentive constraint is that a type-$a$ match does not want to mimic slightly less productive matches. In other words, when they negotiate the wage, the relevant incentive constraint induces the worker and the firm of a type-$a$ job to choose the wage $w_a$ designed for them, and not the wage $w_{a-da}$ designed for slightly less productive jobs of type $a-da$. Obviously, the higher the worker’s bargaining power $\beta$, the harder it becomes for the firm to obtain $w_{a-da}$ as the bargaining outcome instead of $w_a$. Therefore, a rise in the bargaining power $\beta$ relaxes the incentive constraints that prevent worker-firm pairs from mimicking less productive worker-firm pairs, which explains why in such a context, the government can achieve a better outcome.

V Conclusion

We have given a sufficient condition for the minimum wage to be a part of the optimal redistributive policy: If the bargaining power is lower than the elasticity of the matching function, then the introduction of a binding minimum wage is welfare-improving. However, if the government can also control the workers’ bargaining power, it should increase it, at least up to a point where our argument in favor of minimum wage does no longer apply. Hence, our argument in favor of the introduction of a binding minimum wage only holds if the government cannot control the bargaining power, and if this parameter is relatively low. In other words, the minimum wage is an imperfect substitute for a rise in workers’ bargaining power. Hence, the government should prefer the latter, in combination with redistributive taxation.
Whether and how the government can affect the bargaining power is still an open question. It would also be interesting to determine the optimal level of the bargaining power when income taxation is simultaneously optimized. We have shown that as long as the workers’ expected surplus remains increasing in types, increasing the bargaining power is welfare-improving because it relaxes the relevant incentive constraint. Hence, since the workers’ expected surplus is increasing whenever the bargaining power is not higher than the elasticity of the matching function, this suggest that the optimal bargaining power in our redistributive context is higher than the one prescribed by Hosios (1990) in a pure efficiency context. We left the further characterization of the optimal bargaining power for future research. Furthermore, it might be interesting to see whether it is possible to generalize the framework developed in the present paper to other models of adverse selection.

References


Appendix

A Proof of Lemma 1

Let $I_a$ be a function defined for $a \in [a_d, a_1]$ by

$$I_a \equiv \sup_w (a - w) \cdot (w - T(w) - b)^{\frac{\theta}{\sigma}}$$

From (11), one has

$$N_a = (I_a)^{\frac{1-\beta}{\sigma}}$$

(28)

Without any mathematical restrictions on the tax function, for any $w$, the function $a \mapsto (a - w)(w - T(w) - b)^{\frac{\theta}{\sigma}}$ is linear in $a$. Therefore, the function $a \mapsto I_a$ is the convex
envelope of linear and increasing functions of \( a \). This ensures that function \( a \mapsto I_a \) is convex and increasing in \( a \). Therefore, \( a \mapsto I_a \) is continuous on \([a_d, a_1]\) and admits a derivative everywhere except on a countable set (we use henceforth the acronym a.e. for "almost everywhere"). Furthermore, by the envelope theorem, we get that whenever \( a \mapsto I_a \) admits a derivative \( \dot{I}_a \), this derivative verifies

\[
\dot{I}_a \equiv (x_a)^{\frac{\beta}{1-\beta}} \quad \Leftrightarrow \quad \frac{\dot{I}_a}{I_a} = \frac{1}{a - w_a} 
\]  \hspace{1cm} (29)

Since \( a \mapsto I_a \) is convex, one has that \( a \mapsto x_a \) is non-decreasing. To show that \( a \mapsto w_a \) is non-decreasing too, we assume by contradiction it is not and show that the mechanism \( a \mapsto (w_a, x_a) \) then violates (13). Let then assume there exists \( a' > a \) such that \( w_{a'} < w_a \). Recall that according to the definition of the Nash product in (8), \( N(w, x, a) \) is decreasing in the wage \( w \) and increasing in workers’ ex-post surplus \( x \). Hence we get \( N(w_a, x_a, a) < N(w_{a'}, x_{a'}, a) \). Since \( a' > a \), we have that \( x_{a'} \geq x_a \), which induces in turn \( N(w_{a'}, x_{a'}, a) < N(w_a, x_a, a) \). This last inequality contradicts (13). Therefore \( a \mapsto w_a \) is non-decreasing.

We now prove that \( \Sigma_a \) is increasing in \( a \). Consider two skill levels \( a' > a \). Then, from (8) and (13), one gets

\[
\log x' - \log x = \frac{1 - \beta}{\beta} \left[ \log (a' - w_a) - \log (a' - w_{a'}) \right]
\]

From (6), one has

\[
\log \Sigma_a' - \log \Sigma_a = \frac{1 - \gamma}{\gamma} \left[ \log \left( \frac{a' - w_{a'}}{\kappa_a'} \right) - \log \left( \frac{a - w_a}{\kappa_a} \right) \right] + \log x' - \log x_a
\]

So,

\[
\log \Sigma_a' - \log \Sigma_a \geq \frac{1 - \gamma}{\gamma} \left[ \log \left( \frac{a' - w_{a'}}{\kappa_a'} \right) - \log \left( \frac{a - w_a}{\kappa_a} \right) \right] + \frac{1 - \beta}{\beta} [\log (a' - w_a) - \log (a' - w_{a'})]
\]

which gives

\[
\log \Sigma_a' - \log \Sigma_a \geq \frac{1 - \gamma}{\gamma} \left[ \log \left( \frac{a' - w_a}{\kappa_a} \right) - \log \left( \frac{a - w_a}{\kappa_a} \right) \right] + \left( \frac{1 - \beta}{\beta} - \frac{1 - \gamma}{\gamma} \right) [\log (a' - w_a) - \log (a' - w_{a'})]
\]

and finally

\[
\log \Sigma_a' - \log \Sigma_a \geq \frac{1 - \gamma}{\gamma} \int_a^{a'} \left( \frac{1}{t - w_{a'}} - \frac{\dot{\kappa}_t}{\kappa_t} \right) dt + \left( \frac{1 - \beta}{\beta} - \frac{1 - \gamma}{\gamma} \right) [\log (a' - w_a) - \log (a' - w_{a'})]
\]
Since $t - w_{a'} < t$, Equation (1) ensures that the first term in the right-hand side of the last expression is positive. Since $a' > a$, one has $a' - w_a \geq a' - w_{a'}$ from (18). Hence, whenever $\beta \leq \gamma$, the second term in the last expression is the product of two non-negative terms. So $\log \Sigma_{a'} - \log \Sigma_a$ is larger than the sum of a positive term and a non-negative term, which ends the proof that $\Sigma_a$ is increasing in $a$. As a consequence, there exists a unique\(^{11}\) productivity level $a_d \in [a_0, a_1]$ such that $\Sigma_{a_d} = d$. Moreover, for any $a \geq a_d$, one has $\Sigma_a \geq d$, so these workers of type $a$ choose to search for a job. Conversely, for any $a < a_d$, one has $\Sigma_a < d$ so these workers choose not to search for a job.

Finally, since $I_a$ is a continuous function of $a$, the integration of (29) between $a_d$ and $a$ gives $\log I_a = \log I_{a_d} + \exp \left[ \int_{a_d}^{a} \frac{dt}{t - w_t} \right]$. Together with (28), this last equality gives (15). Using (12) on $a$ and on $a_d$ with $d = \Sigma_{a_d}$ finally leads to (16). Finally (17) is directly obtained with either (6) or (8).

We now show the converse. Take a threshold value $a_d \in [a_0, a_1]$ and a non-decreasing function $a \mapsto w_a$ defined on $[a_0, a_1]$. We verify whether the allocation $a \mapsto (w_a, N_a, \Sigma_a, x_a)$ defined by Equations (15) (16) and (17) satisfies the incentive constraints (13) and the participation constraint (7) for all $a \in [a_0, a_1]$.

We first verify that $a \mapsto \Sigma_a$ is increasing in $a$. Let $a < a'$. We get from (16)

$$
\log \Sigma_{a'} - \log \Sigma_a = \left( \frac{1 - \gamma - 1 - \beta}{\gamma} \right) \left[ \log (a' - w_{a'}) - \log (a - w_a) \right] + \frac{1 - \beta}{\beta} \int_a^{a'} \frac{dt}{t - w_t} - \frac{1 - \gamma}{\gamma} \left( \log \kappa_{a'} - \log \kappa_a \right)
$$

$$
= \left( \frac{1 - \gamma - 1 - \beta}{\gamma} \right) \left[ \log \left( \frac{a' - w_{a'}}{a' - w_a} \right) + \log \left( \frac{a' - w_{a'}}{a' - w_a} \right) \right] + \frac{1 - \beta}{\beta} \int_a^{a'} \frac{dt}{t - w_t} - \frac{1 - \gamma}{\gamma} \left( \log \kappa_{a'} - \log \kappa_a \right)
$$

However,

$$
\log \left( \frac{a' - w_{a'}}{a - w_a} \right) = \int_a^{a'} \frac{dt}{t - w_t} \leq \int_a^{a'} \frac{dt}{t - w_t}
$$

To obtain the last inequality, one should note that, since $t > a > w_a$ and $a \mapsto w_a$ is non-decreasing, the inequality $1/(t - w_a) \leq 1/(t - w_t)$ holds. For $\beta \leq \gamma$, one has $\frac{1 - \gamma - 1 - \beta}{\gamma} \leq 0$, thereby:

$$
\left( \frac{1 - \gamma - 1 - \beta}{\gamma} \right) \left[ \log \left( \frac{a' - w_{a'}}{a' - w_a} \right) + \log \left( \frac{a' - w_{a'}}{a' - w_a} \right) \right] \geq \left( \frac{1 - \beta - 1 - \gamma}{\gamma} \right) \log \left( \frac{a' - w_a}{a' - w_a} \right) + \left( \frac{1 - \gamma - 1 - \beta}{\gamma} \right) \int_a^{a'} \frac{dt}{t - w_t}
$$

Since, $\log \kappa_{a'} - \log \kappa_a = \int_a^{a'} (\kappa_t/\kappa_t) dt$, we get

$$
\log \Sigma_{a'} - \log \Sigma_a \geq \left( \frac{1 - \beta - 1 - \gamma}{\gamma} \right) \log \left( \frac{a' - w_a}{a' - w_{a'}} \right) + \frac{1 - \gamma}{\gamma} \int_a^{a'} \left( \frac{1}{t - w_t} - \frac{\dot{\kappa}_t}{\kappa_t} \right) dt
$$

\(^{11}\)With the convention that if $\Sigma_{a_0} > d$ this solution is $a_d = a_0$ and if $\Sigma_{a_1} < d$, this solution is $a_d = a_1$. 23
Since \( a \rightarrow w_a \) is non-decreasing (thereby \( a' - w_a \geq a' - w_{a'} \)), the first term in the right hand side of the inequality is non-negative. From assumption (1), the second term is positive. Hence \( \Sigma_{a'} > \Sigma_a \) and the participation constraint (7) holds for all \( a \geq a_d \).

We now show that this mechanism also verifies (13). Take \( a_0 \neq a \). If \( w_{a'} \geq a \), then \( N(w_{a'}, x_{a'}, a) \leq 0 < N_a \). If conversely \( w_{a'} < a \), it is equivalent to prove (13), or to prove that \( \log N_a - \log N(w_{a'}, x_{a'}, a) \) is non-negative. Given (8), this last expression equals

\[
\log N_a - \log N(w_{a'}, x_{a'}, a) = \log N_a - \log N_{a'} + \frac{1 - \beta}{\beta} \left[ \log (a' - w_{a'}) - \log (a - w_{a'}) \right]
\]

Given (15), we get

\[
\log N_a - \log N(w_{a'}, x_{a'}, a) = \frac{1 - \beta}{\beta} \left[ \log (a' - w_{a'}) - \log (a - w_{a'}) - \int_{a}^{a'} \frac{dt}{t - w_t} \right]
\]

So,

- if \( a' < a \), then for all \( t \in [a', a] \), one has \( 0 < w_{a'} \leq w_t < t \), so the integrand is non-positive. Since \( a' < a \), the integral is therefore non-negative which ensures that (13) holds.

- if \( a' > a \) and \( w_{a'} < a \), then for all \( t \in [a, a'] \), one has \( 0 < w_t \leq w_{a'} < t \), and the integrand is non-negative. Since \( a < a' \), the integral is therefore non-negative, too.

B The government’s problem

It is convenient to rewrite (16) as

\[
\log \Sigma_a = \left( \frac{1 - \gamma}{\gamma} - \frac{1 - \beta}{\beta} \right) \left[ \log (a - w_a) - \log (a_d - w_{a_d}) \right] + \frac{1 - \beta}{\beta} \int_{a_d}^{a} \frac{dt}{t - w_t} - \frac{1 - \gamma}{\gamma} \log \left( \frac{\kappa_a}{\kappa_{a_d}} \right) + \log d
\]

B.1 Optimality conditions with respect to negotiated wages \( w_a \)

for all \( a \in (a_m, a_1] \)

We consider the effect of a variation \( \delta w \) in the wage \( w_a \) for the agents of type \([a, a + \delta a]\) with \( \delta w \) and \( \delta a \) being infinitesimally small and \( a > a_m \). From Equation (30), the implied variation \( \delta \Sigma_t \) of workers’ expected surplus equals

\[
\delta \Sigma_t = \frac{1 - \beta}{\beta} (a - w_a)^2 \Sigma_t \delta w \delta a
\]
for \( a + da < t \),
\[
\delta \Sigma_t = - \left( \frac{1 - \gamma - 1 - \beta}{\gamma} \right) \frac{1}{a - w_a} \Sigma_t \delta w + \frac{1 - \beta}{\beta (a - w_a)^2} \Sigma_t \delta w \delta a
\]
for \(^{12} a \leq t < a + \delta a \) and \( \delta \Sigma_t = 0 \), for \( t < a \).

From the budget constraint (20), the variation of the welfare benefit is
\[
\delta b = \int_{a_d}^{a_1} (\delta Y_t (w_t) - \delta \Sigma_t) f(t) \, dt
\]
Hence, for any \( a \in (a_m, a_1] \)
\[
\delta b = \frac{\partial Y_a}{\partial w_a} (w_a) \delta w \delta a + \left( \frac{1 - \gamma - 1 - \beta}{\gamma} \right) \frac{1}{a - w_a} \Sigma_a f(a) \delta w \delta a
\]
\[
- \frac{1 - \beta}{\beta (a - w_a)^2} \left( \int_a^{a_1} \Sigma_t f(t) \, dt \right) \delta w \delta a
\]
From the government’s objective (19), one has
\[
\delta \Omega = \lambda \delta b + \int_{a}^{a_1} \Phi'(\Sigma_t + b) \delta \Sigma_t f(t) \, dt
\]
\[
= \lambda \frac{\partial Y_a}{\partial w_a} (w_a) f(a) \int_{a}^{a_1} (\Phi'(\Sigma_t) - \lambda) \delta \Sigma_t f(t) \, dt
\]
where we define the shadow cost of public funds \( \lambda \) through Equation (21). Hence
\[
\frac{\delta \Omega}{\delta w \delta a} = \lambda \frac{\partial Y_a}{\partial w_a} (w_a) f(a) + (\Phi'(\Sigma_a + b) - \lambda) \left( \frac{1 - \beta}{\beta} - \frac{1 - \gamma}{\gamma} \right) \frac{1}{a - w_a} \Sigma_a f(a)
\]
\[
+ \frac{1 - \beta}{\beta (a - w_a)^2} \int_{a}^{a_1} (\Phi'(\Sigma_t + b) - \lambda) \Sigma_t f(t) \, dt
\]
which gives (22), together with (23).

### B.2 Proof of Lemma 2

Since \( t \rightarrow \Sigma_t \) admits everywhere a left and right derivative, so does the function \( t \rightarrow (\lambda - \Phi'(\Sigma_a + b)) \Sigma_t f(t) \). The integral in (23) is therefore well defined, is a continuous function of \( t \), and admits everywhere a left and a right derivative.

From Lemma 1, we know that \( \Sigma_a \) is increasing in \( a \). Hence the marginal social welfare \( \Phi'(b + \Sigma_a) \) is decreasing in \( a \). The shadow cost of public funds \( \lambda \) equals the average of all marginal social welfare (see equation 21). Hence there exists a unique \( a_c \) for which \( \Phi'(b + \Sigma_{a_c}) = \lambda \). For all \( t < a_c \), we get \( \Phi'(b + \Sigma_t) > \lambda \) and \( \Sigma_t < \Sigma_{a_c} \), while for \( t > a_c \), we get \( \Phi'(b + \Sigma_t) < \lambda \) and \( \Sigma_t > \Sigma_{a_c} \). Therefore, for any \( t \neq a_c \) \( [\Phi'(b + \Sigma_t) - \lambda] \Sigma_t < [\Phi'(b + \Sigma_t) - \lambda] \Sigma_{a_c} \). Hence we get from (23):
\[
Z_a = \int_{a}^{a_1} [\lambda - \Phi'(b + \Sigma_t)] \Sigma_t f(t) \, dt < \int_{a}^{a_1} [\lambda - \Phi'(b + \Sigma_t)] \Sigma_{a_c} \cdot f(a) \, da
\]

\(^{12}\)The difference between \((t - a)\) and \( da \) tends to 0 as \( da \) tends to 0 is therefore neglected.
Figure 4: Covariations of $a_m$ and of minimum wage $w$.

However, given equation (21)

$$\int_{a_d}^{a_1} [\lambda - \Phi'(b + \Sigma_t)] \Sigma_{ac} \cdot f(t) dt = (1 - F(a)) \Sigma_{ac} \left\{ \mathbb{E}_f [\Phi'_t] - \mathbb{E}_f [\Phi'_t | t \geq a] \right\}$$

where $\mathbb{E}_f$ is the expectation operator under distribution $f$ for $t$, $\Phi'_t = \Phi'(b + \Sigma_t)$ for $t \geq a_d$ and $\Phi'_t = \Phi'(b + d)$ otherwise. Hence $\Phi'_t$ is non-increasing and decreasing in $t$ over $[a_d, a_1]$. From Lemma 1 this implies that $\mathbb{E}_f [\Phi'_t | t \geq a]$ decreases in $a$ over $[a_d, a_1]$ so $\mathbb{E}_f [\Phi'_t | t \geq a] < \mathbb{E}_f [\Phi'_t]$. Hence $Z_a > 0$.

### B.3 Optimality condition with respect to the minimum wage $w$

Consider a variation of the minimum wage of $dw$. This implies an increase in the wage, but also an increase in the amount of types for whom the minimum wage is relevant, as illustrated in Figure 4.

Hence, we calculate the direct effects of a variation in $a_m$ at a given minimum wage $w$, and then the direct effects of a variation in the minimum wage $w$ for a given $a_m$.

**Effect of $a_m$ at given $w$**  
According to equation (30), $\partial \Sigma_t / \partial a_m = 0$ for all $a \in [a_d, a_1]$. From (20)

$$\frac{\partial b}{\partial a_m} = (Y_{am} - \Sigma_{am}) f(a_m) - (Y_{am} - \Sigma_{am}) f(a_m) - \int_{a_d}^{a_m} \frac{\partial \Sigma_{ac}}{\partial a_m} f(a) \, da - \int_{a_m}^{a_1} \frac{\partial \Sigma_{ac}}{\partial a_m} f(a) \, da = 0$$

Finally, from (19) $\partial \Omega / \partial a_m = 0$. Hence we can concentrate on the direct effect of $w$ for a given $a_m$ for all variables of interest $\Sigma_t$, $b$, $\Omega$. 

26
Effect of $w$ for a given $a$  

From (30) and $w = w_{a_1}$, we get for all $a \in [a_d, a_m]$:

\[
\frac{\partial \Sigma_a}{\partial w} = \Sigma_a \left( \frac{1 - \gamma - 1 - \beta}{\gamma} \right) \left( \frac{1}{a_d - w} - \frac{1}{a - w} \right) + \frac{1 - \beta}{\beta} \int_{a_d}^{a} \frac{dt}{(t - w)^2}
\]

\[
= \Sigma_a \left( \frac{1 - \gamma - 1 - \beta}{\gamma} \right) \left( \frac{1}{a_d - w} - \frac{1}{a - w} \right) + \frac{1 - \beta}{\beta} \left( \frac{1}{a_d - w} - \frac{1}{a - w} \right)
\]

\[
= \frac{1 - \gamma}{\gamma} \Sigma_a \left( \frac{1}{a_d - w} - \frac{1}{a - w} \right) > 0
\]

From (30), we have for all $a \in [a_m, a_1]$

\[
\frac{\partial \Sigma_a}{\partial w} = \Sigma_a \left( \frac{1 - \gamma - 1 - \beta}{\gamma} \right) \left( \frac{1}{a_d - w} - \frac{1}{a - w} \right) + \frac{1 - \beta}{\beta} \int_{a_d}^{a_m} \frac{dt}{(t - w)^2}
\]

\[
= \Sigma_a \left( \frac{1 - \gamma - 1 - \beta}{\gamma} \right) \left( \frac{1}{a_d - w} - \frac{1}{a - w} \right) + \frac{1 - \beta}{\beta} \left( \frac{1}{a_d - w} - \frac{1}{a - w} \right)
\]

\[
= \Sigma_a \left( \frac{1 - \gamma - 1 - \beta}{\gamma} \right) \left( \frac{1}{a_d - w} - \frac{1}{a - w} \right)
\]

From (20) we find

\[
\frac{\partial b}{\partial w} = \int_{a_d}^{a_m} \left( \frac{\partial Y_{1}}{\partial w} (w) - \frac{\partial \Sigma_a}{\partial w} \right) f(t) dt - \int_{a_m}^{a_1} \frac{\partial \Sigma_a}{\partial w} f(t) dt
\]

Hence

\[
\frac{\partial b}{\partial w} = \int_{a_d}^{a_m} \left\{ \frac{\partial Y_{1}}{\partial w} (w) - \frac{1 - \gamma}{\gamma} \left( \frac{1}{a_d - w} - \frac{1}{a - w} \right) \Sigma_a \right\} f(a) da
\]

\[+ \left( \frac{1 - \beta}{\beta} \frac{1}{a_d - w} - \frac{1 - \gamma}{\gamma} \frac{1}{a_d - w} \right) \int_{a_m}^{a_1} \Sigma_a f(a) da
\]

Finally, from (19) and (21):

\[
\frac{\partial \Omega}{\partial w} = \lambda \frac{\partial b}{\partial w} + \int_{a_d}^{a_m} \Phi' (\Sigma_a + b) \frac{\partial \Sigma_a}{\partial w} f(a) da + \int_{a_m}^{a_1} \Phi' (\Sigma_a + b) \frac{\partial \Sigma_a}{\partial w} f(a) da
\]

After some manipulations, one then gets

\[
\frac{\partial \Omega}{\partial w} = \int_{a_d}^{a_m} \left\{ \frac{\lambda}{\gamma} \frac{\partial Y_{1}}{\partial w} (w) + (\Phi' (\Sigma_a + b) - \lambda) \Sigma_a \frac{1 - \gamma}{\gamma} \left( \frac{1}{a_d - w} - \frac{1}{a - w} \right) \right\} f(a) da +
\]

\[+ \left( \frac{1 - \gamma}{\gamma} \frac{1}{a_d - w} - \frac{1 - \beta}{\beta} \frac{1}{a_m - w} \right) \left( \int_{a_m}^{a_1} (\Phi' (\Sigma_a + b) - \lambda) \Sigma_a f(a) da \right)
\]

Together with (23), we obtain (24).
B.4 Optimality condition with respect to the threshold $a_d$

We consider now a variation $\delta a_d$ for the threshold $a_d$, keeping the function $a \mapsto w_a$ unchanged. Using Proposition 1, we know that there is bunching of wages at the bottom of the skill distribution. Therefore, a marginal change of the threshold $a_d$ keeps unchanged the level of the lowest wage $w_a$. Hence, from (30), we get for $a \in [a_d, a_1]$

$$\frac{\delta \Sigma_a}{\delta a_d} = -\frac{1 - \gamma}{\gamma} \left( \frac{1}{a_d - w_{a_d}} - \frac{\kappa_{a_d}}{\kappa_{a_d}} \right) \Sigma_a$$

One then gets from the budget constraint (20)

$$\frac{\delta b}{\delta a_d} = -(Y_{a_d} - \Sigma_{a_d}) - \int_{a_d}^{a_1} \frac{\delta \Sigma_a}{\delta a_d} f(a) \, da$$

Since $\Sigma_{a_d} = d$, one gets

$$\frac{\delta b}{\delta a_d} = -(Y_{a_d} - d) + \frac{1 - \gamma}{\gamma} \left( \frac{1}{a_d - w_{a_d}} - \frac{\kappa_{a_d}}{\kappa_{a_d}} \right) \int_{a_d}^{a_1} \Sigma_a f(a) \, da$$

Finally, from the government’s objective one gets $\delta \Omega = \lambda \delta b + \int_{a_d}^{a_1} \delta \Sigma_a f(a) \, da$. Taking equation (23) into account, we then obtain (27).

C Proof of Proposition 2

To prove Proposition 2, we apply the envelope theorem and prove that the partial derivative of $\Omega$ with respect to $(1 - \beta) / \beta$ for a given function $a \mapsto w_a$ is negative.

From equation (30), one gets for all $a \in [a_d, a_m]$

$$\frac{\partial \Sigma_a}{\partial \frac{1-\beta}{\beta}} = 0$$

From equation (30), one has, for a given function $a \mapsto w_a$ that for all $a \in [a_m, a_1]$

$$\frac{\partial \Sigma_a}{\partial \frac{1-\beta}{\beta}} = \left\{ -\log(a - w_a) + \log(a_d - w_{a_d}) + \int_{a_d}^{a} \left( \frac{1}{x - w_x} - \frac{\kappa_x}{\kappa_x} \right) dx \right\} \Sigma_a$$

So:

$$\frac{\partial \Sigma_a}{\partial \frac{1-\beta}{\beta}} = \left\{ \log \left( \frac{a - w_{a_d}}{a - w_a} \right) \cdot \frac{a_d - w_{a_d}}{a - w_{a_d}} \right\} + \int_{a_d}^{a} \frac{dx}{x - w_x} \} \Sigma_a$$

$$= \left\{ \log \left( \frac{a - w_{a_d}}{a - w_a} \right) + \int_{a_d}^{a} \left\{ \frac{1}{x - w_x} - \frac{1}{x - w_{a_d}} \right\} dx \right\} \Sigma_a$$

Since there is no more bunching in the right-neighborhood of $a_m$, one has together with (18) that $w_a > w_{a_m} = w_{a_d}$. This induces that $a - w_a < a - w_{a_d}$, so the first term in the bracket is positive. Furthermore, for all $x \in (a_m, a]$, one has $w_{a_d} = w_{a_m} < w_x < x$, so
\[
\frac{1}{x-w_x} > \frac{1}{x-w_{a_d}} > 0. \text{ Therefore the second term in the bracket is positive too and }
\frac{\partial \Sigma_a}{\partial \frac{1}{\beta}} > 0.
\]

We now prove that the function \( a \mapsto \frac{\partial \Sigma_a}{\partial \frac{1}{\beta}}((1-\beta)/\beta) \) is increasing. This function is the product of two positive functions, and we already know from Lemma 1 that \( a \mapsto \Sigma_a \) is increasing. We now prove that \( a \mapsto \log \left( \frac{a-w_{a_d}}{a-w_a} \right) + \int_{a_d}^{a} \left\{ \frac{1}{x-w_x} - \frac{1}{x-w_{a_d}} \right\} dx \) is increasing too. Its partial derivative with respect to \( w_a \) holding \( a \) constant is

\[
\left. \frac{\partial}{\partial w_a} \left\{ \log \left( \frac{a-w_{a_d}}{a-w_a} \right) + \int_{a_d}^{a} \left\{ \frac{1}{x-w_x} - \frac{1}{x-w_{a_d}} \right\} dx \right\} \right|_{a} = \frac{1}{a-w_a} > 0
\]

Moreover, its partial derivative with respect to \( a \) holding \( w_a \) constant is

\[
\left. \frac{\partial}{\partial a} \left\{ \log \left( \frac{a-w_{a_d}}{a-w_a} \right) + \int_{a_d}^{a} \left\{ \frac{1}{x-w_x} - \frac{1}{x-w_{a_d}} \right\} dx \right\} \right|_{w_a} = \frac{1}{a-w_{a_d}} - \frac{1}{a-w_a} - \frac{1}{a-w_{a_d}} = 0
\]

Since wage \( w_a \) is nondecreasing in \( a \) (See 18), the function \( a \mapsto \frac{\partial \Sigma_a}{\partial \frac{1}{\beta}}((1-\beta)/\beta) \) is the product of two positive function, one being increasing in \( a \), and the other one being nondecreasing. Hence, it is increasing in \( a \).

From the budget constraint (20), one gets

\[
\frac{db}{d^{1-\beta}} = \frac{\partial b}{\partial^{1-\beta}} = - \int_{a_m}^{a_1} \frac{\partial \Sigma_a}{\partial^{1-\beta}} f(a) da < 0
\]

Finally, from the social objective (19), we find

\[
\frac{d\Omega}{d^{1-\beta}} = \lambda \frac{\partial b}{\partial^{1-\beta}} + \int_{a_m}^{a_1} \Phi'(b + \Sigma_a) \cdot \frac{\partial \Sigma_a}{\partial^{1-\beta}} \cdot f(a) da
\]

\[
= \int_{a_m}^{a_1} [\Phi'(b + \Sigma_a) - \lambda] \cdot \frac{\partial \Sigma_a}{\partial^{1-\beta}} \cdot f(a) da
\]

Since the function \( a \mapsto \Phi'(\Sigma_a + b) \) is decreasing from the concavity of \( \Phi(.) \) and Lemma 1, two cases are possible:

1. \( \lambda \geq \Phi'(b + \Sigma_{a_m}) \). Then for all \( a > a_m \), \( \lambda \geq \Phi'(b + \Sigma_a) \) where this inequality is strict for at least some of these types. Hence, one has

\[
[\Phi'(b + \Sigma_a) - \lambda] \cdot \frac{\partial \Sigma_a}{\partial^{1-\beta}} \cdot f(a) \leq 0
\]

and this inequality holds strictly for at least some of these types. This implies

\[
\frac{d\Omega}{d^{1-\beta}} < 0
\]
2. Otherwise, $\lambda < \Phi'(b + \Sigma_{a_m})$. From equation (21) and Lemma 1, we know that there exists a $a_c \in (a_m, a_1)$ such that $\lambda = \Phi'(b + \Sigma_{a_c})$. Furthermore, the function $\partial \Sigma_a / \partial ((1 - \beta) / \beta)$ is positive and increasing.

- For $a \in (a_m, a_c)$, we have $\Phi'(b + \Sigma_a) \geq \lambda$ and thus

$$[\Phi'(b + \Sigma_a) - \lambda] \cdot \frac{\partial \Sigma_a}{\partial 1 - \beta} \leq [\Phi'(b + \Sigma_a) - \lambda] \cdot \frac{\partial \Sigma_{a_c}}{\partial 1 - \beta}$$

- For $a \in (a_c, a_1)$, we have $\Phi'(b + \Sigma_a) \leq \lambda$ and thus

$$[\Phi'(b + \Sigma_a) - \lambda] \cdot \frac{\partial \Sigma_a}{\partial 1 - \beta} \leq [\Phi'(b + \Sigma_a) - \lambda] \cdot \frac{\partial \Sigma_{a_c}}{\partial 1 - \beta}$$

Hence for all $a$

$$[\Phi'(b + \Sigma_a) - \lambda] \cdot \frac{\partial \Sigma_a}{\partial 1 - \beta} \leq [\Phi'(b + \Sigma_a) - \lambda] \cdot \frac{\partial \Sigma_{a_c}}{\partial 1 - \beta}$$

and therefore

$$\frac{d \Omega}{d 1 - \beta} \leq \int_{a_m}^{a_1} [\Phi'(b + \Sigma_a) - \lambda] \cdot \frac{\partial \Sigma_a}{\partial 1 - \beta} \cdot f(a) \, da$$

$$\frac{d \Omega}{d 1 - \beta} \leq \frac{\partial \Sigma_{a_c}}{\partial 1 - \beta} \left\{ \int_{a_m}^{a_1} [\Phi'(b + \Sigma_a) - \lambda] \cdot f(a) \, da \right\}$$

$$\frac{d \Omega}{d 1 - \beta} \leq \frac{\partial \Sigma_{a_c}}{\partial 1 - \beta} (1 - F(a_m)) \{ \mathbb{E} [\Phi'(b + \Sigma_a) | a \geq a_m] - \lambda \}$$

From Lemma 1, we now that function $a \mapsto \Phi'(\Sigma_a + b)$ is decreasing in $a$. Hence, given (21), one has $\lambda > \mathbb{E} [\Phi'(b + \Sigma_a) | a \geq a_m]$, therefore,

$$\frac{d \Omega}{d 1 - \beta} < 0$$

Hence, in both cases, one finds

$$\frac{d \Omega}{d \beta} > 0$$